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Commentary on the economic situation

Excessive institutional liquidity behind rising asset prices

Recent asset price increases are inconsistent with further economic slowdown

Financial markets, particularly the gilt market, have become too relaxed about the prospects for a slowdown in the economy. It is true that the drop in mortgage lending and declines in house prices signal a weakening in consumer demand, and that businessmen expect slower growth in sales and output today than they did a year ago. But the slowdown needs to be put into perspective. In the summer of 1988 domestic demand was increasing at an extraordinarily rapid rate, about 8% p.a. in real terms. It would be very surprising if - after a virtual doubling of interest rates - the growth of domestic demand were not to moderate from these numbers. The evidence so far is less than convincing that demand growth has fallen to a beneath-trend rate of 1%-2%. But beneath-trend growth over a sustained period will be needed if inflation is to be brought under control.

Indeed, one aspect of the economy is plainly inconsistent with a slowdown in economic activity. Apart from house prices, asset prices have risen sharply in recent months. The jump in share prices (of 30%) in the first half of 1989 has been conspicuous, but it is also worth mentioning further rises (at about 1¼% - 1½% a month) in the value of commercial and industrial property. Share and property prices are not perfect leading indicators for the economy, but they have some predictive value. It would be unusual for the economy to enter a recession after an asset price surge of the kind seen in early 1989.

Overfunding would curb asset price inflation

Why are asset prices still rising quickly? One explanation is undoubtedly the weight of money. The high level of the institutions' liquidity is a reflection of the continuing fast growth of broad money, with M4 recording a 19% increase in the twelve months to June, a peak figure for the current cycle. The strength of takeover activity has been partly responsible for the latest acceleration in money growth, because most of the bids have a cash element which the aggressor companies are financing by bank loans. But funding policy has also had an important role. When the Government buys back gilts from the institutions at the reverse auctions, it boosts the institutions' liquidity and obliges them to find an investment outlet other than gilts. For this reason official funding policy in recent quarters has probably had an important influence on the gains on the stock market. Of course, if the Government were to resume overfunding, monetary growth would decline, institutional liquidity would increase at a more modest pace, and there would be less upward pressure on asset prices. This issue of the *Gerrard & National Economic Review* therefore argues that a resumption of overfunding would be a valuable reinforcement of anti-inflationary monetary policy.

Tim Congdon — 28th July 1989

Summary of paper on

'The case for a resumption of overfunding'

Purpose of the paper

The economic slowdown is too weak and ambiguous for the Government to be confident that inflation will come back under control. Indeed, recent asset price inflation is inconsistent with a further slowing in the economy. Fast growth of broad money is arguably the dominant reason for the strength of share and property prices. This paper argues that there is a case for a resumption of overfunding in order to reduce the rate of broad money growth, to moderate asset price increases and so to dampen inflation pressures generally.

Main points

* **Funding policy is an effective means of influencing the quantity of bank deposits in the economy and can, if desired, reinforce anti-inflationary monetary policy.**

* **The official decision to end overfunding in 1985 was partly responsible for the asset price inflation of 1986-88 and was therefore causally relevant to both the boom in economic activity in those years and to the subsequent upturn in inflation.**

* **The 'distortions' attributed to overfunding (the bill mountain, artificial steepening of the yield curve and unwieldy money market operations) in the mid-1980s were trivial compared to the need to keep monetary growth under control.**

* **The paper argues three points which are basic to understanding the validity of active funding tactics in anti-inflationary monetary policy. These are**
  - deposits, not loans, are money
  - money is nevertheless created by credit, and
  - sales of public debt to non-banks reduce the quantity of deposits, and so the amount of money, in the economy.

This paper was written by Tim Congdon

The case for a resumption of overfunding
A technique for reducing the growth of broad money

More interest in monetary analyses of inflation

The acceleration in inflation since early 1988 has again stimulated interest in monetary explanations of inflation. The upturn in the growth of the money supply (on the broad definitions) which began in mid-1985 has been followed after a lag of three years by an upturn in inflation. The length of the lag is fairly typical of stop-go cycles in the post-war period, while certain aspects of the boom in 1987 and 1988 suggest strongly that excessive monetary expansion was to blame. Most obviously, the soaring prices of assets such as houses, shares and land could not have been sustained unless companies and financial institutions had abnormally strong balance sheets, with an abundance of 'cash' (i.e., bank deposits, which make up the bulk of broad money).

