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Commentary on the economic situation

The slowdown is speeding up

Continuing scepticism about the slowdown is not justified

The March trade figures seem to have persuaded the *Financial Times* (26th April) that demand is not responding enough to the Government's high interest rate policy. The Lex column refers to demand remaining "surprisingly strong", while Mr. Samuel Brittan says in his 'Economic Viewpoint' that there can "no relaxation of the squeeze" if the Government wants to reduce inflation.

There will, indeed, be much difficulty about bringing inflation down on a sustained basis. Last September's *Gerrard & National Monthly Economic Review* argued that, on the plausible assumption that the natural rate of unemployment (i.e., the rate of unemployment at which pay settlements would stabilize) is 9%, a long period of beneath-trend output growth would be needed to dampen inflationary pressures. It therefore concluded - just ahead of the rise in base rates to 15% on 5th October - that "the slowdown needs to be speeded up". But that was six months ago. The *Financial Times*' writers are wrong if they think that demand is still buoyant now. On the contrary, the slowdown has speeded up very definitely and the prospect is that the economy will enter a recession in the second half of 1990 unless interest rates are cut soon.

The housing market and such indicators as sales of consumer durables and cars are classic lead indicators for the economy. The message they are now giving is clear. Orders for private housing in the three months to February were 41% lower than a year earlier; the latest figures from the John Lewis group show that department store sales in the eleven weeks to 14th April were a meagre 2.2% up in money terms (i.e., down in real terms) compared to the same weeks in 1989 and that the most recent week was 7.0% down on a year earlier; and car registrations, which continued to grow until mid-1989, were 9% lower in the first quarter 1990 than in the first quarter 1989. With the corporate sector also under great pressure to cut its stocks because of its large financial deficit, domestic demand must now be falling. Unless interest rates are lowered, it will continue to fall for the next two or three quarters.

Although high interest rates are working, the Government should remove excess money balances by overfunding

High interest rates are working and, in due course, will curb inflation. But that does not mean all is well with UK monetary policy. The large few years of mismanagement have created very large money balances, which are being kept idle only because of the attractive interest rates paid on them. These excess money balances need to be removed from the economy. At any rate the Government has finally recognised that something has gone wrong with monetary policy. This *Review* argues that the most serious mistakes were to end overfunding and scrap broad money targets in 1985. In our research paper we therefore consider in some detail five official objections to a resumption of overfunding and find them all unconvincing.

Tim Congdon — 27th April 1990

Summary of paper on

'The case for a resumption of overfunding, continued'

Purpose of the paper The 1990/91 *Financial Statement and Budget Report*, published at Budget time, and the Governor of the Bank of England's Durham Castle speech reiterated the official opposition to overfunding. This issue of the *Gerrard & National Monthly Economic Review* considers five objections to overfunding made in these two statements, and a number of others, in the last few months. It takes further the argument of the August 1989 ('The case for a resumption of overfunding') and the November 1989 ('Mr. Lawson on funding policy') *Reviews*.

Answers to the five official objections

Five official objections to overfunding are identified and listed below and on p. 4. The answers are also summarized below.

Objection 1. Overfunding reduces broad money, but broad money does not matter.
Answer: ***On the contrary, broad money measures plays a significant causal role in the inflationary process.***

Objection 2. Overfunding does not reduce broad money, because the money taken out has to be re-injected elsewhere in the system.
Answer: ***Simple accountancy shows that overfunding does reduce broad money.***

Objection 3. Overfunding does not reduce broad money, because it indirectly obliges the private sector to borrow more from the banks.
Answer: ***The end of overfunding in 1985 was followed by a sharp increase in bank lending to the private sector.***

Objection 4. Overfunding leads to the creation of a "bill mountain".
Answer: ***Broad money matters, the bill mountain does not.***

Objection 5. Overfunding distorts yield curves.
Answer: ***Yes, there are some distortions, particularly in the money markets, but these are secondary matters compared to the need for monetary control.***

This paper was written by Tim Congdon.

