

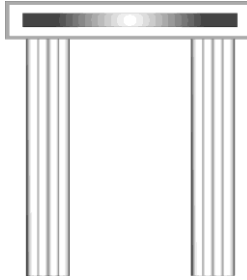


Douglas Carswell

**After Osbrow**  
**Mending Monetary Policy**

**POLITEIA**

A FORUM FOR SOCIAL AND ECONOMIC THINKING



# POLITEIA

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# I

## A Flawed Recovery

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Growth is back and output is rising.<sup>1</sup> Sales and house prices are up.<sup>2</sup> Unemployment has fallen faster than expected.<sup>3</sup> Each week seems to bring a flurry of upgraded forecasts.

Like the arrival of spring after a long winter, imminent economic recovery seems to have lifted the mood of the pundits from gloom to boom. But headline growth figures do not tell us the full story. They only tell us about headline growth, not why there is growth.

Strong though the increase in output may well be, the recovery is likely to be flawed. It is possible to raise output – and all other kinds of economic indices – with a combination of cheap credit and by having government spend more than it takes in tax. The trouble is, as Ted Heath once found out, doing that is not quite the same thing as sustainable growth.

‘We want to create a ... more balanced economy’, the prime minister told us, ‘where we are not so dependent on a narrow range of economic sectors’ ... with growth ‘shared between regions and industries’. Now that growth has arrived, it is hardly the balanced sort the prime minister said we need. Instead of a healthy recovery, the economy is in remission – ‘drugged on cheap money, subsidised credit and rock-bottom interest rates’.<sup>4</sup>

Rebalancing the economy ought to mean consuming and borrowing less, and investing<sup>5</sup> and producing more. If consumer spending remains below its peak, with output having fallen even further, we are more – not less – dependent on consumer spending than ever before. The current account deficit has deteriorated from 1 per cent of GDP in 2009, to an estimated 3.7 per cent for 2013, suggesting excessive demand and consumption. Far from Britain having an export-led recovery, we should bear in mind that tiny Belgium today sells more to India and China than we do. Manufacturing continues to decline as a share of GDP. Productivity is falling. Non-wage labour costs have risen, yet wages have failed to keep pace with living costs. Energy prices are high, and rising. Instead of saving more, the savings rate has fallen to its lowest level since the first quarter of 2009, to just 4.9 per cent. We now invest, in the correct sense of the term, less than 158 other countries around the world, as a

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<sup>1</sup> GDP growth averaged approximately 1 per cent between 2010 and 2012. The IMF now forecasts GDP will have increased by 1.4 per cent in 2013 and almost 2 per cent in 2014. Others, such as the Confederation of British Industry are now forecasting as much as 2.4 per cent in 2014.

<sup>2</sup> The price of the average UK house grew by over 8 per cent in 2013. Office of National Statistics data showed a strong increase in year-on-year retail sales in September 2013, and there has been a steady rise in consumer confidence.

<sup>3</sup> Office of National Statistics data shows unemployment has fallen to 7.4 per cent, faster than many expected.

<sup>4</sup> *If you think Britain is on its way back to prosperity*, Allister Heath, *The Telegraph*, July 23<sup>rd</sup>, 2013.

<sup>5</sup> The term “investment” in this paper is used in the correct economic sense, to denote the purchase of goods that are not consumed today but are used in the future to create wealth. It is not used as shorthand for public spending.

share of national income. Total public and private investment has collapsed by over a quarter since 2008, while government consumption is up by 6 per cent.

The Coalition's 'most urgent task', said David Cameron and Nick Clegg when they came to office in May 2010, was to 'tackle our record debts' and restore sanity to Britain's public finances. However, it now appears that the Coalition will borrow more over five years than Gordon Brown did in thirteen. The chancellor, George Osborne, may speak of paying down our debt. He has increased it, with public sector net debt expected to rise from £1.104 trillion in 2011/12 to £1.637 trillion in 2017/18. This financial year 2013/14, Mr Osborne will spend a mere £16 billion less in real terms than his predecessor managed to during his final year in Downing Street.<sup>6</sup> The deficit – the gap between what the government takes in tax and spends each year – might be falling, but this year the government is still likely to spend £100 billion more than it takes in tax.

