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Commentary on the economic situation

Was Mr. Lawson preparing a final zigzag?

A return to broad money?

Mr. Lawson's Chancellorship saw an attempted U-turn in macroeconomic policy, from a focus on domestic monetary targets to exchange rate management as a member of the European Monetary System. The Prime Minister, acting on the advice of Sir Alan Walters, frustrated him in his designs for EMS membership. He resigned in protest. But is it possible that in his last few months he was preparing a final zigzag? Was he considering the re-introduction of broad money targets? In an article on Lawson's resignation in the *Financial Times* (27th October) Mr. Samuel Brittan remarks that the fiscal side of the medium-term financial strategy "is very much alive *and the monetary side will be taken up again* "(our italics). This followed a curious concluding sentence to his piece on 23rd October to the effect the days of "old M3" were "still immensely better than what is normally said on such occasions". It is well-known that Brittan is close to the former Chancellor.

Is there a hint here of a return to broad money targets, presumably to be expressed in terms of M4? This would fit in with the tentative changes in funding policy announced in the Mansion House speech. But Mr. Lawson ought to have gone further. The accompanying analysis of the Mansion House speech (which may seem rather dated after the Chancellor's resignation) argues that the official case against overfunding does not stand up.

15% base rates taking their toll

A more active funding policy would increase long-term gilt yields and take some of the burden of anti-inflationary monetary policy away from short-term rates. This is not to deny that 15% base rates are having powerful deflationary effects on the economy. Consumer spending seems to have stopped growing, while it is clear from the latest CBI survey that there has been a complete change of mood in industry. Some bits of evidence do not fit in with the general impression of a sudden halt to growth. For example, when allowance is made for the re-classification of Abbey National, building society net new commitments in the third quarter were about 15% higher in the third quarter of 1989 than a year earlier. But new mortgages approved at the London & Scottish bankers (i.e., the clearers) collapsed by 55% from £3,341m. in the third quarter 1988 to £1,498m. in the third quarter this year. When the building societies' and clearers' figures are added together, mortgage commitments were probably about the same in the third quarters of 1988 and 1989. Other series which were strong in early 1989 have begun to crumble. For example, constructions orders averaged £1,748m. a month (in 1985 prices) in the first half of 1989, but were £1,452m. in July and £1,470m. in August. The Government will be under strong pressure to reduce interest rates in early 1990.

Tim Congdon — 27th October, 1989

Summary of paper on

"Mr. Lawson on funding policy"

Purpose of the paper The Mansion House speech set out the official case against the resumption of overfunding. Mr. Lawson tried to answer criticism of his approach by claiming that overfunding was ineffective "because the money had to be injected in the system elsewhere". This paper argues that certain key paragraphs in the speech were self-contradictory and ambiguous, and that the official case against overfunding does not stand up.

Comment on the key sentence

The key sentence on funding policy stated that "any money drained out of the system by selling gilts over and above the Government's funding requirements, or by buying in fewer gilts than these requirements dictate, would simply have to be injected in the system elsewhere". In this sentence "money in the system" could have any one of the following four meanings,

1. **broad money (i.e., private sector deposits),**
2. **all deposits, both government and private,**
3. **the amount of lending by the banking system, or**
4. **bankers' balances at the Bank of England.**

As it stands, the sentence is hopelessly ambiguous. If meaning 1 (broad money) is intended, it is also wrong. ***There are few propositions in monetary economics less controversial than that gilt funding reduces the money supply on the broad definitions.*** **If one of meanings 2, 3 or 4 is intended, the sentence is correct, more or less. But presumably the Chancellor did not want his speech to have three different meanings simultaneously.**

This paper was written by Tim Congdon

Mr. Lawson on funding policy

An analysis of six paragraphs in the Mansion House speech

Several points of interest

The Mansion House speech gave Mr. Lawson an opportunity to outline the latest official thinking on monetary policy. It did not signal any radical changes and was widely described as dull. In fact, it contained several new points, with much of the interest lying in the relative emphases placed on different subjects. In one guise or another funding policy took up about a third of the speech, which suggests that the Treasury and the Bank have been thinking hard about this question in recent weeks. The new openness to ideas may lead to further movement in this area in coming months, with potentially important implications for financial markets and the economy.