The case for a resumption of overfunding, continued

A critique of the Governor's Durham Castle speech and other recent official statements

Rise in inflation stimulates policy re-appraisal

The possibility of 10% retail inflation sometime in the next few months has made the Government and the Bank of England think hard about monetary policy. The section on monetary policy in the 1990/91 *Financial Statement and Budget Report* showed that policy-makers were keen to set out the thinking behind the key decisions of recent years. The Governor of the Bank of England's speech at Durham Castle (on 5th April) went even further, conceding that "something has gone badly wrong" and not denying "that policy mistakes and forecasting errors played a part". But in one respect both the *FSBR* and the Durham Castle speech were rather curious. While admitting that policy as a whole went wrong, they were unable to find much to fault in particular aspects of policy. For example, while it was recognised that interest rates were too low in much of 1987 and early 1988, this was seen as an essentially tactical misjudgement.

but no regrets about the decision to end overfunding

Officialdom apparently believes that it has been right on the framework of policy and large questions of strategy. In particular, it still thinks that broad money is an unreliable basis for policy decisions and that the official approach to funding policy in recent years has been appropriate. It remains opposed to overfunding. (In the early and mid-1980s overfunding was the policy of selling government debt to the non-bank private sector in excess of the budget deficit in order to reduce broad money. Nowadays, with the Government running a budget surplus, it would be the practice of making net gilt re-purchases of less than the surplus.)

The Durham Castle speech was particularly interesting in this context, since it set out a relatively new official argument against overfunding. The gist of this argument was that official sales of government debt in the capital markets "crowded out" private sector debt issues and so forced companies to borrow more from the banks. As a result, the reduction in broad money growth from higher official debt sales would be offset by the increase in broad money growth from higher bank lending. In Mr. Leigh-Pemberton's words, "the absence of government funding has arguably had less of an effect than might be expected on the growth of broad money".

Need for an analysis of official objections to overfunding

The August 1989 issue of the *Gerrard & National Monthly Economic Review* presented the argument for a resumption of overfunding, noting that "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". Since then the Treasury and the Bank have put forward a number of objections to overfunding, of which the Durham Castle speech is the most recent. The purpose of this issue

of the *Gerrard & National Monthly Review* is to assess whether any of these objections are valid. Our procedure will be to list the objections and analyse them one by one.

But perhaps we should note at the outset, in a consciously polemical spirit, the miscellaneous character of the official response. There has not been one official statement, with a lucid, confident and emphatic refutation of the case in our August 1989 *Review*. Instead there have been a series of statements, some from the Treasury, some from the Bank, each making two or three points, usually different from the points in the previous statement and sometimes inconsistent with them. Many people are undoubtedly weary with this debate and, indeed, the whole subject of monetary control. But they ought to ask themselves, "if the Government really knows what it is doing in funding policy, why does it hop from one argument to another? why can't it meet the critics head on?".

A list of the five key official objections to overfunding

The official objections to overfunding (with a suggested label, a summary and a reference to the speech or document in which they are stated most strongly) are as follows:

Objection 1. Irrelevance of broad money
Funding policy does reduce broad money, but broad money does not matter. (Several of Mr. Lawson's Mansion House speeches in the 1980s, the Durham Castle speech)

Objection 2. Ineffectiveness of overfunding (I)
Overfunding does not reduce broad money, because the money taken out by overfunding would have to be injected into the system elsewhere. (Mr. Lawson's last Mansion House speech in October 1989)

Objection 3. Ineffectiveness of overfunding (II)
Overfunding involves higher gilt sales than exact funding. The higher gilt sales reduce the private sector's scope to borrow from capital markets and therefore force it to borrow more from the banking system. As a result, the contractionary effect of higher gilt sales on broad money is offset by the expansionary effect of higher bank lending. (The Durham Castle speech)

Objection 4. The "bill mountain" and money market complications
Overfunding leads to an increase in the Bank of England's holdings of commercial bills, which may eventually reach the scale of a "bill mountain". This is undesirable, partly because of the large scale of bill transactions. (The 1990/91 *Financial Statement and Budget Report*)

Objection 5. Yield curve distortions
Overfunding causes various distortions in the money markets, because it requires that a large quantity of commercial bill be created to provide the raw

material for official operations in the money markets. The creation of these bills tends to make bill yields artificially low relative to inter-bank rates. Moreover, the heavy gilt sales at the long end associated with overfunding drive up long-dated gilt yields relative to both short-dated yields and money market rates. (Some of Mr. Lawson's Mansion House speeches in the late 1980s)

Before we discuss the objections, it is worth mentioning that they sometimes merge into each other. For example, objection 5 (on yield distortions) is closely related to objection 3 (ineffectiveness II), because the upward tilt imparted to the yield curve by overfunding is said to be one reason why the private sector borrows less from capital markets. However, the objections are independent enough to be analysed separately. (It should also be said that the objections are also occasionally inconsistent with each other. For example, there is something odd about complaining both that overfunding does not affect broad money growth (ineffectiveness I and II) and that broad money does not matter (the irrelevance of broad money). After all, if something does not matter, why worry about how it behaves?)