George Osborne likes to describe himself as a 'fiscal conservative' but 'monetary activist'. It is a curious kind of fiscal conservatism that outspends Gordon Brown.<sup>7</sup> The Coalition not only failed to meet its own deficit reduction targets, but also failed to meet the more modest deficit reduction targets set by Gordon Brown's chancellor, Alistair Darling. Far from being fiscally conservative, the gap between what the government spends and what it takes in tax is so large that by 2015, the current chancellor will have presided over the largest Keynesian stimulus in our history.

As for monetary activism, Mr Osborne has picked up where his predecessors left off. Despite the debate about which party would cut the deficit faster, neither the Conservatives nor Labour even pretend to hold an opposing view about monetary policy.

Three chancellors, Gordon Brown, then Alistair Darling, and now George Osborne, have presided over a £375 billion money creation scheme known as Quantitative Easing (QE). On their watch, the monetary base has expanded far beyond any corresponding increase in output. Interest rates have been held down about as low as it is possible to go. Cheap credit has been made available to banks. Banks have been pressurised to make cheap loans available to business. The Coalition's flagship 'Help to Buy' scheme seems rather similar to what Alistair Darling had in mind before the last election. Gordon Brown believed that cheap credit – together with wise central bankers – was the way to produce prosperity. Today George Osborne looks to low rates – and the munificence of the new Governor of the Bank of England, Mark Carney – to conjure growth.

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<sup>6</sup> Public sector total manage expenditure in 2009/10 was £719 billion. Latest Office of Budget Responsibility forecasts expect it to be £703 in 2013/14. In constant 2012/13 prices, that means a fall of a mere £16 billion! Public spending is forecast to fall to £699 billion in 2017/18 – a fall of a further £4 billion over four years (again in constant 2012/13 prices). Office of Budget Responsibility December 2013 forecast.

<sup>7</sup> Indeed, he is arguably less fiscally conservative than Brown would have been had he remained in office after 2010. See Alistair Darling's deficit targets as compared to George Osborne's.

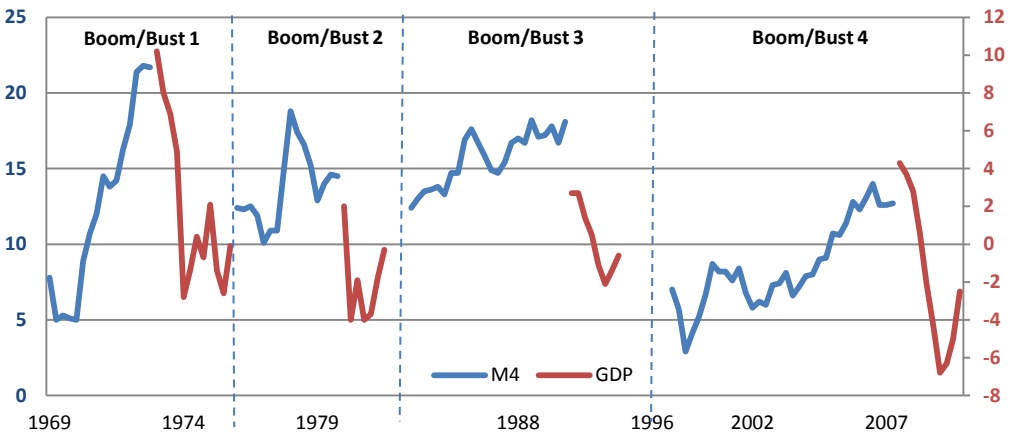


Like Mr Brown, Mr Osborne often talks about the need for simpler taxes. Yet under the current and previous governments, the tax system has become more complicated, and no serious effort at supply side reform appears to have been made.

The Coalition’s economic policy is not merely reinforcing many of the errors of the previous administration. The tragedy is that they are repeating many of the mistakes made by successive governments over the past forty years.

Britain has experienced four periods of sustained economic contraction since the early 1970s.<sup>8</sup> Each time, a downturn was preceded by the same thing: an unsustainable credit-induced boom. The cause and the justification for the credit bubble might have differed, as we shall see. The effect, however, was always the same; a sharp contraction in GDP.