This experience has not caused the Government to re-think its approach to monetary policy. According to official statements, it continues to regard broad money statistics as difficult to interpret and unclear in their message for inflation. The official indifference must have been partly responsible for the decision to scrap the M3 definition of money, which was announced on 29th June. However, there are a number of observers who believe that the growth of broad money is very important for its impact on the economy and price level, and there is a continuing need for analysis of the influences on the growth of broad money. Since broad money is dominated (in the case of M4, to the extent of over 95%) by bank and building society deposits, this analysis has to concentrate on the forces driving the growth of bank and building society balance sheets. The first *Gerrard & National Monthly Economic Review* last month considered the principal influence at work, which is lending to the private sector. Its main conclusion was that, in order to bring M4 growth down to a rate consistent with 5% inflation over the medium term, lending should be cut to about £5b. a month. The £5b.-a-month figure would be about 25% less than the average over the last year. This second *Gerrard & National Monthly Economic Review* looks at a further aspect of monetary control, known as funding policy. Funding policy works through deliberate variations in sales of government debt to non-banks since these affect the quantity of deposits they hold.

Three basic points
1. Deposits, not loans, are money

But, before we consider funding policy as such, we need to clarify three fundamental issues which are never far from the surface in public debate. The first of these is that the money supply consists of *deposits*, not *loans*. The idea that loans are money, and that M3 and M4 should be regarded as the same thing as lending, is surprisingly general. Indeed, in newspaper articles and even some brokers' circulars it seems to be taken for granted that M3 and M4 are interesting only because they are guides to bank and building society lending. *It cannot be emphasized too strongly that this*

habit of thought is quite wrong and the source of much popular misunderstanding about how monetary policy works.

The reason that bank deposits are money is simple. Just as transactions are completed when notes and coin are tendered in payment, so transactions are completed when cheques are written against deposits. The turnover of cheques at the London clearing house is enormous, always a multiple of the amount of new lending being extended by the financial system. The contrast in scale between the London cheque clearing and the new lending total is demonstrated dramatically by the figures given on the next page. Of course, every cheque represents the payment for a good, a service or an asset. The circulation of cheques lies behind virtually all the serious expenditure in the economy, being far more important in terms of the value of transactions than notes or coin.

The predominance of cheque payment - and the implication that deposits are the most important form of money - demonstrates the artificiality of the claim that notes and coin are uniquely and especially 'transactions money'. This claim appears in Sir Alan Walters' *Britain's Economic Renaissance* and appears to explain much of his commitment to M0 as a target aggregate. Of course, notes and coin are the most familiar kind of money for everyday transactions in the shops, but these everyday transactions should not be an obsessive concern of macroeconomic analysis.

Notes and coin are unimportant, even as 'transaction money'

If we regard 'spending' as Keynesian aggregate demand, notes and coin are used in perhaps 40%-50% of consumers' expenditure (e.g., purchases of food, clothing and minor household items), which is equivalent to 25%-30% of GDP. The remainder of transactions (purchases of consumer durables, capital investment by companies, exports) are completed mostly by cheque payments or electronically automated payments against deposits. If instead we think of 'spending' as all the accounts settled within an economy (including payments of income, and debits and credits between customers and suppliers of intermediate products which are netted out in the GDP figures), notes and coin matter little, since they are hardly ever used for large payments between companies. If, finally, we include asset transactions in 'spending', the role of notes and coin is trivial. Nowadays, and indeed for several centuries, transactions in stocks and shares, houses, land and commercial property, and foreign exchange have involved transfers of money by the banking system, not the tendering of notes and coin.

The objection could be made that transactions in financial assets are not part of aggregate demand and therefore should not be considered as 'transactions' on a par with the purchase of, say, groceries or heavy machinery. But changes in asset prices undoubtedly have an effect on people's attitudes and behaviour, and so on their spending on current items. Ironically, much casual comment about lending takes it for granted that loans are important for economic activity and retail price inflation, even

though most loans are intended to purchase the acquisition of assets, e.g., mortgages to buy houses, corporate finance loans to buy company shares. Why is there this differentiation between loans which finance asset purchases and deposits which pay for them? What is the magic which says that loans matter and that deposits do not?

