Money and Asset Prices in Boom and Bust

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The Institute of Economic Affairs

First published in Great Britain in 2005 by
The Institute of Economic Affairs
2 Lord North Street
Westminster
London SW1P 3LB
in association with Profile Books Ltd

The mission of the Institute of Economic Affairs is to improve public understanding of the fundamental institutions of a free society, with particular reference to the role of markets in solving economic and social problems.

A CIP catalogue record for this book is available from the British Library.

ISBN 0 255 36570 5

Typeset in Stone by MacGuru Ltd
info@macguru.org.uk
Printed and bound in Great Britain by Hobbs the Printers

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THE AUTHOR

Professor Tim Congdon is one of Britain's leading economic commentators. He was a member of the Treasury Panel of Independent Forecasters (the so-called 'wise men'), which advised the Chancellor of the Exchequer on economic policy, between 1992 and 1997. He founded Lombard Street Research, the City of London's leading economic research and forecasting consultancy, in 1989, and is its Chief Economist. He has been a visiting professor at the Cardiff Business School and the City University Business School (now the Sir John Cass Business School). He has written a number of books on monetary policy, contributes widely to the financial press, and makes frequent radio and television appearances. He writes a column in the Institute of Economic Affairs journal, *Economic Affairs*. He was awarded the CBE for services to economic debate in 1997.

FOREWORD

The Institute of Economic Affairs was at the forefront of promoting a wider understanding of the relationship between the money supply and inflation at a time when virtually the whole of the British economics profession was either sceptical or hostile to monetarism. Eventually, the IEA succeeded in educating a generation of economists, commentators, opinion formers and policymakers. Now it is widely believed not only that inflation is a monetary phenomenon, but that output and employment cannot be expanded, in anything other than the short term, by loosening monetary policy. The decision to make the Bank of England operationally independent, in May 1997, perhaps suggests that the IEA's work in this field is complete.

But to take this view would be to exhibit a reckless degree of complacency, for two reasons. The first is because fashions in economic opinion can change if correct and rigorous theories are not updated and explained in terms relevant to changed times. The second is because, while the basic, underlying, long-term relationship between money and inflation is widely accepted, many aspects of monetary policy are not well understood. Arguably, it is for this reason, among others, that inflation did not fall smoothly from the high levels of the 1970s to the lower levels of today, and it is also for this reason that there were booms and busts in asset prices and the real economy during the intervening 30 years.

In Hobart Paper 152, Tim Congdon argues that, on many occasions in the last 30 years, policy-makers have taken their eyes off money supply growth. As a result, we have suffered booms and busts in asset prices and lapses in our record of reducing and then controlling inflation. Congdon looks at several episodes in history, such as the Great Depression in the USA, the bubble of the late 1980s in Japan and the subsequent malaise of weak demand in the 1990s, and the Heath–Barber boom of the early 1970s in Britain. He concludes that in every case the underlying cause was a large fluctuation in the growth rate of the money supply, broadly defined to include all bank deposits. When broad money growth is too rapid, excess money leads to asset price gains and buoyant demand, and ultimately to inflation. On the other hand, when broad money growth slows too abruptly (and particularly when broad money contracts), asset prices and demand weaken, and in due course inflation moderates or is replaced by deflation.

Despite the widespread acceptance of the monetary explanation of inflation in general terms, the details of the transmission mechanism from money to the economy remain controversial. Congdon argues that in the UK poor understanding of the transmission mechanism was responsible for mistakes in monetary policy in the late 1980s (in the so-called 'Lawson boom'). These mistakes were similar to those in the Heath–Barber boom of the early 1970s. Largely because of violent swings in money supply growth, an asset price boom and subsequent inflation were followed by a slump in asset prices and a recession.

It is tempting to dismiss ideas about the relationship between the money supply and the economy as issues that should be discussed mainly by central bank technocrats and academics, as technical matters relevant only to those involved with the minutiae of monetary policy in a world where most people are persuaded that inflation is a monetary phenomenon. To do so would be very dangerous. Congdon's message is relevant to financial institutions that are making forecasts about the future direction of equity and bond markets. It is relevant to individuals trying to deal with 'ups and downs' in housing markets. Most of all, if Congdon is right, and if his message is not understood by policy-makers, there will be surges and slumps in inflation as we have continually to relearn the lesson that money matters. Indeed, many argue that at least the scale of the Conservatives' last three election defeats, if not their fact, can be explained by the mismanagement of the economy between 1985 and 1992. Congdon argues that the dramatic increase in broad money growth in the late 1980s and the plunge in broad money growth in the early 1990s, which reflected mistakes in monetary policy, were the main causes of the boom–bust cycle. If the boom–bust cycle had been avoided, our recent political history might have looked rather different.

Thus the issues raised in Hobart Paper 152 are of profound importance, not just to those involved with directing and commenting on economic policy, but also to a wider public, including those working in financial markets and those who wish to understand recent political history.

The views expressed in this Hobart Paper are, as in all IEA publications, those of the author and not those of the Institute (which has no corporate view), its managing trustees, Academic Advisory Council members or senior staff.