Analysis of the first objection, that broad money does not matter

The claim that "broad money does not matter" was not made in forthright terms in any official statement of the late 1980s, but it was implicit on many occasions. In several of his Mansion House speeches Mr. Lawson questioned the significance of broad money, apparently in the conviction that it no longer bore any close relationship with nominal GDP or inflation. The theme was developed in great detail in the Governor of the Bank of England's Loughborough speech on 22nd October 1986 and has been repeated on a number of occasions since. The Durham Castle speech is the latest example, with the Governor claiming that

> The case for overfunding depends on there being a robust and predictable relationship between the behaviour of broad money and the level of demand. There was indeed a time when we thought that this relationship was such that managing broad money did provide a reliable indirect means of managing demand, and thus inflation. But developments in the first half of the 1980s, including deregulation, led us to abandon that view, and nothing since has persuaded me that a firm relationship has been re-established.

Usually there are two ideas in mind

When Treasury ministers and Bank officials talk about the unreliability of broad money, they seem to have two ideas in mind which often become confused. The first is that the ratio of broad money to nominal GDP varies over time, which means that a particular x% growth rate of broad money will not be followed in due course by a particular x% growth rate of nominal GDP. The second is that the relationship between broad money and nominal GDP - as measured by econometric tests - is so untrustworthy that recent movements in broad money do not enable any worthwhile conclusions to be drawn about the future course of nominal GDP.

Changes in velocity of circulation not too serious a problem

It is only the second of these that is crucial. If the velocity of circulation were to change in a stable and predictable way, it would be straightforward for the Government to adjust its monetary targets accordingly. (Thus, if it knows with a fair degree of confidence that velocity will fall by 4% a year, a broad money target of 12% should lead - after some lag - to 8% growth of nominal GDP. If the trend rate of real output growth is 3% a year, that ought to be accompanied eventually by 5% inflation.) Nevertheless, the Treasury and the Bank have sometimes made statements - about the effect of changing real interest rates and financial deregulation on the demand for money - which imply that variations in velocity are by themselves a problem. This is not the case. If the authorities knew with reasonable accuracy how much changes in real interest rates or financial deregulation affected the desire to hold money, broad money targets could be adjusted for these special factors and still used as a means of influencing demand.

Unpredictability of changes in velocity, as revealed in econometric work, more fundamental

The second point appears, by contrast, to be very troublesome. If rigorous econometric tests show that the Government cannot be confident that x% growth of broad money will be associated over time with y% growth of nominal GDP, targets for broad money cannot achieve accurate management of demand. According to the econometrics, the problem is not that the velocity of circulation varies but that it varies unsystematically and unpredictably. It seems to follow - in the words of the 1987 Budget speech - that there is ample justification for "eschewing an explicit target altogether". For Mr. Lawson and his key advisers in the mid-1980s the econometric tests were the nail in the coffin of broad money targetry.

But lack of confidence in a statistical relationship is not the same thing as the absence of a relationship

In fact, this was the key blunder. Strictly speaking, the econometric tests did not show that there no relationship between broad money and nominal GDP; they showed only that the Government could not have much confidence in the best estimate of nominal GDP likely to be associated with a particular rate pf broad money growth. A lack of confidence in the precision of a relationship is not the same thing as the absence of a relationship. It is one thing to say that, if M4 growth in 1986 is 15%, we cannot predict with an acceptable degree of probability that nominal GDP growth in 1987 will be between 10% and 14%; it is something quite different to claim that, if M4 growth in 1986 is 25% rather than 15%, the higher monetary growth will have no effect whatsoever on nominal GDP in 1987, 1988 and 1989.