2. Money is created by credit

The second basic point is that new bank and building society deposits come into being as a result of new bank and building society lending. In short, *money is created by credit.* This money-creating characteristic of new credit can be seen, in the simplest terms, as the consequence of double-entry book-keeping. Banks and building societies have assets (loans, mainly) and liabilities (deposits, to the extent of over 90%). If the assets expand, so too do the liabilities; if loans increase, so too do deposits. Money is created by banks' efforts to expand their balance sheets.

This may seem peculiar, even shocking and astounding. It seems that money is made by a few strokes of bankers' pens, almost as if it comes out of thin air. But money must not be confused with wealth. When a bank grants a loan facility to a customer, a sum is credited to his deposit (probably a current account) and debited from a loan account. The customer has a new asset (the deposit) and a new liability (the loan); the bank has a new asset (the loan) and a new liability (the deposit). The extra assets and liabilities cancel out. Neither bank nor customer is better-off. Although new loans create more deposits and increase the money supply, the expansion of bank lending does not mean that society is richer.

3. Funding policy can influence the amount of money in the economy

Our third essential idea is that funding policy can influence the level of bank and building society deposits, and so the money supply. In the last few months there has been a surprisingly widespread belief that funding policy is unable to alter the

The unimportance of bank credit compared to cheque clearing

all figs. in £b. except final column

	Value of clearing through banking system			Bank lending to private sector	Multiple of clearing to credit
	Paper items	Automated items	Total		
1980	5,484.3	91.3	5,575.6	9.6	580.8
1981	6,072.8	104.3	6,177.1	8.8	701.9
1982	7,245.6	130.4	7,376.0	12.8	576.3
1983	8,470.0	154.5	8,624.5	13.5	638.9
1984	9,340.4	931.0	10,271.4	14.7	698.7
1985	10,278.2	2,608.6	12,886.8	19.8	650.8
1986	11,483.8	4,445.3	15,929.1	30.0	531.0
1987	11,966.8	7,688.3	19,655.1	42.4	463.6
1988	11,363.0	11,711.4	23,074.3	56.0	412.0

Source: The Committee of London and Scottish Banks, and *Financial Statistics*

quantity of deposits, because the 'money' used to buy government debt has 'to go somewhere'. This belief has even been expressed by officialdom, with Mr. Lawson claiming in a House of Commons debate on 7th June that it was an illusion to think that overfunding could change the amount of money in the economy. It also appeared in a letter from Mr. Brian Reading to the *Financial Times* on 7th June.

The line of thinking behind the Lawson/Reading view may be as follows. When a private sector non-bank agent buys a new issue of gilts, it writes out cheques to the Government. These cheques are credited to a government account at the Bank of England and debited from private sector deposits. The drop in private sector deposits unquestionably represents, by itself, a fall in the money supply. (Government deposits are not included in the money supply, on the grounds that the Government's behaviour - unlike that of a private sector agent - is not affected by a change in its deposits.) However, the Government may decide to spend the extra sum in its account. If it purchases assets from non-banks, private sector deposits are rebuilt and the money supply effect is cancelled.

But this is a silly argument. Clearly, if the Government sells government debt to non-banks and almost immediately buys back the same quantity of government debt from them, there are no monetary consequences. What happens if instead the Government uses the extra money in its account to buy assets from banks? Does not that also put money back into the economy and so negate the initial drop in the money supply? The answer is 'no'. When the Government instructs its agent, the Bank of England, to buy assets from the banks, a sum is credited to the banks' balances at the Bank of England and they surrender assets such as commercial bills, gilts or Treasury bills in return. There is a change in the composition of banks' assets, with lower bill holdings offset by higher bankers' balances. There is no change in the size of their balance sheets, their deposit liabilities or the money supply. Surprising though it may seem, funding causes money to disappear from the economy.

Funding policy and monetary control before 1985

With these three basic ideas clarified, we can move on to more substantive issues. As is well-known, in the decade to mid-1985 the Government actively varied official gilt sales in order to meet broad money targets. In the 1970s it consistently under-estimated the strength of bank lending to the private sector and had to counteract the monetary effects of excessive lending by stepping up official gilt sales. (According to Professor Charles Goodhart in his book *Monetary Theory and Practice*, the Government cut monetary growth between 1972/3 and 1978/9 from over 17% per annum to under 14% per annum by raising official gilt sales above levels planned at Budget time.) In the early 1980s official gilt sales were on such a heavy scale that they exceeded the PSBR and were, in effect, neutralizing monetary expansion due to high bank lending. This overfunding reduced the rate of broad money