*A credit boom before each bust<sup>9</sup>*



*Preceding each sustained fall in GDP percentage (red line) since 1971 there has been a sharp increase in money and credit (blue line).*

The chancellor’s monetary activism, far from delivering sustainable recovery, is sowing the seeds of a fifth downturn. The growth that we see is a product of stimulus economics, which helped to ‘unbalance’ economic growth to begin with.

Why is the current chancellor repeating not only the monetary mistakes of his predecessor, making some of the errors made by successive chancellors? Because, fundamentally, free market thinkers have failed to develop an alternative to many of the Treasury orthodoxies that envelop whichever minister sits within it.

<sup>8</sup> These four periods of contraction lasted approximately from Q1 1974 – Q4 1976, Q2 1980 – Q3 1981, Q1 1991 to Q4 1991 and Q3 2008 to Q4 2009. NB. The term recession is deliberately not used, and technically, the first contraction constituted two recessions, rather than one.

<sup>9</sup> The House of Commons library provided the data on which this and subsequent graphs and charts are based.

Conservative thinkers for a generation or more, appear to have failed to develop a coherent, credible free market approach to monetary policy. This has not only caused enormous economic harm, it has hurt the Conservative party electorally, too.

With no free market concept of monetary policy, the Conservative leadership under Mrs Thatcher blundered into – and subsequently out of – the European Exchange Rate Mechanism (ERM). With no alternative sense of how we might manage the money, we could only look during Gordon Brown’s boom years. When that turned to bust, we had nothing to say. We still appear to have no alternative to offer beyond more Continuity Brown.

Osborn economics may indeed generate yet another boom. But it will no more produce sustainable prosperity the second time round than it did the first. We instead test to destruction the idea that cheap credit can make us rich. Sooner or later, Osborn economics will not only fail, but be recognised as having failed. An alternative will be needed for free market Conservatives. This paper considers what that free market monetary alternative might be.

## II

### A Failure to Think

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How should a government manage the money? For years, free market Conservatives have scarcely ever asked the question. Their failure to provide a satisfactory answer lies at the heart of the economic problems we face. That government ought to manage a currency is seldom questioned. Even classical liberal economists agree that there is a role for government in maintaining a currency. But how a government might best manage the money is an elementary economic question that needs answering.

A generation ago, in 1989, the question of how to manage the money was the cause of a spectacular public row between Sir Alan Walters, economic adviser to the then prime minister, Margaret Thatcher, and her Chancellor of the Exchequer, Nigel Lawson.

#### **Monetarism**

Sir Alan Walters, economic adviser to the prime minister, Margaret Thatcher, was a conventional monetarist. He believed that if the supply of money increased relative to the demand for money, people would no longer hold on to the money, but spend it. The surplus money would flow out of people's bank accounts or company balance sheets, and in so doing, raise economic output. Expand the supply of money relative to the demand too much, and all the extra money would stimulate inflation.

Conversely, argued Walters and the conventional monetarists, if the demand for money rose relative to the supply, the price of money – interest rates – would go up. Entrepreneurs would delay investing in new businesses, consumers would cut back on spending, and the economy would slow. The key, thought Walters and the monetarists, was to control the supply of money and get the balance just right. How? Being a conventional monetarist, Walters believed that the way to do this was by setting money targets and manipulating interest rates to reflect the level of goods in circulation. Policy makers, he believed, could measure the different types of money, and make sure that the increase in the supply of money matched the broader needs of the economy.

The then chancellor, Nigel Lawson, did not agree. Lawson felt that setting interest rates to meet money targets was no longer working. The monetary targets were moving. The published money targets had, he felt, lost credibility. He was on the lookout for an alternative benchmark. By early 1987, it seems, Lawson had convinced himself that targeting the exchange rate was a better way of managing the money than focusing on internal measures of money that kept moving. Having stopped targeting M3 as early as 1985, in March 1987 he began surreptitiously to shadow the

Deutschmark. This was, he convinced himself, ‘exchange rate monetarism’.<sup>10</sup> From early 1987, interest rates were set in order that Sterling shadowed the Deutschmark at a ratio of £1:3 Deutschmark. When conventional monetarists, like Walters, realised that interest rates were being manipulated to manage the exchange rate, they were appalled. Although Lawson resigned - followed soon after by Walters – the former’s scepticism about conventional monetarism prevailed. There was no return to orthodox monetarism.

