# GERRARD & NATIONAL

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## Contents





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# Commentary on the economic situation

**Continuing uncertainty about policy intentions**

**Domestic vs. external**

Everyone agrees that mistakes have been made in British macroeconomic policy in the last few years. But there is no consensus about what precisely the mistakes have been. The uncertainty about diagnosis has led to a debate about the right prescription, with some commentators arguing that more attention should be paid to the exchange rate and others that domestic monetary numbers are the really crucial pointers for policy-making. The debate has taken place at the highest levels of the Government. Mr. Lawson is known to be a strong believer in the European Monetary System (and so in the virtues of the exchange rate as a benchmark for interest rate decisions) whereas Mrs. Thatcher, influenced by Sir Alan Walters, is generally thought to be more influenced in the domestic situation. Walters' (and the Treasury's) view is that domestic monetary trends are best measured by the very narrow measure of money (effectively just notes and coin) known as M0.

The recent Thatcher/Lawson rift echoes some very old controversies in British economic policy. There have been tensions between external and domestic priorities in monetary management since at least the 1920s. However, the official emphasis on M0 is - by historical standards - rather peculiar. The majority of monetary economists had agreed fifty years ago that the quantity of notes and coin had little significance for people's future behaviour, but was instead determined by their current spending habits. When Keynes advocated a managed currency in the 1920s and 1930s, he was thinking about the management of credit and the overall size of bank balance sheets. The purpose of broad money targets between 1976 and 1985 was to set interest-rate decisions within this larger context.

**The need to restrain credit growth**

Despite the success of broad money targets in reducing inflation, there is no support within the official machine for a return to this method of determining monetary policy. But financial markets still look carefully at bank and building society lending. In this first *Gerrard & National Monthly Economic Review*, we argue that bank and building society lending of about £5b. a month would be consistent with 12% M4 growth and 5% inflation over the medium term. Since this is much above the £6.7b. average figure seen in the last year, there is still an arduous task of credit restraint ahead. In broad terms, credit needs to be reduced to about 75% of its level over recent quarters if the Government is to restore an inflation rate which it would once have regarded as no more than satisfactory. It is not encouraging that in May the building societies' net new commitments were only 15% down on May 1988.

Tim Congdon 30th June 1989

# Summary of paper on

# 'How much lending is consistent with 5% inflation?'

**Purpose of the paper**

Financial markets correctly perceive that the excessive credit growth of the last three years is largely responsible, through its effects on monetary growth, for the current inflationary pressures. But how much is a "high", "average" or "low" lending number? This paper tries to answer the question, by quantifying the link between lending growth, monetary expansion and inflation, and so estimating the lending figure consistent with 5% inflation over the medium term.

**Main points**

* Bank and building society lending of £5b. a month is consistent with 5% inflation over the medium term. (This conclusion relies on various assumptions about the credit counterparts to money growth.)
* The £5b.-a-month figure assumes that a 12% annual rate of M4 growth would achieve 5% inflation over the medium term.
* The £5b. monthly target compares with a monthly average of £6.7b. in the year to March. 14% base rates will be sufficient to cut lending by the required 25%, but it may take several months before corporate loan demand moderates appropriately.
* The exact funding rule is complicating monetary control and should be changed. (This point will be developed in more detail in the next Gerrard & National *Monthly Economic Review*.)

This paper was written by Tim Congdon

# How much lending is consistent with 5% inflation?

## A monetarist approach to the inflation problem

**Bank lending - a vital concern for financial markets**

Financial markets recognise that high levels of bank and building society lending are inflationary. They react unfavourably after an unexpectedly strong lending figure, with gilt yields and short-term money rates often moving upwards soon afterwards. But most comment on the lending figures is a bit vague about what constitutes a "high", "average" or "low" number. The purpose of this paper is to quantify the link between lending growth and inflation, and so to set out criteria for judging whether a particular figure is worrying or not.