Misuse of econometrics seems to have led to a dreadful error

If the Treasury and the Bank did convince themselves from their econometric work that broad money could vary over a very wide band and have no effect on macroeconomic outcomes, they were making a dreadful error. But there is little doubt - in view of the sequence of policy decisions and statements - that this is more or less what they did. The mistake was substantially a linguistic one and stemmed essentially from carelessness in the use of words. The various officials were so hallucinated by their high-powered econometrics, with all the

magic of extreme mathematical complexity, that they forgot to check what statistical statements actually mean. If Mr. Lawson and his advisers did believe that the economy would behave much the same in 1989 and 1990 with broad money growth in 1986 and 1987 averaging 20% rather than 10% (or 18% rather than 12%, or 16% rather than 14%), they were very wrong.

as well as the selection of M0 as the key monetary aggregate

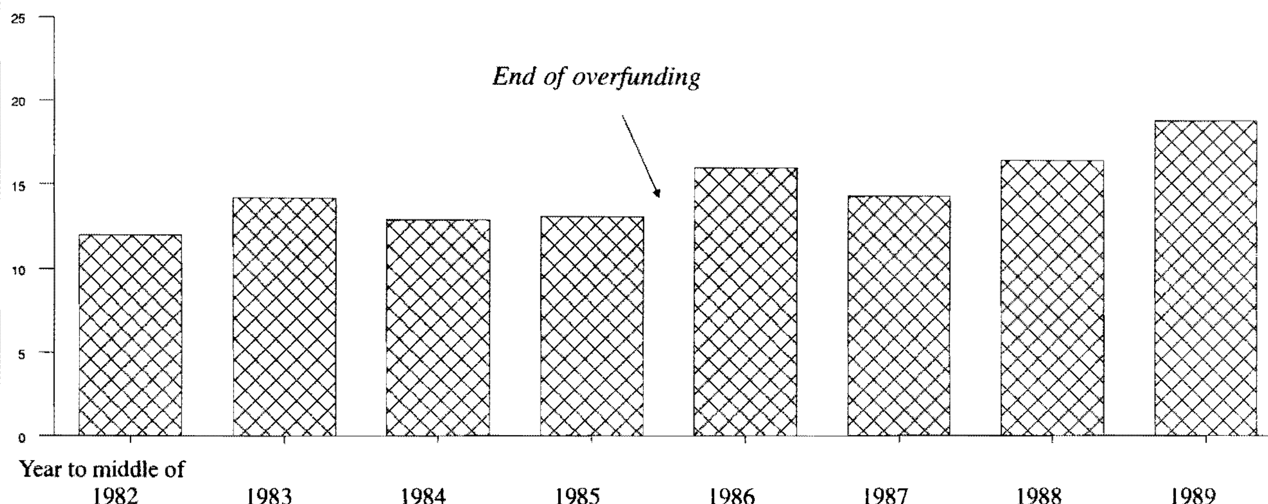
Over-reliance on econometrics is also largely to blame for the selection of M0 as the key aggregate for policy purposes. As explained in the April *Gerrard & National Monthly Economic Review*, narrow money measures - and particularly M0 - do not determine nominal GDP, but are instead substantially determined by it. The high quality of the econometric relationships between M0 and nominal GDP do not mean that M0 has any great macroeconomic significance, but is merely a tribute to the efficiency of money transmission in this country. (Because the clearing banks are so good at supplying notes and coin to the economy, their customers can keep notes and coin closely in line with their spending requirements.) Nevertheless, the econometrics persuaded Treasury civil servants to favour M0.

Only broad money can play a causal role in the inflationary process

The 1990/91 *FSBR* admitted that M0 is only an indicator of the economy, not a cause of inflation. But it still insisted that inflation is a monetary phenomenon with monetary causes. As a matter of logic, the Treasury must now concede that some other measure of money plays the causal role. As we saw in last month's *Review*, that measure of money has to be one which agents cannot easily adjust by money transfers (i.e., transfers between different kinds of bank account or between their bank accounts and notes and coin). It turns out that only broad money measures have this property; it is therefore these measures which are responsible for inflation.

Broad money growth and overfunding

Chart shows % growth of M4. Adjustments have been made to M4 in the year to mid-1982, to reflect breaks in statistical series. The faster rates of money growth after the end of overfunding are obvious.



In fact, the quest for precise econometric relationships has been the bane of recent monetary decision-taking. The economists who have busied themselves in this activity seem to have forgotten that monetary targets were introduced in the mid-1970s not as a means of "managing demand". (It is intriguing that this phrase should appear in the Durham Castle speech.) Instead they were introduced because of despair at the lamentable forecasting record of large-scale econometric models and disillusionment with fiscal fine-tuning. British macroeconomists were as bad in their failure to forecast the Barber boom of the early 1970s and the later inflation, as they have been with the Lawson boom of the last few years.