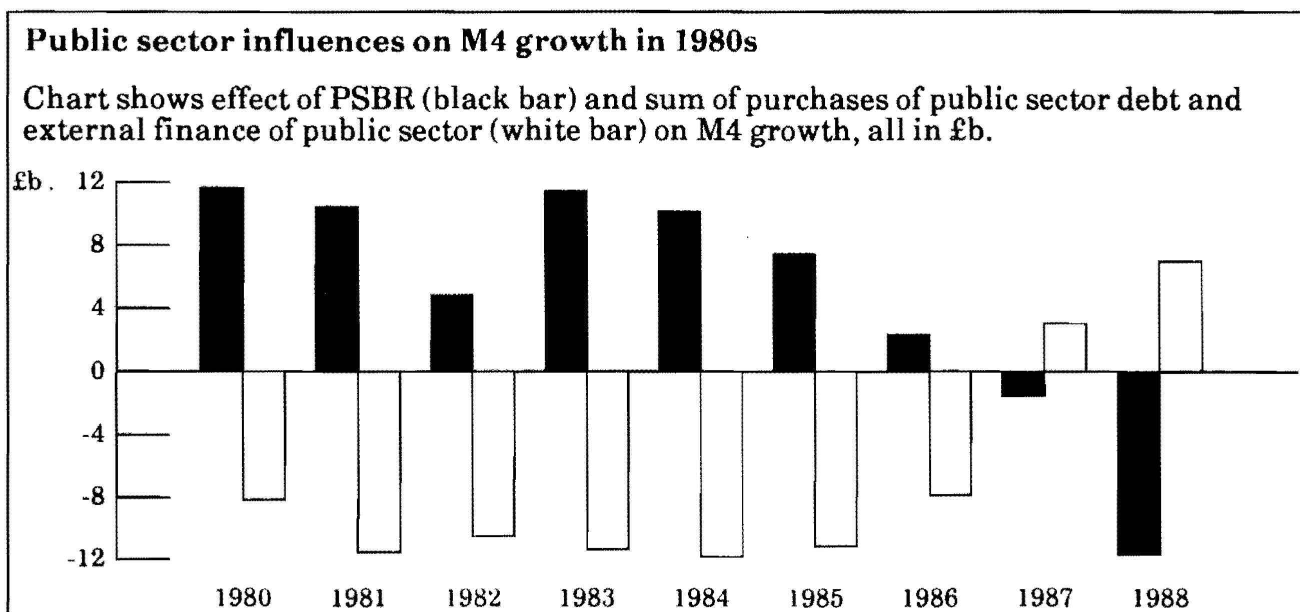
growth, but had a number of allegedly unfavourable side-effects. Because of these side-effects overfunding was stopped. With the Government no longer able to adjust official gilt sales if broad money overshot its target, broad money targets became difficult to meet and were abandoned. As argued in my Centre for Policy Studies' pamphlet *Monetarism Lost: and why it must be regained*, the subsequent acceleration in broad money growth was the driving-force behind the boom of 1987 and 1988, and the recent upturn in inflation.

If this version of recent events is accepted, two questions arise. The first is 'how did the acceleration of broad money growth have such powerful unfavourable effects?' and the second is 'were the benefits from the end of overfunding (in terms of removing its adverse side-effects) nevertheless still such as to justify the Government's decision?'.

Faster money growth leads to more inflation after 1985

The answer to the first question is not difficult in general terms. The increase in the rate of broad money growth - from a typical figure of 11%-14% in the four years to mid-1985 to a typical figure of 15%-18% since then (depending on the particular measure of money and period under consideration) - has been followed, after an unsustainable boom, by an increase in the trend rate of inflation from 3%-6% in the mid-1980s to 5%-8% in the late 1980s. The impact on trend inflation would have been higher than this if it had not been for a major diversion of demand from domestic to overseas suppliers, which has led to a large deterioration in the balance of payments.

But what were the precise mechanisms at work? People often seem to be puzzled that the quantity of bank and building society deposits can be so important for the economy. For example, in his column in the *Financial Times* on 1st June, 1989, Mr. Samuel



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.

Brittan remarked that, after funding, 'The assets and liabilities of the banks are reduced, which means a,lower total for broad money. But that is merely a cosmetic aspect.' There are a number of naive, almost intuitive ideas available to counter this kind of scepticism. It is plausible, for example, that people will try to keep a fairly stable ratio between, on the one hand, their income and expenditure, and, on the other, their deposit holdings. (If they have too little in the bank, they may suffer some inconvenience with their transactions; if they have too much, they will miss out on the higher returns on building society deposits, unit trusts and so on.)