The approach is to guesstimate the relationship between broad money and inflation, and then to assess the implications for the credit counterparts to monetary expansion. Since bank lending is the principal credit counterpart, it becomes possible to calculate a bank lending figure consistent with a particular inflation rate. This style of analysis was very familiar in the early 1980s, but has become unfashionable since the abandonment of broad money targets in 1985. In my Centre for Policy Studies' pamphlet *Monetarism Lost: and why it must be regained* I argued that rapid broad money growth was the main cause of both the recent boom and the resurgence of inflationary pressure. It is well-known that the Government, which was once deeply committed to broad-money "monetarism", is nowadays more or less indifferent to the broad money numbers. The analysis here therefore neither provides particular insights into official thinking, nor is it directly relevant to the appraisal of policy decisions. However, the analysis will be helpful to those in financial markets who agree that the behaviour of credit and broad money is important to future inflation trends.

**The relationship between broad money growth and the increase in nominal gross domestic product**

During the 1980s broad money has grown appreciably faster than nominal GDP, unlike the 1970s when it grew more slowly. The contrast between the two decades led to official disillusionment with broad money, with the Governor of the Bank of England's Loughborough speech in October 1986 spelling out the detailed criticisms. The failure of rigorous econometric tests to identify a stable relationship between M3 or M4 and nominal GDP was regarded as a particularly telling objection to broad money targets. (M3 used to be the most closely-watched measure of broad money and consists of notes, coin and bank deposits. M4 is a wider measure, which includes building society deposits as well.)

But the lack of a statistically close and easily identified relationship between two variables does not mean that there is no relationship at all. The ratio of broad money to nominal GDP may sometimes vary erratically, but it would be contrary to economic common sense to believe that it can rise or fall without limit. In fact, experience in the early 1980s was that the economy remained fairly stable when the ratio of M4 to nominal GDP was rising by about 4% a year. The approximate economic stability of these years may seem surprising in view of the apparently quite large injection of money balances. The economy's ability to absorb so much extra money without inflationary consequences may have resulted from various measures of financial liberalisation and the rise in real interest rates, which increased people's willingness to keep their wealth in monetary form. Financial liberalisation, such as the scrapping of exchange controls and the entry of banks into the mortgage market, had been substantially completed by 1985. After 1985, when M4 growth accelerated to about 6% a year higher than the growth of nominal GDP, the economy was clearly suffering from excess liquidity. The excess liquidity contributed to - and, indeed, probably the main influence behind - a surge in asset prices (houses, shares, land) in 1986, 1987 and 1988. The surge in asset prices in turn helped to drive the wider economic boom and the return of inflationary pressures.

A reasonable judgement on the events of the early and mid-1980s is that the ratio of M4 to GDP can be allowed to rise by 2% - 4% a year. Of course, this assessment is subjective, at least to some extent, but it provides a reasonable working assumption. Since the spate of institutional changes in the financial system may now be slowing down, the trend rise in the ratio of desired broad money holdings to GDP should be less than before. Let us also assume that the Government wants to bring inflation back down to 5%. (Of course, it may eventually want to reduce it further, but 5% seems a plausible interim objective.) Then, with the trend rate of GDP growth at 2½% - 3%, the desired rate of increase in nominal GDP is 7½% - 8%.

Given the projected rise in the ratio of broad money to GDP, the implied target for M4 growth is at most 12%. Our argument is that this is the maximum figure which can be reconciled with 5% inflation over the medium term. We shall use it in the following section when we analyse the credit counterparts arithmetic.

An alternative would be to specify the broad money target in terms of M3. However, in the 1980s there have been large shifts in the share of the mortgage market between banks and building societies, and these shifts have been reflected in variations in M3 growth which have had only limited economic significance. Moreover, with building societies offering cheque-clearing and other payments services more extensively, building society deposits increasingly resemble bank deposits. It seems sensible to look at a measure of broad money which includes both kinds of deposit.

### Influences on broad money growth: a general overview

Bank deposits represent almost 95% of M3, and bank and building society deposits over 96% of M4. It follows that analysis of the influences on broad money growth is virtually equivalent to analysis of the influences on the growth of bank and building society balance sheets. This analysis is best conducted with the help of the statistics on the credit counterparts to monetary expansion.