Since then, no Conservative chancellor or shadow chancellor has advocated conventional monetarism. But neither have free market Conservatives had a coherent free market idea as to how else the government should manage the money. The disagreement between two of her lieutenants in late 1989 was a portent of Margaret Thatcher’s own demise almost exactly a year later. Ditching Margaret Thatcher as party leader had enormous consequences for Conservatism. The consequences of abandoning conventional monetarism were arguable even greater.

Since the Walters/Lawson row, the Conservative party has had a further five leaders of varying credibility. It has yet to find a credible and coherent monetary policy. Having parted company with conventional monetarism, free market conservatives have yet to formulate a coherent post-monetarist alternative. It is a failure that has had enormous economic – and for the Conservative party, political – implications.

### **After monetarism**

Nigel Lawson quietly ditched conventional monetarism long before many monetarists realised it. At the Plaza Accord meeting in New York in September 1985, finance ministers from the world’s leading industrial nations – including Lawson – agreed to take action to lower the value of the US dollar. The idea of exchange rate management – albeit in a different context – seems to have stuck. From early 1987, Mr Lawson was manipulating interest rates in order to maintain a fixed exchange rate with the Deutschmark. Pretty soon, however, this began to cause problems. Managing the money after monetarism started to get messy. Interest rates in 1987/88 were lower than they would otherwise have been, which caused – as conventional monetarists might have feared – a rapid growth in the money supply. This caused the economy to overheat. House prices rose sharply, the economy sucked in imports causing a deterioration in the balance of payments, and a rise in inflation.

If the problems caused by exchange rate targeting were already evident before Lawson resigned, with no free market means of appraising monetary policy, his successor,

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<sup>10</sup> Why Nigel Lawson came to favour exchange rate targeting remains a puzzle. In private conversations, some of those familiar with the debate in Westminster at the time, have expressed the opinion that Lawson wanted change because he was, by temperament, attracted to the new and the faddish. Exchange rate targeting, they suggest, appealed to him less because of any supposed external discipline it might bring and more because of its novelty. It should also be noted that others who advocated exchange rate targeting, although perhaps not Lawson, had another agenda. They saw British membership of the Exchange Rate Mechanism as a precursor to joining a single European currency. Many, like Lawson’s successor as chancellor, John Major, seemed to favour ERM membership as an ends in itself. Some appeared to favour exchange rate targeting for reasons of Europhilia rather than economics.

John Major was unable to see it. Indeed, Mr Major institutionalised those arrangements whereby interest rates were set in order to keep Sterling pegged to the Deutschmark when he took Britain into the ERM in October 1990. Being part of the ERM, claimed John Major and others at the time, would prevent destructive boom-busts. The ERM, they suggested, would impose on Britain a discipline she seemed unable to impose on herself. They could not have got it more wrong.

At the time Britain joined the ERM, the German Bundesbank specifically requested that the UK adopt tighter reserve asset ratios for her banks, and tighter money targets. Far from working by providing Britain with monetary discipline, the Bundesbank was saying, ERM would only work for Britain if she had monetary discipline. They were right. Managing interest rates in order to peg our currency to the Deutschmark was already causing difficulties before we even formally joined the ERM. Instead of leading to prosperity, setting interest rates to manage the exchange rate had already begun to choke off growth before we formally joined the ERM. The Lawson boom – a product of inappropriate low interest rates and easy money – was followed by a downturn in 1990/91 – for the inverse reason.