There are also good reasons for thinking that companies will try to avoid both over-geared balance sheets, which involve high risks of failure if there are sudden shocks, and excessively cash-rich balance sheets, which may mean that investment and profit opportunities are being missed. An over-geared balance sheet implies a high ratio of loans to deposits, or inadequate net liquidity (i.e. deposits minus loans) in relation to equity capital; a cash-rich balance sheet is one with a high ratio of deposits to equity. It is therefore implicit in virtually any discussion of company finances that the quantity of deposits has a bearing on key business decisions and that there is - over the long run - some sort of desirable, average relationship between deposits, turnover and capital.

The end of overfunding and its effects on institutions' investment behaviour

These ideas are central to any explanation of how money affects economic activity and inflation. But a somewhat different story can be told about the sequence of events which followed the halt to overfunding in mid-1985. The first and most obvious monetary consequence of the move to 'exact funding' was that the money that would previously have gone into new gilt issues became available for investment elsewhere. The scale of this effect is shown very clearly by the figures below. In 1983 life assurance companies and pension funds made net purchases of over £5.3b. of gilt-edged securities; in 1987, by contrast, they were net sellers of £0.8b. of gilt-edged securities. Their purchases in 1983 absorbed about a third of their annual net inflow of funds; their sales in 1987 increased it by almost 5%. The result was a striking change in their asset allocation. Much more money was committed to the equity market and to relatively new categories such as home mortgages.

How did this change in asset allocation affect the economy? When the institutions channelled equity money into equities via rights issues, new issues, vendor placings and so on, deposits were transferred from the financial sector to the industrial and commercial sector. Whereas before the problem had been that the institutions had too high ratios of 'cash' to assets, it was now companies which had excessive liquidity. They adjusted either by purchasing more assets (such as land and shares) or by embarking on more ambitious expansion programmes. When they stepped up expansion programmes, they began to influence the price of goods

and services, and so to affect such recognised inflation indicators as the producer and retail price indices.

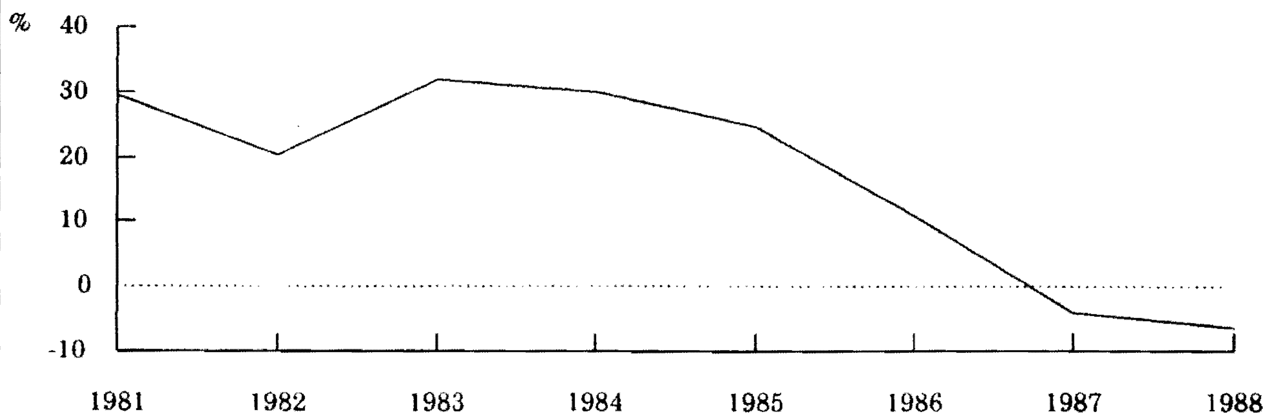
However, if individual institutions responded to the stronger liquid position by buying more equities from other institutions, the extra deposits stayed within the financial sector. The re-shuffling of bank deposits between the institutions was apparently an endless game of musical chairs. As long as the money was confined to buying and selling equities and property within the financial system, it could not impact on the price of goods and services. This point caused some wry comment among sceptics about broad money. In the two years after the end of overfunding, from end-1985 to end-1987, sterling deposits held by non-bank financial institutions soared by 88%. But how could deposits held by the Prudential or Eagle Star be spent in the High Street? Wasn't it obvious that they had no relevance to retail price inflation?