Two substantive changes

There were two substantive changes to funding policy straightaway. Foreign exchange intervention to support the pound will no longer be sterilised by official gilt repurchases in the same financial year and Treasury bills will be excluded from the definition of funding. The effect of these two changes will be to reduce the Government's repurchases at the reverse gilt auctions, a development which is desirable and appropriate as a reinforcement of anti-inflationary monetary policy. But the changes could be relatively minor in their effects. The exclusion of Treasury bills is likely to reduce unfunding by only £1b.-£2b.

Still scope for better policy

There is scope for much further improvement. It was the decision to end overfunding in mid-1985 which made broad money targets difficult to attain. Shortly afterwards, in the October 1985 Mansion House speech, broad money targets were suspended and then abandoned. The removal of this constraint on financial policy was followed by the boom of 1986-88 and more recently by an upturn in inflationary pressures. Inflation will brought under control on a sustained basis only if broad money growth is also brought under control on a sustained basis. A frank endorsement of overfunding is likely to be essential if the growth of broad money is to be reduced to a rate compatible with long-run price stability.

An analysis of six key paragraphs

The focus of this paper is therefore not on the small changes to funding policy announced in the Mansion House speech, but on the reasons given for not making a larger and more significant policy shift. The speech devoted six paragraphs of about 300 words to an attack on overfunding and defence of the present arrangements. In this paper about 4,000 words will be written in criticism of the six paragraphs. The effort of analysis may seem excessive, but the subject is of immense importance to the future evolution of monetary policy in the UK. The argument here will be that the six paragraphs were contradictory, ambiguous and, in some respects, downright wrong. (The relevant paragraphs are re-printed in the Appendix.)

Comment on the first and third paragraphs

Much of the trouble in the speech stems from a failure to define terms. The problems start with the opening sentence of the first paragraph on funding which says that, "the purpose of funding is to ensure that the public sector as a whole does not inject liquidity into the economy - but nor should it extract liquidity from it". Nowhere is the notion of "liquidity" defined.

It is true that at one time the Bank of England did publish numbers for "PSL 1" and "PSL 2" (private sector liquidity 1 and 2), but the series were discontinued in May 1987. If liquidity is taken as equivalent to the constituents of PSL1 or PSL2, it would be dominated by bank and building society deposits. If so, liquidity is effectively the same thing as the money supply, on either the M3 or M4 definitions. This would appear to be confirmed by the third paragraph, which notes that - by setting aside the present approach with its neutral effect on "liquidity" - the Government might return to the "practice of overfunding in order to control the published figures for the broad money aggregates". It concludes by acknowledging that overfunding was something "which we indeed did for a time in the early 1980s".

Two points seem to emerge from the first and third paragraphs:

1. Funding policy does change the money supply.
2. Funding policy was used in the early 1980s to control the money supply.

Comment on the fourth paragraph

The next paragraph, however, has a very different message. Mr. Lawson begins by saying that, "If this [i.e., an active funding policy] offered a better way of curbing inflation, I would of course gladly go back to it. But it would not do so." A long sentence then followed, claiming that

> Quite apart from the limitations of broad money, any money drained out of the system by selling gilts over and above the Government's funding requirements, or by buying in fewer gilts than these requirements dictate, would simply have to be injected into the system elsewhere.

This difficult sentence is at the heart of the debate. As we shall see, it is highly ambiguous, being open to at least four interpretations. The first, which seems justified by the phrase about "the limitations of broad money", is that the quantity of official gilt sales (funding) does not affect the money supply. If so, two points seem to emerge from the fourth paragraph:

1. The mid-1980s are different from the early 1980s, in that monetary policy, focussed on broad money targets and assisted by overfunding, is no longer a good way to reduce inflation.
2. Funding policy does *not* change the money supply.

How funding reduces broad money

Stage 1. Balance sheets before funding

Bank of England: Assets	Bank of England: Liabilities	Commercial Banks: Assets	Commercial Banks: Liabilities	Non-banks: Assets
£10b. Treasury bills	£6b. Notes and coin.	£6b. Advances	£10b. Bank deposits	£10b. Bank deposits
	£2b. B. of E. balances	£2b. Commercial bills		
	£2b. Public deposits	£2b. B. of E. balances		

Non-banks hold £16b. of broad money (i.e, £10b. bank deposits and £6b. notes and coin). Banks hold £2b. of clearing balances at Bank of England, their "target" level.