The motivating idea here is that every addition to bank and building society assets is matched, on the other side of the balance sheet, by an equal addition to bank and building society deposit liabilities. In recent years lending to the private sector has regularly been by far the largest single factor behind the growth of bank and building society assets. Indeed, it has also been continuously higher than the increase in M4, as is clear from the following figures:

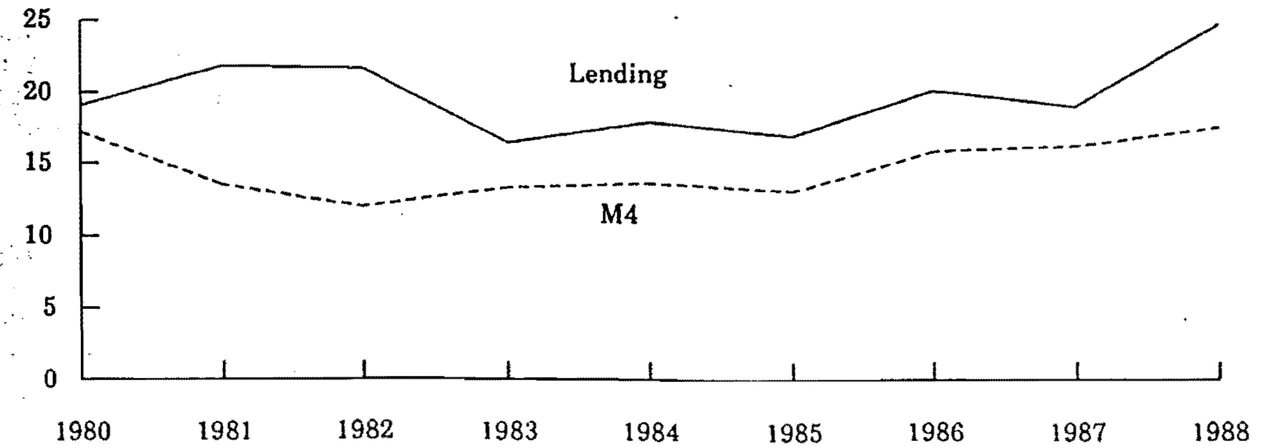
| | Lending to the private sector - £m. | Increase in M4 - £m. |
|---|---|---|
| 1983 | 23,035 | 19,895 |
| 1984 | 30,314 | 23,431 |
| 1985 | 34,430 | 25,872 |
| 1986 | 47,069 | 34,718 |
| 1987 | 53,278 | 42,620 |
| 1988 | 81,933 | 53,028 |

Sources: *Financial Statistics*, Bank of England *Long Runs of Monetary Data 1963-88*

It is evident that, in order to assess the implications of a particular level of bank lending for M4 growth, we have to look at the other credit counterparts. These explain, in arithmetical terms, the difference between lending and M4 growth. They can be analysed under three headings - the public sector position, external influences and the change in non-deposit liabilities.

**Growth rates of lending and M4 in the 1980s**

Chart shows % growth in relevant years of stock of bank and building society lending, and M4.



The procedure will be to project likely numbers for the impact of the three kinds of credit counterpart on M4 growth, add them up and then see what is left over for bank lending within the constraint imposed by the 12% M4 target for the year to April 1990. M4 at the end of April 1989 amounted to £377.5b. (seasonally adjusted). It follows that monetary growth would be on target if the credit counterparts summed to about £45b.

**The credit counterparts: 1. The public sector position**

In principle, the size of the public sector contribution to monetary growth is determined by the "exact funding" rule laid down by Mr. Lawson in the Mansion House speech of October 1985 and subsequently amplified in a number of policy statements. The *1989/90 Financial Statement and Budget Report* indicated that it is now sales of public sector debt to non-banks *and non-building societies* which are relevant to the funding calculation. Previously, sales of public sector debt to non-banks alone had been included. (Note that the official definition of "exact fudning" includes two external items, overseas purchases of gilts and "other external and foreign currency finance of the public sector", which can be virtually equated with the change in the reserves.)

In practice, exact funding was attained more or less precisely when it was only the split between banks and non-banks which mattered. The public sector contribution to M3 growth was positive by a mere £0.3b. in 1986/87, negative by a trifling £0.1b. in 1987/88 and negative by £1.0b. in 1988/89. But the exact funding on the M3 definition was accompanied by continued overfunding on the M4 definition. The public sector contribution to M4 growth was negative by £3.5b. in 1986/87, £1.2b. in 1987/88 and £2.5b. in 1988/89. The move to exact funding on the M4 definition implies - if the policy is indeed pursued as announced - that M4 growth will be somewhat higher in 1989/90 than it would otherwise have been.