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July 2005

SUMMARY

- While most economists today accept that inflation is a monetary phenomenon, there is still much dispute about the mechanism of transmission from monetary policy to inflation and about the significance of different measures of the quantity of money.
- These areas of dispute are extremely important in policy-making. If appropriate measures of the money supply are not monitored and controlled, serious episodes of 'boom and bust' will arise.
- In the USA and to some extent the UK the quantity of broad money has been neglected in setting monetary policy in the last few years. Interest rates have been regarded not just as the main or even the only instrument of monetary policy, but as defining the stance of monetary policy.
- Fluctuations in the growth rate of broad money played a causal role in:
  - the UK's boom–bust cycles of the 1970s and 1980s (i.e. the Heath–Barber boom and subsequent bust of the early 1970s, and the Lawson boom and ensuing recession between 1985 and 1992);
  - the US's Great Depression in the early 1930s; and
  - the Japanese bubble in the 1980s and the macroeconomic malaise of the 1990s.

- In the upswing phase of the Heath–Barber boom and the Lawson boom, the broad money holdings of non-bank financial institutions rose explosively. This led directly to an asset price boom as institutions tried to adjust their money balances to the desired proportion of their total portfolios.
- The US's Great Depression was accompanied by a collapse in broad money and the Japanese asset price malaise of the 1990s by stagnation in broad money.
- Because of the link between assets and goods markets, asset price booms play a major part in the development of general inflation that inevitably follows a period of lax broad money growth.
- Causality runs from money to asset prices and inflation, not the other way round. In an analysis of the mechanisms at work it becomes clear that the quantity of broad money, but not of narrow money, can cause financial institutions and companies to change their behaviour. In fact, the narrow money holdings of companies and financial institutions are insignificant.
- Theories that relate asset price booms to the volume of credit, or to bank lending, rather than to the quantity of money are misconceived.
- The key variable for understanding and controlling periods of boom and bust is the growth of broad money. The behaviour of the quantity of broad money will remain fundamental to understanding the behaviour of asset prices and the general price level in market economies in the future.

TABLES AND FIGURES

AUTHOR'S PREFACE

The themes of this paper have been with me for my 35 years as an economist, first as a student and then as a practitioner in the City of London and a visiting professor at two business schools. The paper's central message is simple and has always seemed obvious to me. It is that fluctuations in asset prices and economic activity must be related to, and can be largely explained by, more or less contemporaneous fluctuations in a broadly defined, all-inclusive measure of money. But aspects of the analysis are quite complex and have over the years generated immense controversy, particularly my insistence that only a broadly defined aggregate can be relevant to the determination of asset prices (and so of national income). As the controversies have sharpened my thinking, I would like to thank a number of people for their contribution to its development.

I first applied a naive theoretical understanding of monetary economics to the day-to-day reporting and interpretation of events as a journalist on *The Times* between 1973 and 1976, and am hugely grateful to Peter Jay, then the economics editor, and William Rees-Mogg (now Lord Rees-Mogg), then the editor, for their interest in my work. I developed parts of the argument as one of the economics partners of the stockbroker firm L. Messel & Co., and benefited from collaboration with Paul Turnbull, particularly in the introduction of the concept of 'mortgage equity withdrawal'. In the late 1970s I got to know Terry Burns (now Lord Burns) and Alan (now Sir Alan) Budd at the London Business School, and we usefully discussed the impact of excess money on the prices of foreign goods and assets via the exchange rate. Later Dr Peter Warburton worked with me in creating a small econometric model of the UK economy incorporating monetary variables. Together we forecast the main features of the 'Lawson boom' in 1987 and 1988, when virtually all other forecasting groups were hopelessly wrong. I founded a company, Lombard Street Research, in 1989 to analyse the relationships between money and the economy in greater depth. I was lucky there to have the support both of numerous clients and of several excellent colleagues, and I would particularly like to mention Simon Ward and Stewart Robertson. Simon and Stewart carried out most of the difficult back-room work on the Lombard Street Research model, and I am most grateful to them. The current chairman of Lombard Street Research, Professor Gordon Pepper, has challenged and improved my thinking, and again I must say 'thank you'. Much of the work in this paper was carried out while I was engaged in a more ambitious research project at Cardiff Business School. Richard Wild, now of the Office of National Statistics, was my research assistant at Cardiff and helped me by preparing an index of asset prices, and again: 'thank you'. I am also much obliged to my editor at the IEA, Professor Philip Booth, who asked some good questions, kept the study under control and made necessary changes.

Over the years I have benefited from considerable interaction with academic economists. Professor Vicky Chick, Dr Walter Eltis, Professor Charles Goodhart and Professor David Laidler have commented on my pieces with sympathetic criticism, and I owe them a great deal. Professor Allan Meltzer disagrees with the main thesis of this paper, but I greatly valued his thoughts on it. Finally, may I say that some of the best criticism of my work in the last two years has come from Milton Friedman? He has taken time and trouble to find weak links in the argument, and to point them out to me. My debt to him both for this, and as the background inspiration for much of my work for over 30 years, will be obvious from the paper itself. However, my emphasis on the role of *broad* money in the determination of asset prices, and on the rather chaotic and highly institutional nature of the processes at work, now seems to me more Keynesian than monetarist in spirit. In effect the whole paper is an analysis of the empirical significance of the speculative demand for money. But in one respect Keynes was wrong and Friedman right. In the real world instability in the *supply* of money is a far more important cause of macroeconomic turbulence than instability in the *demand* for money.

Of course, I alone am responsible for the contents of the paper and its remaining mistakes.