The blunders of boom and bust

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Economic Agenda

Stability has been the greatest economic blessing of the period since Black – or Golden – Wednesday (September 16 1992) when the pound was expelled from the European exchange rate mechanism. Inflation has been within 1 per cent either side of 2 to 2·5 per cent, demand and output have grown without interruption, and employment has increased from 25·5m to almost 29m. These have been the Nice (non-inflationary, consistently expansionary) years of which the Bank of England – in charge of economic management since 1997 – has rightly been so proud.

The 1970s and 1980s seem a long time ago; for the young, the boom-bust era is barely a memory. The first-time homebuyer in 2006 would be startled to be told that the average mortgage rate in the 1980s was 12 per cent, over double what he or she would regard as a high rate.

But will economic Niceness last for ever? Crucial in any assessment of the future is an analysis of the past and, in particular, an explanation of why the boom-bust cycles happened. The subject is difficult and hugely controversial. However, one view – that the boom-bust cycles were caused by wild swings in monetary growth – is backed by a great deal of evidence.

The bad old days

THE typical cycle started with a cut in interest rates or a relaxation of credit restrictions. That encouraged the banks and building societies to lend more, with much of the extra credit financing house purchase. When banks increase their loans, they also expand their deposits. Deposits are money that can be spent an indefinitely large number of times in the future.

So low interest rates and credit relaxation – as in late 1971, mid-1977 or late 1985 – were followed by rapid growth of bank deposits in 1972, 1978 and 1986. Within the UK, the extra deposits then had to be held by households, companies or financial institutions. It followed that if the money holdings of one of these three groups grew at much the same rate as before, the rise in the growth rate of total bank deposits had to be accompanied by a leap in the growth rate of the deposits held by one or the other of the two groups. In practice, much the same pattern was repeated in all the big fluctuations in the boom-bust era.

The household sector's money balances plodded along at much the same sort of growth rate year after year, roughly in line with personal incomes. Companies' bank balances were more volatile, but were still related to turnover and activity. The result was that quite modest changes in the growth rate of total money translated into enormous swings in the growth rate of money held by the remaining sector, the financial institutions.

Total money (dominated by bank deposits, but with notes and coin tacked on) rose by 20 per cent in 1972, 15 per cent in 1978 and 15 per cent again

Does the explosion in financial sector money matter?

in 1986 and 1987. Now annual money supply growth rates of 15 to 20 per cent are much too high, and should have by themselves warned policy-makers that excessive risks were being taken with inflation. But the growth rates of money held by financial institutions were even more fantastic, at 60 per cent (yes, 60 per cent!) in 1972, over 20 per cent in 1978, 28 per cent in 1986 and almost 60 per cent (incredible though it may seem) in 1987.

Monetary analysis in the UK was discouraged in British universities in the immediate post-war decades, largely because of a misunderstanding of the policy message of Keynes' great book, *The General Theory of Employment, Interest and Money*. So the clever backroom boys at the Treasury and the Bank of England were bewildered by these huge oscillations in financial sector money. They told the senior officials that annual growth rates of financial sector money of 20 per cent, 30 per cent or 60 per cent were the result of "distortions" and could be ignored, and the senior officials passed their conclusions on to the politicians.

This was the source of dreadful mistakes in monetary policy and, hence, of the boom-bust cycles themselves. Financial institutions are varied and complex entities, and there is ample scope for debate about the details of the relationship between their money-holding behaviour and the rest of their activities. But to dismiss the annual growth rates of financial sector money of 30 to 60 per cent as entirely due to "distortions" was to fail to see the wood for the trees.

Money myopia

BRITISH macro-economists suffer from a deeply engrained tendency to separate developments in financial markets from developments in "the real economy" of shops and factories. Financial institutions don't buy groceries in supermarkets. But most financial institutions – pension funds, insurance companies, unit trusts, even hedge funds and private equity groups – have to balance their money holdings against their other assets. Many of them try to keep a stable ratio of money to total assets. So the result of the 30 to 60 per cent money growth rates in the financial sector was wild asset price inflation.

Each organisation by itself thought that it could get rid of its excess money by buying more shares or office buildings or unquoted companies than it was selling. But – for all organisations taken together – the buying was identically and necessarily equal to the selling. The desired stable ratio of money to assets was restored by asset prices catching up with the 30 to 60 per cent money growth. So 1972, 1978, 1986 and 1987 were all wonderful years for both asset prices and the incomes of stockbrokers, estate agents and the other worthies of free market capitalism.

The truth is that financial markets and the real economy are closely interrelated. People can sell shares to buy houses, and sell houses (or borrow on their security) to buy cars and foreign holidays. Every participant in financial markets needs to be reminded of the famous quip "Where are the customers' yachts?" at the top of the American stock market in 1929. Nevertheless, a fair deduction is that US yacht production was higher in 1929 at the stock market peak than it was in 1933 at the stock market trough. And in the UK, the booms of 1972, 1978, 1986 and 1987 were followed by busts between two and four years later.

The end of bust?

WHAT is the relevance of this discussion at present? The answer is provided by the accompanying chart. As it shows, the growth rate of money held by households is a virtual straight line for almost a decade, reflecting the stability of inflation and personal income growth. By contrast, financial sector money cavorts all over the place. Since late 2004 its growth rate has been climbing, and in the year to July it went up by about 30 per cent. The 30 per cent figure is the highest since 1989, the final year of the Lawson boom.

The past two years have been a good period for asset prices and economic growth. Fortunately, they have not been as "good" as 1972 or 1987, but they do bear a mild resemblance to the boom phases of the boom-bust episodes.

Is a bust inevitable? Although the precedents are discouraging, the economy is not as over-extended as in boom phases of the boom-bust cycles, and the Bank has done a much better job in the past few years than in the 1980s. Let's hope that the clever backroom boys advising the Monetary Policy Committee now know how to separate out the distortions from the fundamental trends. They are probably telling the MPC that further increases in interest rates will be necessary.

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