But there must be growing doubts that the authorities will adhere to the "exact funding" rule. On general grounds it seems illogical for the Government to be engaged in a large-scale programme to buy back gilts from non-banks and simultaneously to proclaim its anti-inflationary resolve. Whenever the Government buys back public sector debt from non-banks, it writes out cheques to the previous holders of the debt and increases their bank deposits. These extra bank deposits add to the amount of money in the economy and therefore reinforce inflationary pressures.

This point is hardly complicated and it is perhaps surprising that criticism of the Government's funding policy has taken so long to emerge. At any rate, there is now a groundswell of unease about exact funding. A letter in the *Financial Times* from Professor Brian Tew of Nottingham University on 15th May and research papers by Roger Bootle of Greenwell Montagu (notably *Monetary Policy and the Yield Curve: the Case for Over-Funding*, March

1989) commented on the oddness of current funding strategy in an inflationary context. There has also been a recommendation from Adam Bennett of Shearson Lehman Hutton that the authorities switch from full funding to full financing of the PSDR, on the grounds that full funding of the PSDR causes chronic excess liquidity in the money markets.

Despite Mr. Lawson's protestations to the contrary, funding policy mut be under review. The outcome of the current re-examination is uncertain, but it seems plausible that there will again by overfunding on the M4 definition. For the purpose of the current exercise we shall assume that M4 overfunding amounts to £2½b. to £5b. in the twelve months to April 1990, slightly higher than in recent years.

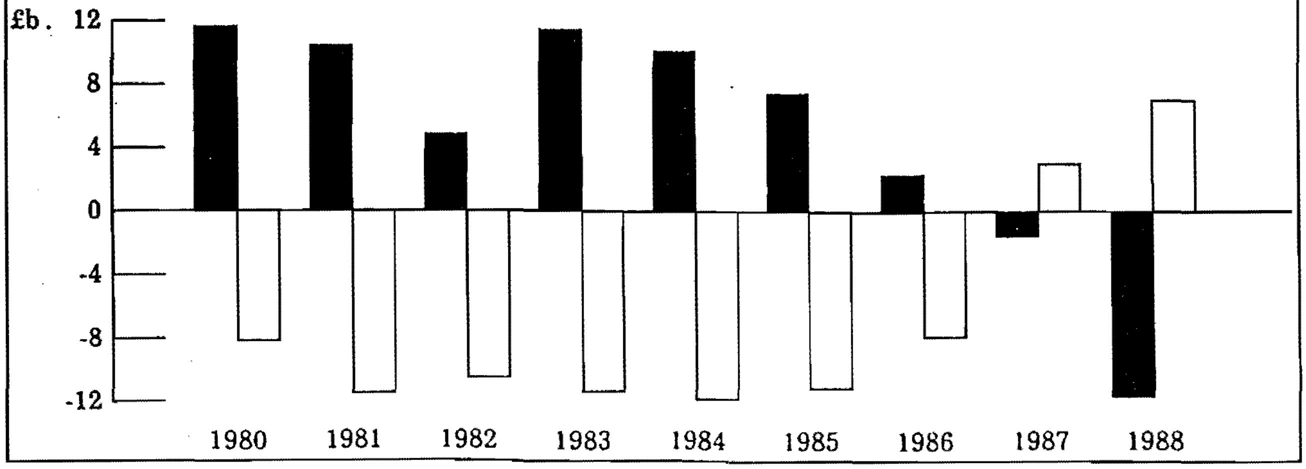
**The credit counterparts: 2. External influences**

The effects of overseas gilt transactions and changes in the reserves on broad money have already been discussed in the previous section, since they are subsumed under the "public sector contribution" as it is now defined. The external influences under consideration in this section therefore consist solely of transactions with foreign parties and/or in foreign currencies by banks and building societies.