Stage 2. After funding, but before relief of shortage

Bank of England: Assets	Bank of England: Liabilities	Commercial Banks: Assets	Commercial Banks: Liabilities	Non-banks: Assets
£10b. Bank deposits	£6b. Notes and coin	£6b. Advances	£9b. Bank deposits	£1b. Gilts
	£1b.	£2b. Commercial bills		£9b. Bank deposits
	£3b. Public deposits	£1b.		

B. of E. Balances

Non-banks have bought £1b. gilts by reducing their deposits and broad money is down to £15b. Banks' balances at the Bank are reduced correspondingly to £1b. They are beneath target and the money market is short.

Stage 3. After funding and relief of shortage

The balance sheets are purely for illustration. They bear no relation to the real-world values of the various assets and liabilities.

Bank of England: Assets	Bank of England: Liabilities	Commercial Banks: Assets	Commercial Banks: Liabilities	Non-banks: Assets
£10b. Bank deposits	£6b. Notes and coin	£6b. Advances	£9b. Bank deposits	£1b. Gilts
£1b.	£2b. B. of E. balances	£1b.		£9b. Bank deposits
	£3b. Public deposits	£2b. B. of E. balances		

Commercial bills

Bank of England has bought £1b. bills from banks and credited their balances accordingly. Shortage is relieved, but broad money holdings are still £1b. lower than at stage 1.

First and third paragraphs contradict the fourth

On the face of it, the first and third paragraphs openly contradict the fourth. Now it is a serious matter if an official speech which is supposed to be the authoritative annual guide to monetary policy contradicts itself in successive paragraphs. It is even more disturbing if the Government is uncertain about an issue as basic as the impact of funding on the money supply. Can common sense and intellectual consistency be rescued from Mr. Lawson's remarks?

Official gilt sales *do* reduce broad money

One point that needs to be cleared up without further ado is the relationship between funding and broad money growth. There is really not much doubt about this question. If official gilt sales are to the non-bank public (i.e., if they count as genuine funding), they do reduce broad money. There are many difficult and controversial subjects in economics, but this is not one of them.

The argument can be set out with the help of hypothetical balance sheets of the whole banking system and of the non-bank public. The balance sheets are given on page 5. Three separate transaction stages are set out. It is quite clear that in stage three, after the non-bank public has bought a new issue of gilt- edged securities, the quantity of bank deposits held by the private sector is lower than in stage one, before it has done so. Since bank deposits constitute the greater part of broad money on the M3 definition, gilt funding reduces broad money.

What does the fourth paragraph really mean?: Three more possibilities

It has to be assumed that Mr. Lawson did not mean that funding has no effect on broad money. But what, then, did the Chancellor intend by the awkward proposition about the "money" having "to be injected elsewhere in the system"? We shall suggest that there are three further possibilities, with the outcome depending on whether the phrase "money in the system" means

1. all deposits (held by both private and public sectors),
2. the amount of lending to the private sector, or
3. the banks' clearing balances at the Bank of England.

1. "Money in the system" means all deposits including government deposits

Let us examine, first, the possibility that Mr. Lawson was referring to the sum of private sector and government deposits. In the example we have given on page 5 the Government's receipts from official gilt sales accumulate in its deposits ("public deposits") at the Bank of England. If such deposits were to be categorised inside broad money, the sequence of transactions we have described would not affect broad money. The non-bank public would have less deposits and more gilts, but the drop in its deposits would be offset by the increase in public deposits.

It is important to recognise here that traditional broad money definitions exclude - and always have excluded - deposits held by the central government. The explanation is straightforward. Monetary aggregates are interesting when they have the power to influence decisions to spend and save. Thus, bank deposits in private sector hands can cause the people and companies who hold them to review their financial position and adjust their behaviour. But deposits in

government hands have no effect on official spending decisions. After all, the Government has absolute tax-raising powers and can borrow virtually at will from the Bank of England. Since it has the right to print money, why should it need to hold money in significant quantities?

It is obvious that the size of the Government's account at the Bank of England has no relevance to the amount of public expenditure and is of no macroeconomic significance. It matters not one jot to consumption, investment or stockbuilding whether government deposits are £100m., £1b. or £100b. On these very sensible grounds official statisticians have kept central government deposits out of money supply definitions ever since the "money supply" was first invented as a distinct statistical category.