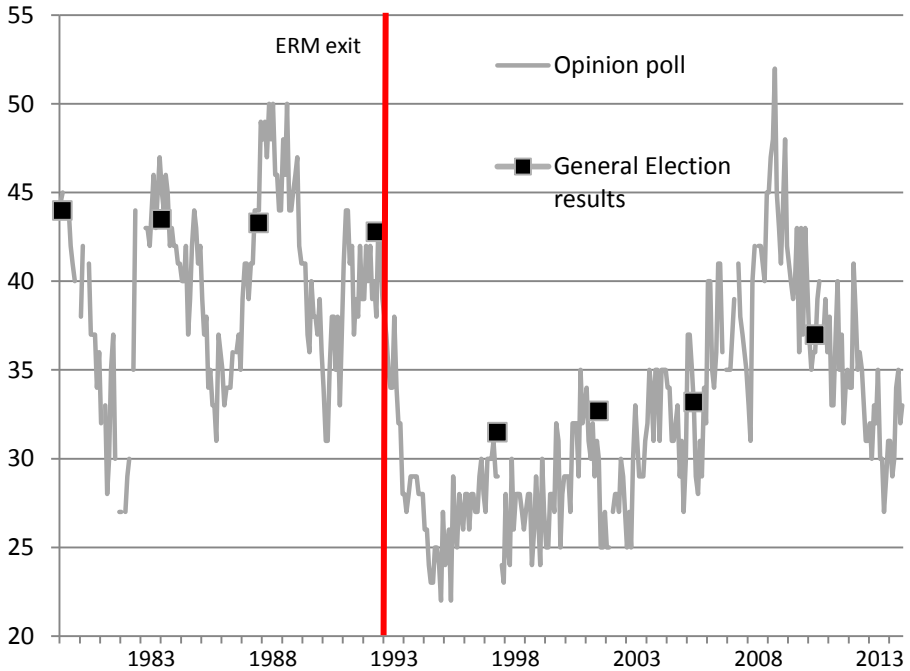
Yet still post-monetarist conservative economic policy continued to be defined by expediency and drift. With the Lawson boom turning to bust, and inflation in the UK three times the rate in Germany, Sterling was under pressure. And thanks to the decision to join the ERM, the government was therefore under pressure to raise interest rates. A party that claimed to believe in free markets ended up raising interest rates to 15 per cent in order to try to maintain a fixed price exchange rate. In doing so, the Conservative administration not only destroyed jobs and enterprises. Having parted with any notion of first principle in monetary policy, the Tories lost their reputation for economic competence, which to this day they have never quite recovered.<sup>11</sup>

On 16<sup>th</sup> September 1992, Britain not only fell out of the ERM. The notion of managing the money through exchange rate targeting fell apart, too. Although the economy subsequently recovered, there was no renewal of free market thinking about monetary policy. Exchange rate targeting might have come to an abrupt end, but the intellectual drift over monetary policy did not. Instead of rethinking the question of how to manage the money from first principles, Conservative ministers seemed to drift along with the next fashionable notion of what they might target, inflation. Few seemed to ask why there ought to be a target at all. In politics, more often than is widely understood, politicians take up an idea not because they have pondered long and hard. But because they need a policy, and it is there.

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<sup>11</sup> Before Britain was forced out of the ERM, the Conservative party held a consistent lead on the economy. Their reputation of economic competence collapsed after ERM exit. Even in 2005, years afterwards, a Mori poll found that 46 per cent of voters believed the Labour government, led by Tony Blair, still offered the best economic policies, whereas only 21 per cent preferred the Conservatives led by Michael Howard.

## **Conservative party poll ratings and General Election results before and after ERM exit**



*Britain's exit from the ERM exposed quite how muddled Conservative thinking about monetary policy had become. Having ditched monetarism, their experiment with exchange rate targeting produced one recession and one ERM fiasco. Their electoral fortunes have never been quite the same since. Anyone who doubts that the ERM debacle had an impact on the electoral fortunes of the Conservative party should ponder this; Sterling left ERM in September 1992. According to Ipsos MORI, over the previous five years, the Conservative party polled above 40 percent in 35 out of 60 months. Over the five years that followed ERM exit, the Conservative party failed to poll over 40 percent in any single month.*

In the weeks before Britain's ejection from the ERM, the Bank of England's International Division just happened to have been studying the New Zealand model of monetary management using inflation targeting. A study commissioned out of intellectual interest was seized upon and became the new orthodoxy.

According to Mervyn King, speaking in 2012 as Governor of the Bank of England, three weeks after Sterling was forced out of the ERM, 'newspapers reported that for the first time monetary policy in Britain would be based on an explicit target for inflation'.<sup>12</sup> And how did this decision come about? Well, Mr King continued, 'After debates within the Treasury and the Bank of England, the answer emerged – the

<sup>12</sup> See *Twenty Years of Inflation Targeting* speech by Mervyn King, 9<sup>th</sup> October 2012, London School of Economics.

inflation target'. Having jettisoned the idea – or rather been jettisoned by the idea – that we should steer monetary policy so as to manage the external value of the currency, those in government circles effortlessly took up the idea that we might do so by managing the internal value of the currency. From one folly, they lurched to another.