If excessive growth of broad money causes inflation, anything which results in faster growth of broad money is inflationary. If the 1985 decision to move from overfunding to exact funding did lead to faster growth of broad money, it must therefore have been inflationary. So we must now look at the two "ineffectiveness" objections to overfunding to see whether overfunding does reduce broad money growth or not.

Analysis of the second objection,* *that money taken out by overfunding has to be re-injected elsewhere

The most complete statement of the first "ineffectiveness" objection was in October 1989 Mansion House speech, where Mr. Lawson devoted six paragraphs to funding policy. The key sentence ran, "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."

The November 1989 *Gerrard & National Monthly Economic Review* examined this sentence in much detail and argued that it had at least four meanings, depending on whether "money in the system" referred to broad money (i.e., notes and coin, and private sector deposits), the total of private and public sector deposits, bank lending to the private sector or bankers' balances at the Bank of England. The speech was such a muddle that all of these interpretations could be construed from one passage or another. At any rate, if the speech meant broad money by the phrase "money in the system", it was wrong. The Chancellor may have intended one of the other three meanings, all of which were right in some sense or other, but presumably he did not want his speech to have three meanings simultaneously.

Officialdom seems to have dropped this objection

There has been no answer to the criticisms made in the November *Review* and no official clarification of the speech. Moreover, this objection to overfunding was not repeated in either the 1990/91 *FSBR* or the Durham Castle speech. Apparently it has been dropped. It does not need to be discussed further here.

Instead we have to consider a second "ineffectiveness" objection, the one given in Mr. Leigh-Pemberton's Durham Castle speech. The key passage is as follows:

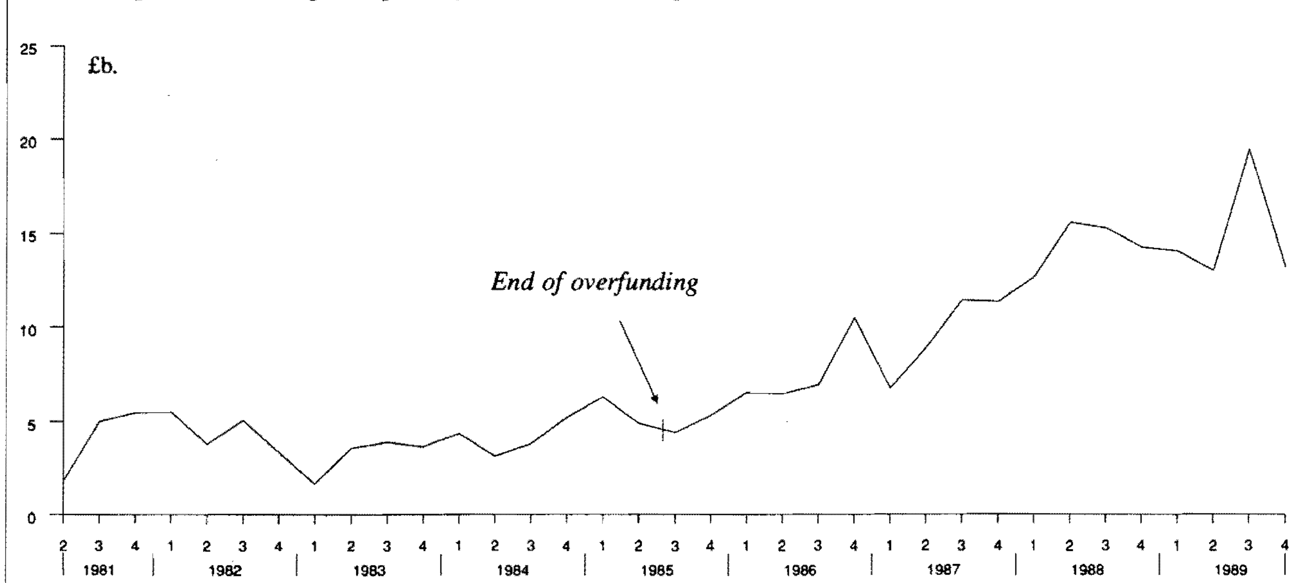
Analysis of the third objection, ***about official gilt sales "crowding out" private sector from capital markets***

funding - or, rather, over-funding - has in any case become a less than effective means of managing broad money. While there are various accounting relationships that suggest this this might be straightforward, in fact in the real world we have to take account of the behaviour of other users of the capital markets. In contrast to the early 1980s when the private sector made very little use of the sterling capital market, it has not unexpectedly exploited the opportunity to tap the market for funds since the Government ceased to be the dominant borrower; indeed, "crowding out" has been replaced by "crowding in" on an impressive scale. In consequence, the absence of government funding has arguably had less of an effect than might be expected on the growth of broad money.