It follows that, although funding may leave the overall quantity of deposits (i.e., private and government) unchanged, it undoubtedly reduces private sector deposits. Since only private sector deposits are included in standard broad money definitions, the money supply is lower than it would otherwise have been.

The origins of the "bill mountain"

The point can be pressed home in another way. In the sequence of transactions set out on page 5 the Government uses its receipts from gilt sales to build up public deposits at the Bank of England. But it does not have to do so. It could alternatively buy back some of its own debt instruments held by the banking system. By so doing, it would reduce the banks' assets and hence their deposit liabilities. In this case funding results in a fall in private sector deposits, with no offsetting rise in public sector deposits. Indeed, this is exactly what did happen in the early years of overfunding when the banks still had substantial claims on the public sector. Only in 1985 did the banks' holdings of public sector debt drop to such a low level that this avenue was closed. The only remaining use of receipts from official gilt sales was to build up government deposits at the Bank of England. As public deposits grew on the liabilities side of the Bank's balance sheet, so did holdings of commercial bills - the notorious "bill mountain" - on the assets side.

2. "Money in the system" means lending to the private sector

This introduces the second possible rationalization of Mr. Lawson's remarks. Could he have meant by "money in the system" the amount of lending to the private sector? As we have seen, the accumulation of public deposits in the Bank of England is matched by commercial bill holdings. Since the issue of commercial bills represents credit to the private sector, the private sector is receiving as much "money" from the banking system as before. Funding does not change the availability or level of bank lending.

If this is what Mr. Lawson meant, he is correct, but the result is to confuse the money supply and credit. *It again needs to be emphasized that the money supply consists of notes and coin, and deposits held by the private sector. Deposits, not loans, are money.* Although the volume of credit may be unaffected by funding policy, funding does change the quantity of deposits in private sector hands. That is what matters for money supply control.

3. "Money in the system" means the bankers' balances at the Bank of England

Finally, there are some versions of the argument where the injection of "money into the system" is taken to be the rebuilding of bankers' balances at the Bank of England. The idea here is that, when the non-bank public buys a new issue of gilt-edged securities, it instructs the banks to make a payment to the Government's account at the Bank of England. (The drop in bankers' balances on the asset side of the banks' balance sheet is the counterpart to the drop in private sector deposits on the liabilities' side.) The consequent fall in bankers' balances may leave them beneath the target level required for the daily clearing. The Bank of England then steps in, purchasing enough bills from the banks for bankers' balances to be rebuilt to the target level.

The contents of the fifth paragraph suggest that this final interpretation of the fourth paragraph is the one intended. The fifth paragraph says "in today's circumstances it would mean using part of the public sector surplus to acquire short-term assets, rather than reduce long-term Government debt, thus injecting money into the system at the shorter end of the market". The word "it" in this sentence presumably refers to the practice of overfunding. If so, the injection of "money into the shorter end of the market" must be the increase in bankers' balances due to the purchase of commercial bills from them. (The "short-term assets" acquired are these bills, which - as we have seen - come to appear on the assets side of the Bank of England's balance sheet.)

This story is, completely accurate as a description of how the money market adjusts to official gilt-edged sales. If Mr. Lawson wants to use the phrase "money in the system" in this sense, he is entitled to do so. But, again, this particular kind of "money" is *not* part of a traditional definition of the money supply. When the Bank of England buys bills from the bankers and restores their clearing balances, it changes the composition of banks' assets. But it does not change the quantity of banks' deposit liabilities. Only such deposits, held by the non-bank private sector, are included in the money supply, as conventionally understood.

An astonishing remark

The final sentence of the fifth paragraph claims that "such money" (i.e., bankers' balances at the Bank of England) "would be more likely to end up financing consumption" and concludes "it is not at all clear why this should be considered desirable". This is an astonishing remark. No reputable economist has suggested that changes in bankers' balances at a central bank influence consumption. Does Mr. Lawson seriously believe that the £200m. or so of operational balances held

by the clearers at the Bank of England have some role in explaining the behaviour of aggregate consumption, which amounts to about £275b.?