Asset inflation connected to broader inflation trends

This view was too narrow-minded. It was true that, as long as the money stayed within the financial sector, retail price inflation was not affected. But there were - and, of course, still are - a wide variety of mechanisms which connect asset transactions in financial markets with expenditure decisions by companies and individuals. Because of the astonishing surge in their bank deposits in 1986 and 1987, the institutions found that their liquidity was always rather high in relation to their assets. They were generally more inclined to buy than to sell, and share and land prices increased very rapidly. Once asset prices had risen in this way, the behaviour of companies and individuals was bound to be affected. Most obviously, because people were better-off, they were more prepared to spend out of income and reduce their savings.

Investment in gilts as proportion of institutional cash flow

Chart shows gilt purchases by life companies and pension funds as % of their net inflow of premiums and contributions



It is naive to focus on the direct connection between transactions money (e.g., the notes and coin which make up most of M0) and spending in the shops, in the manner recommended by Sir Alan Walters in *Britain's Economic Renaissance.* Instead it is essential to look at the looser and more complicated linkages between broad money holdings (i.e., bank deposits) and asset prices, and between asset prices and expenditure decisions. *The end of overfunding in mid-1985 played a role in the asset price inflation of 1986, 1987 and 1988, and was therefore causally relevant to both the boom in economic activity in those years and the upturn in inflation from mid-1988 onwards.*

Three 'distortions' attributed to overfunding

Of course, there is much more to add. The analysis here has not been a rigorous statistical demonstration of the importance of changes in funding policy. But at least enough has been said to suggest that the decision to end overfunding had damaging macroeconomic consequences. What, then, of the Government's reasons for taking the decision? How serious were the various distortions commonly attributed to overfunding? Three such distortions - the 'bill mountain', the steepening of the yield curve and the excessive volume of money market operations - received particular attention in brokers' circulars and newspaper comment. They may be considered in turn.

1. The 'bill mountain'

The bill mountain caused much anguish among policy-makers, apparently because of worries that the Bank of England, a nationalized company, was becoming the largest lender to the UK private sector. The Bank of England's new lending role was regarded as ideologically inappropriate under a Conservative Government committed to privatisation and market forces. But this overlooked that the risk on the bills taken into the Bank's balance sheet had been accepted by the private-sector banks concerned (indeed, that is why they were called 'acceptances') and that their pricing had been determined by a market process. There was nothing ideologically improper or dangerous about the bill mountain.

2. Artificial raising of 'long' yields

The yield curve was said to be distorted by the Government simultaneously selling long-dated gilt-edged securities and buying up commercial bills in order to relieve the resulting money market shortages. Long rates were supposed to be artificially high and short rates artificially low. High long rates were then condemned because they discouraged private sector bond issues. However, this criticism of overfunding seems to ignore that the early 1980s saw a trend away from a positive-sloping yield curve to an inverted yield curve. (In 1980 the gross redemption yield on the *Financial Times* long-dated gilt index averaged 14.75%, whereas the yield on Treasury bills was 13.45%; in 1985 - after five years of overfunding - the g.r.y. on long-dated gilts was 10.62% and the yield on Treasury bills 11.48%.)

It is also unclear why the Government was so eager to revive private-sector bond issues. In the early 1980s several economists

(including the author of this paper) wanted companies to raise more from the capital markets and less from the banks, in order to reduce the amount of bank lending and moderate money supply growth. But the resuscitation of the corporate bond market was not, by itself, an end of public policy. So the way that policy evolved was rather odd. It may have been true that overfunding deterred an active corporate bond market, but it also reduced monetary growth. To stop overfunding in order to stimulate the corporate bond market was to forget the ultimate purpose of the whole exercise, which was to facilitate monetary control.