In other words, the money taken out of capital markets by official gilt sales reduces the amount that the private sector can borrow in capital markets. The private sector therefore borrows more from the banking system. It follows that the contraction in broad money due to gilt funding is largely offset by the increase in broad money due to the additional bank lending.

If correct, the third objection would have devasting consequences for monetary theory and policy

If this line of argument were correct, it would have devastating consequences for monetary theory and policy, as traditionally understood. Generations of textbook writers and Bank of England officials have taken it for granted that funding operations take liquidity out of the economy and reduce the inflationary threat from budget deficits. In the Durham Castle speech the Governor has denied the validity of this thoroughly conventional view. What - one has to ask - was the rationale for the Treasury's and the Bank's approach to debt management over the last three centuries?



The Durham Castle speech presumably did not mean that any increase in official gilt sales to non-banks is matched by a similar increase in bank lending. Instead the idea may be that net gilt sales up to the level of the budget deficit have no effect on bank lending, whereas net gilt sales above the deficit increase it bank lending by roughly the same amount. Mr. Leigh-Pemberton gave no justification for this arbitary cut-off point, which is hardly surprising since it is difficult to imagine why there should be one.

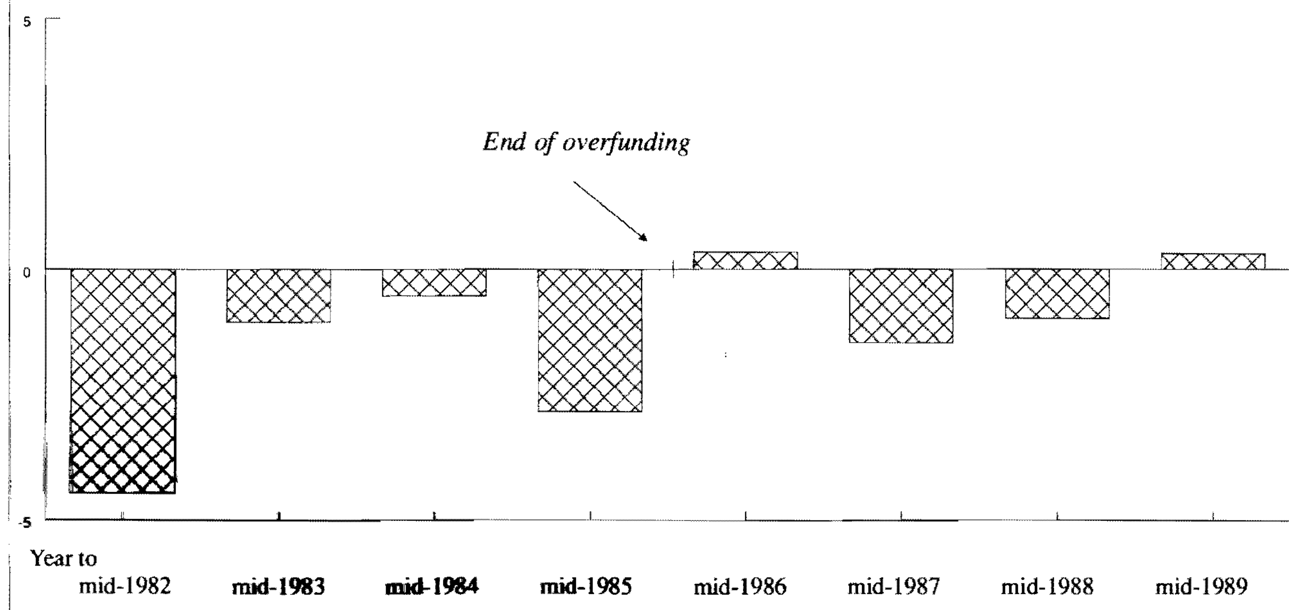
But it is contradicted by the facts

The question can, however, be resolved to some extent by looking at the facts. If the Governor were right, the end of overfunding in mid-1985 ought to have been followed by lower bank lending to the private sector and little change in the rate of broad money growth. In fact, new bank lending to the private sector soared in the three years from mid-1985, while broad money growth (on either the M3 or M4 measures) increased noticeably. In the first and second quarters of 1985 bank lending to the private sector was £6.3b. and £4.9b. respectively; in the third and fourth quarters of 1988 it was £15.2b. and £14.2b. M4 growth in the four years to mid-1985 averaged 13.1%; in the four years afterwards it averaged 16.4%.