Until the last two or three years such transactions were not a significant influence on monetary growth. In the five financial years from 1982/83 to 1986/87 they on average reduced the growth of M4 by £0.8b., with the maximum positive effect £324m. in 1984/85 and the maximum negative effect £1,608m. in 1986/87. But in 1987 the position changed radically. In 1987/88 banks' and building societies' external transactions cut M4 by £7,846m. and in 1988/89 by £13,110m. Without this help, M4 growth would have been 2.9% higher in 1987/88 and 4.2% higher in 1988/89. The increased contractionary impact of these external transactions was the monetary expression of the

**Public sector influences on M4 growth in 1980s**

Chart shows effect of PSBR (black bar and sum of purchases of public sector debt and external finance of public sector (white bar) on M4 growth, all in £b.



deterioration on the current account of the balance of payments. In effect, the international banking system provided the UK private sector with the means to finance a large increase in expenditure.

There were two particularly important kinds of transaction. First, foreigners sharply increased their holdings of sterling deposits and these deposits became available for lending to the UK private sector. In fact, the overseas sector's sterling deposits soared by 56% from £39,490m. at the end of 1986 to £61,561m. at the end of 1988, and by a further £5b. or so in the first quarter of 1989. Secondly, foreign banks, companies and indviduals lent money in foreign currency either directly to the UK private sector or indirectly to it via the UK banking system. Bank lending in foreign currency to the private sector amounted to £13.0b. in 1986/87, dipped to £5.2b. in 1987/88, but picked up again and reached £7.8b. in the first three quarters of 1988/89.

These two kinds of transaction could have been conducted on the recent scale only on the assumption that sterling would remain a reasonably strong currency. Foreigners would not have been prepared to build up their sterling deposits by over £20b. in two years unless they expected the rate of sterling depreciation to be less than the favourable interest rate differential between sterling and other currencies; and the UK banking system would have been unwilling to incur foreign currency liabilities to acquire sterling assets if it had envisaged a heavy fall in sterling's value. But what will happen in the next year or two if sentiment changes? A loss of international confidence in the pound would imply a marked change in the availability of foreign finance via the banking system. It would also signal - unless there were a weakening in domestic credit demand and/or some offsetting movement in another credit counterpart - faster monetary expansion.

If monetary policy were still being organized on traditional lines, sterling weakness and an associated decline in the finance provided to the UK banking system from abroad would be offset by increased official intervention on the foreign exchanges. As foreign banks and companies cut back on their sterling holdings, the Bank of England would buy up pounds and try to keep the exchange rate steady. This intervention would lower monetary growth, since the extra sterling acquired from the foreign exchanges would reduce the need for the Government to borrow sterling from the banking system. But at present the operation of these checks and balances, which was routine in earlier periods of sterling weakness, is impeded by the exact funding rule. This rule dictates that increased foreign exchange intervention to counter sterling weakness be accompanied by reduced official gilt sales to non-banks. So the intervention would not have the appropriate effect on broad money growth.

It follows that an increased reluctance by foreigners to provide banking finance to the UK private sector would cause faster monetary expansion. If a reduction in monetary growth were to be achieved, the implied squeeze on bank lending would be yet tighter. Given all the uncertainties, various assumptions could be suggested about the behaviour of externals over the next twelve months. Perhaps the least pessimistic is that banks' and building societies' external transactions reduce M4 growth by between £10b. and £15b., similar to the experience of 1988/89. But that view is plausible only if foreign confidence in sterling can be sustained. A more realistic figure might be between £5b. and £10b., with a reduction in the UK's large foreign exchange reserves playing a greater role in financing the current account deficit. The less the availability of banking finance from abroad, the lower is the bank lending figure consistent with a given broad money target.

**The credit counterparts: 3. the change in non-deposit liabilities**

Expansion of bank and building society assets is not necessarily accompanied by identical expansion of bank and building society deposit liabilities. Banks and building societies also have non-deposit liabilities in the form of shareholders' funds, deferred tax liabilities and loan capital. For any given level of lending (i.e., asset growth) to the private sector, the larger is the increase in non-deposit liabilities, the smaller is the rise in deposit liabilities and the slower is monetary growth.

In recent years the increase in non-deposit liabilities has been on a sharply upward trend. As the following figures show, it almost quadrupled from £3.5b. in 1983/84 to £12.9b. in 1988/89. This trend has reflected improving bank and building society profitability, combined with a desire to rebuild capital adequacy after the debt crisis of the early 1980s. A sensible assumption for the twelve months to April 1990 is that non-deposit liabilities will continue to grow, but - since banks' capital adequacy is now satisfactory - at a somewhat slower rate than in 1988/89. A figure of £10b. is used in our analysis.