A plea for the clarification of official thinking

The purpose of the discussion so far has not been to indulge in elaborate verbal jousting just for the sake of it, but to ask for a clarification of official thinking on a major issue of public policy. As a journalist, Mr. Lawson had a well-deserved reputation for the precision, lucidity and elegance of his prose. (That was why he was invited to help write speeches for three successive leaders of the Conservative Party.) But the 1989 Mansion House speech was badly written and confusing. Mr. Lawson ought to be able to define what he means by words like "money", "liquidity" and "the system" and phrases such as "funding requirements". He ought also to be able to use these words and phrases clearly and consistently in official speeches. In particular, he must spell out exactly what he intended by the long sentence beginning "Quite apart from the limitations of broad money...". As we have seen, this sentence has at least four meanings, depending on what is understood by the hopelessly ambiguous phrase "money in the system". All four meanings are open to misinterpretation, they cannot all apply simultaneously and at least one is downright wrong.

Conclusion: control over broad broad money is necessary to contral of inflation

It is fair to ask, after this rather arduous analysis, why does it all matter? Why have we dissected a few hundred words of only one official speech with so much thoroughness? The answer is that much is at stake. The Government may think it has many choices in monetary policy, but in one crucial sense it has none. The speeches Mr. Lawson gave in 1979 and 1980 as Financial Secretary to the Treasury were correct. Control over broad money is a necessary condition for control over inflation. The ratio of broad money to money GDP cannot rise without limit; it is ultimately constrained by the refusal of people, companies and financial institutions to accumulate excess money balances. Whether the UK joins the EMS or not, inflation will not be reduced on a long-term basis unless the rate of broad money growth is also reduced.

And overfunding is essential to control of broad money

The Government has turned a blind eye to these ancient truths since 1985, at heavy cost to itself in terms of its political popularity and its reputation for fighting inflation. The original reason for its neglect of broad money was that it had become embarrassed by various so-called "distortions" due to overfunding. Anxiety about these distortions was basic to understanding why broad money targets were scrapped. The argument of the August 1989 *Gerrard & National Monthly Economic Review* was that the importance of these distortions had been much exaggerated. Mr. Lawson has subsequently defended his policy by putting about the claim that overfunding is futile because somehow "the money has to be injected back into the system". The point of this issue of the *Gerrard & National Monthly Economic Review* has been to refute Mr. Lawson's claim. The official case against overfunding is confused and incoherent, and does not stand up.

Appendix

The six key paragraphs on funding policy in the Mansion House speech

Below are the six paragraphs on funding policy which have been analysed in this paper:

> The purpose of funding is to ensure that the public sector as a whole does not inject liquidity into the economy - but nor should it extract liquidity from it.
>
> In recent years, the tightness of our fiscal policies has, of course, meant that, instead of funding a borrowing requirement we are defunding, or unfunding, a debt repayment: so we have had reverse gilt auctions and seen the Bank of England regularly purchasing gilts, rather than selling them, in the secondary market. But the principle remains what it has always been: to ensure that the Government conducts its financial affairs so as to have a broadly neutral effect on liquidity.
>
> There are some who argue that we should set this principle aside and return to the practice of deliberate over-funding in order to control the published figures for the broad money aggregates, which we indeed did for a time in the early 1980s, and in particular during my first two years as Chancellor.
>
> If this offered a better way of curbing inflation, I would of course gladly go back to it. But it would not do so. Quite apart from the limitations of broad money, which I have already described, any money drained out of the system by selling gilts over and above the Government's funding requirements, or by buying in fewer gilts than these requirements dictate, would simply have to be injected into the system elsewhere. If it were not, the outcome would be higher interest rates than those the authorities consider necessary.
>
> Moreover in today's circumstances it would mean using part of the public sector surplus to acquire short-term assets, rather than reduce long-term Government debt, thus injecting money into the system at the shorter end of the market rather than the longer end. Since such money would be more likely to end up financing consumption, it is not at all clear why this should be considered desirable.
>
> It is also worth recalling why over-funding was abandoned in 1985. It was creating distortions in the financial markets which were undesirable in themselves, and made policy harder to operate. The full fund policy avoids such distortions. It also means that as the Government reduces its debt it makes space for other borrowers in the sterling bond market. Since the beginning of 1988-89 the nominal value of gilts on issue has fallen by £13 billion, while over £16 billion of other sterling bonds have been issued. This replacement of public sector borrowing by the private and overseas sector incidentally exposes the fallacy that the Government has been artificially depressing long-term yields.