The conclusion has to be that this second "ineffectiveness" objection to overfunding, just like the first one, does not stand up. It has neither theoretical underpinning nor factual support.

Impact of public sector financial transactions on M4 growth

Chart shows public sector contribution as % change in M4. The end of overfunding in mid-1985 clearly had an effect, in simple accounting terms, on M4 growth.



Analysis of the fourth objection, on the "bill mountain"

The fourth objection points to the "bill mountain", the accumulation of commercial bills in the hands of the Bank of England, as the main drawback of overfunding. There is no doubt that a bill mountain did emerge in the mid-1980s and that it was a direct result of overfunding. The payments received from gilt sales in excess of the PSBR were credited to the Government's account at the Bank (i.e., on the liabilities side of its balance sheet) and the Bank used the money to purchase bills from the banking system (i.e., with the bills then forming part of the Bank's assets).

Appearance of bills among Bank of England's assets rather than among banks' assets had no macroeconomic significance

But, so what? The emergence of the bill mountain had, in itself, no implications for inflation, unemployment or the balance of payments. It mattered very little to any important economic variable that bills appeared on the *asset* side of the Bank of England's balance sheet rather than among the *assets* of the commercial banks. Of course, there was a vital monetary side-effect associated with the bill mountain, as it changed the composition of the banking system's *liabilities*. Because of the bill mountain, overfunding had the result that lending to the private sector led to an increase in government deposits (which have no wide macroeconomic significance) rather than an increase in private sector deposits (which are of immense macroeconomic significance). But - by itself - the reshuffling of bills between the Bank of England and the banks was a trivial matter, with no meaning for the wealth, health and happiness of nations.

The passage on the bill mountain in the 1990/91 *FSBR* runs as follows:

> With sales of debt greater than the public sector's net borrowing needs, the excess had to be recycled into a build-up in the public sector's holdings of financial assets, such as commercial bills. Rather than proving of practical benefit, sustained overfunding made monetary policy increasingly difficult to operate. It also created undesirable distortions in the financial markets, discriminating in particular against long-term private sector borrowing for investment.

And that is all. Apart from the reference to distortions (objection five, to be discussed below), no substantial reason is given for regarding the bill mountain as a proper matter of public concern. There may have been some problems of money market management due to overfunding, simply because of the volume of bills being transacted. But it ought not to have been beyond the wit of man to devise arrangements to ease the difficulties, such as they were. The authorities could have encouraged the relevant parties to increase the original term to maturity on the bills, in order to reduce the volume of transactions; or, if they really did dislike the pile of bills on the Bank's balance sheet, they could have suggested that the Government switch some of its deposits to the commercial banks, in order that the banks could again hold the bills among their assets. To end overfunding because of arcane problems like these was to throw out the monetary baby with the technical bathwater.

Analysis of the fifth objection, that overfunding distorted yield curves

What, finally, about the "distortions" to yield relationships alleged to have accompanied overfunding? These were considered at some length in the August *1989 Gerrard & National Monthly Economic Review* and perhaps do not need to be discussed again. The claim that overfunding raised long rates relative to short rates is difficult to sustain in view of actual experience in the early 1980s. 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%. The "distortion", if there was one, seems to have been the opposite of that alleged!

By contrast, overfunding certainly did have an effect on the relationship between bill rates and inter-bank rates, and this effect did amount to a distortion. (Occasional arbitrage possibilities between bills and inter-bank funds demonstrated the point.) But, again, how important was this compared to the need to keep the growth of broad money under control? If distortions to money market interest rate differentials caused the authorities in 1985 to cast aside the entire framework of financial control on which they had relied for a decade, they had surely lost their sense of proportion.

The official objections to overfunding do not stand up

None of the five objections to overfunding stands up. As we said earlier, the official reply to the critics of its funding policy has been curiously miscellaneous and inconsecutive. That is not an accident, but a reflection of confusion and incoherence of official thinking. The Government has finally accepted that serious mistakes in monetary policy occurred in the late 1980s. It ought now to recognise that the most important of these mistakes were the decisions to end overfunding and scrap broad money targets in 1985.