**External finance for the banking system in the 1980s**

Charts show effect of banking system's external transactions onM4 growth, in £b.

| | Increase in banks' non-deposit liabilities £m. | Increase in building societies' non-deposit liabilities £m. | Total increase £m. |
|---|---|---|---|
| 1983/84 | 2,306 | 1,215 | 3,521 |
| 1984/85 | 2,650 | 869 | 3,519 |
| 1985/86 | 1,991 | 2,337 | 4,328 |
| 1986/87 | 4,627 | 3,825 | 8,452 |
| 1987/88 | 4,487 | 1,649 | 6,136 |
| 1988/89 | 6,094 | 6,779 | 12,873 |

Sources: Bank of England *Long Runs of Monetary Data 1963-88* and Bank of England *Monetary statistics.*

**The implications of the credit counterparts arithmetic for bank lending**

We are now in a position to bring together our projections of the credit counterparts and to work out the implications for bank lending. Our guesstimates of the M4 credit counterparts in the year to April 1990 are as follows:

| | | £b. | |
|---|---|---|---|
| Public sector contribution | -2½ | to | -5 |
| Banks' and building societies' external and foreign currency transactions | -10 | to | -15 |
| Increase in non-deposit liabilities | | -10 | |
| Sum of credit counterparts to M4, exc. bank lending | -22½ | to | -30 |

The key identity for our analysis is

Increase in M4 = Lending to the private sector - public sector contribution - externals - increase in non- deposit liabilities.

We argued above that the rate of M4 growth consistent with a medium-term inflation rate of 5% is 12% and that, in the twelve months to April 1990, the permitted absolute growth of M4 with a 12% target is £45b. The central conclusion of our analysis is therefore that an annual rate of bank and building society lending of between £67½b. and £75b. (i.e. £45b. plus the sum of the other credit counterparts which is £22½b. - £30b.) can be reconciled with the objective of bringing inflation back down to 5% over the next few years. This is roughly equivalent to a monthly rate of £5½b. - £6b.

But a figure of £5½b. - £6b. a month gives no margin for error. 12% a year growth of M4 assumes that the economy will in future, as in the recent past, be able to absorb money balances rising a few per cent faster than nominal GDP. But that assumption may be too optimistic. Our work on the credit counterparts has taken it on trust that foreigners will still be prepared to channel money to the UK via the international banking system. But that relies on continued confidence in sterling, which may in practice be undermined by the large current account deficit.

To be on the safe side, the monthly bank lending figure should therefore be somewhat less than £5½b. - £6b. A target of £5b. a month is probably about right.

**Recent credit trends**

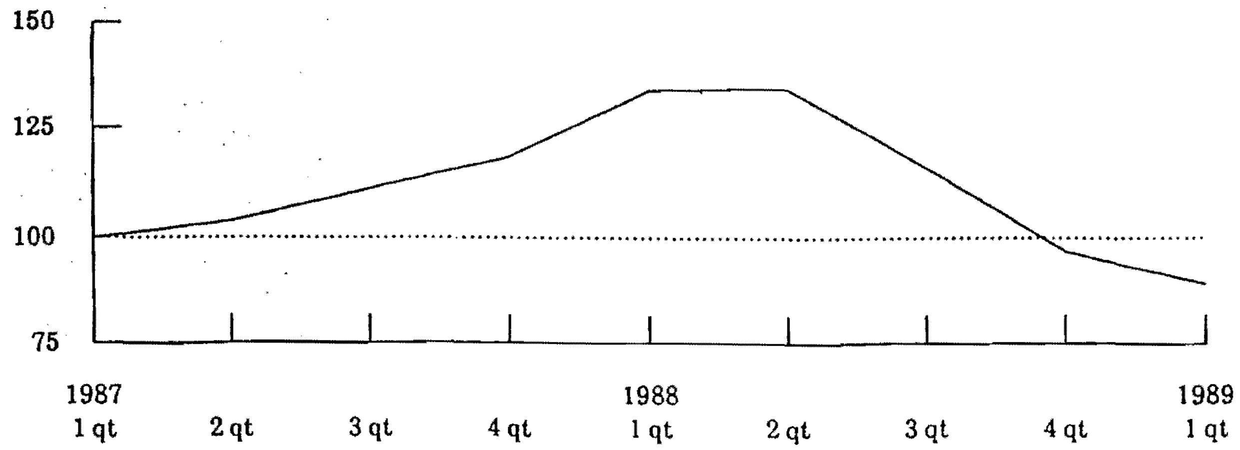
How easy will it be to attain the £5b.-a-month target? A perspective on this question is given by recent credit trends. In the year to March bank and building society lending totalled £80.1b., giving a monthly average of £6.7b. To reach the £5b.-a-month figure, it will therefore be necessary to cut lending growth by about a quarter compared to this figure.