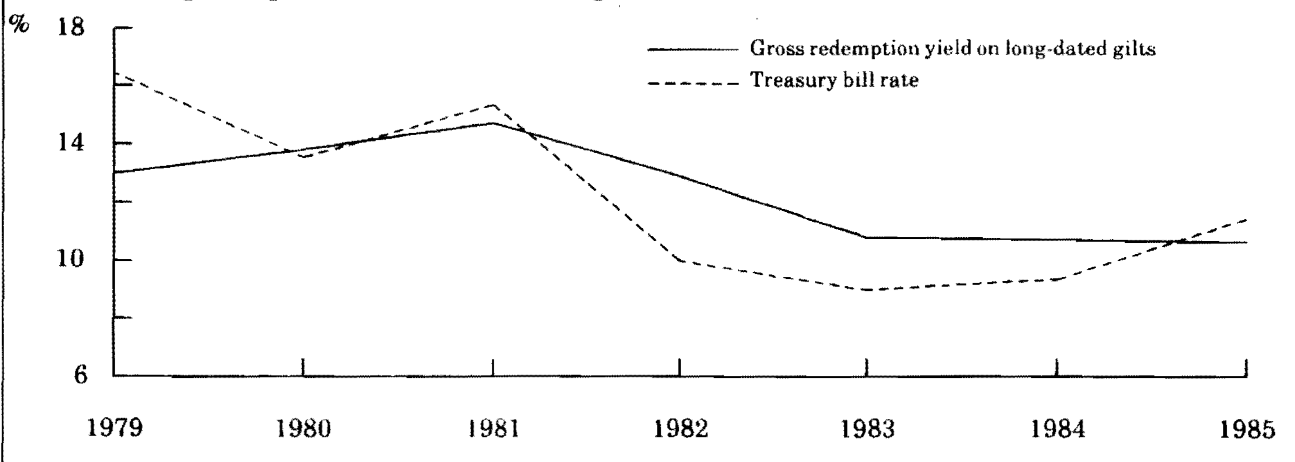
3. Unwieldy money market operations

The final complaint about overfunding - that, because of the scale of bill redemptions and issues, it led to massive and rather unwieldy money market operations - was true as far as it went. But, again, was this a valid concern for policy-makers? A substantial amount of paper-churning in the City may have been a nuisance to the institutions involved, but it had no implications for major goals of economic policy such as inflation and economic growth. In any case, the excessive paper-churning could have been partly overcome by the simple expedient of companies issuing more six-month, nine-month and one-year bills and the Bank taking these onto its balance sheet. (Obviously, one-year bills come up for redemption less often than three-month bills.)

Our conclusion has to be that none of the distortions alleged to have been caused by overfunding was important compared to the need to maintain control over broad money. The so-called 'distortions' were technical irritations to various City institutions, but they were peripheral to economic policy. In comparison with the Government's central objective of reducing inflation, all the perplexities of the bill mountain, the yield curve and money market operations were trivial. To end overfunding because of them was to throw out the monetary baby with the technical bathwater.

The shape of the yield curve in the 1980s

'Long' yields fell, both *absolutely* and *relative* to 'short' rates, in the early 1980s, while overfunding was practised. Overfunding ended in 1985



Conclusion: overfunding would facilitate monetary control

The argument of this paper has been critical of a policy decision taken almost four year ago. It is of rather more than historical interest. The change in funding policy in mid-1985 mattered not just because of its effects on monetary growth, but also because of what it implied about official attitudes towards monetary control. The rethinking about funding policy and broad money was quite sudden. As late as October 1984 (in a lecture at the University of Kent) the Governor of the Bank of England had said that 'the central banker is concerned...with the aggregate total of bank deposits...and worries about the overall effect on the economy, particularly on inflation' and insisted that 'in this context overfunding is a clearly rational approach'. If the University of Kent speech is to be taken at face value, it is clear that in 1984 and 1985 officialdom (or, at any rate, some part of officialdom) was both well-aware of the risks of abandoning broad money targets and dismissive about the supposed embarrassments of overfunding. The abruptness and finality of the decisions to end overfunding and abandon broad money targets are all the more surprising.

It is obviously implied by our argument that the Government should renounce the exact funding rule and restore a flexible approach to funding policy. The thinking behind our view is thoroughly conventional. It is almost a platitude that financing a budget deficit by long-dated debt sales to non-banks is less inflationary than financing it from the banking system. It should also be uncontroversial that a reduction in the rate of growth of bank deposits is the centrepiece of an anti-inflationary monetary policy. A cut in bank and building society lending will have the desired effect, because deposits are created by new credit, and in our first *Gerrard & National Monthly Economic Review* we suggested that lending would have to be lowered by 25% if 5% inflation were again to be attainable over the medium term. Since recent evidence is that many months of high interest rates will be needed before the 25% target is met, the main conclusion of this second *Gerrard & National Monthly Economic Review* is that it would be sensible to reinforce anti-inflationary monetary policy by a return to overfunding.