One way of judging the feasibility of the £5b. objective is to decompose lending into its personal and corporate constituents. In general terms, personal lending - particularly for mortgages - tends to be most buoyant in the early stages of a business cycle when interest rates are low, whereas corporate lending is often higher in the late stages when interest rates have been raised to curb incipient inflationary pressures. The present cycle seems to be evolving in very much this way.

Total personal borrowing peaked in the third quarter of last year, when it amounted to £17.6b., and then fell sharply (in part for seasonal reasons) to £12.1b. in the fourth quarter. The evidence from the monthly clearers' statements is that it weakened even further in the first quarter of 1989. There has also been a large drop in both banks' and building societies' mortgage commitments. The clearing banks' new mortgages approved in the first quarter were £1,431m., 27% down on the first quarter 1988; the building societies' net new commitments in the first four months were £14,280m., 20% less than in the first four months of 1988. There has been a dramatic fall in turnover in the housing market and a consequent weakening in the demand for those consumer durables, such as carpets and furniture, which are typically bought at the same time as moving home. The further rise in base rates to 14% should reinforce these tendencies. In the summer mortgage commitments and lending are likely to be at two-thirds the level of a year earlier. This is

**The rcent collapse in the demand for housing**

Chart shows building societies' net new commitments deflated by the increase in house prices, with 1st qt. 1987 = 100.



clearly in agreement with the aim of cutting credit growth by a quarter.

The corporate side is more problematic. The quarterly analysis of lending which accompanied the clearers' February statement remarked that, "Corporate lending remained strong..., with large increases in sterling advances to 'other services' +£1,587m. (+11%), construction companies +£1,177m. (+16%) and to property companies +£1,113m. (10%)". But manufacturing was not a heavy borrower, while it is difficult to see property and construction companies continuing to seek bank finance on the recent scale. These two kinds of business activity are known to be particularly interest-rate-sensitive and may want to cut back their borrowings after the recent rate rise.

**Assessment**

If the Government is serious about bringing inflation back down to 5%, it has to reduce the growth rates of credit and broad money. Excessive growth of credit and broad money has caused the inflationary and balance-of-payments problems of recent quarters, and these problems cannot be overcome unless credit growth is lowered.

The credit counterparts arithmetic, taken in conjunction with a crude but plausible guesstimate of the relationship between M4 growth and inflation, suggests that M4 growth of about 1% a month and lending of about £5b. a month would be consistent over the medium term with 5% inflation. If the Government still paid much attention to these statistics and still believed in this approach to financial control, monthly bank lending above £5b. would imply continued high interest rates or even a need for another rise, £5b. would be "steady as she goes" and figures beneath £5b. would permit some interest rate easing. Although the Government apparently no longer monitors the credit counterparts numbers with much care, our calculations provide a means of analysing the link between lending and inflation, and so of deciding whether a particular monthly lending figure is "high", "low" or "average".

The ideas presented in this paper should not be pressed too hard or applied too mechanically. In the real world the relationships between credit, money and inflation can be upset in many ways. In recent years extremely fast growth of lending and money was associated - until quite recently - with only moderate inflation. Some of the extra credit benefitted foreign suppliers and caused a widening of the payments deficit rather than a worsening of inflation, while rapid money growth was assimilated without inflation because of institutional changes in the financial system. If the Government is lucky, these processes may continue. But they could go into reverse, aggravating the inflation problem and requiring an even more rigorous control over lending to the private sector.