At no point did ministers who paid lip service to the idea of free markets stop to ask if managing an economy on the basis of inflation targets is any more free market than managing it on the basis of tractor production targets. The pursuit of one set of arbitrary targets – exchange rate targets – produced one boom/bust. It was as nothing compared to the boom/bust produced by anchoring monetary policy around the second set of arbitrary targets – inflation. Inflation targeting was to produce even great instability and an even larger boom/bust cycle.

A consequence of not managing to manage the money is that we have had a series of credit induced bubbles. The most recent was the Brown bubble.

### **The Brown bubble**

What is free market about monetarism? Should we not be puzzled that politicians who believe in the free market at the same time want government to control the supply of the currency? Actually, it is not that odd. Even classical liberal economists have seen a role for government in managing the money. Setting targets for the growth of M3 or M4 is, in an era of fiat money, not so different from the role that governments once played in making sure that the coinage was not debased. Setting money targets is perfectly compatible with free market economics. But is fixing the exchange rate? Is inflation targeting or GDP targeting? At what point does a monetary policy, whereby a small group of central bankers forecast and plan, merely become a form of state planning? Free market conservatives never seem to ask. We accepted, by a process of osmosis and omission, the notion that monetary policy should target inflation. We then came to accept the idea that independent central bankers should preside over the targeting much the same way.

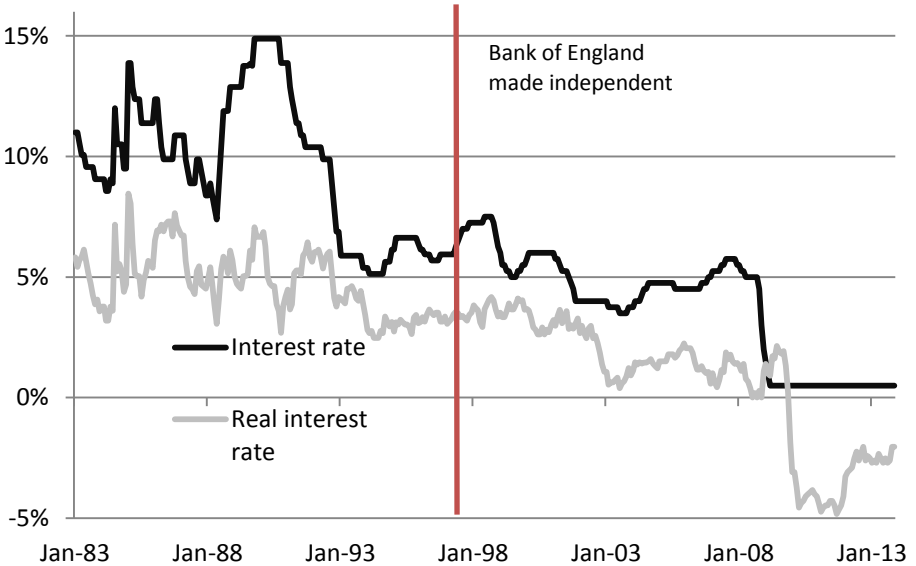
In recent decades, monetary policy, it was often said, has been more lax than it should have been because of politics. First in 1980, then just before the 1983 election, and again in 1987-88, interest rates were supposedly eased because of political considerations.

To prevent this, it was said, those who set interest rates needed to be independent. And so initially under the then chancellor Kenneth Clarke, the Bank of England was given greater freedom to set rates independently of the Treasury. Gordon Brown formalised these arrangements in 1997 when he granted the Bank of England independence. 'Now' wrote Mervyn King about independence 'we really did have a chance to show

what the Bank of England and price stability could do for this country'.<sup>13</sup> And they did.

Unaccountable central bankers presided over an even greater monetary policy disaster than the ERM debacle. Given independence in order to ensure that they could set a sufficiently tight monetary policy when needed, the Bank of England has in fact done the opposite. Once independent, the central bank's monetary policy has been consistently loose.

### *Interest rates before and after the Bank of England was made independent*



*Interest rates have been historically lower since the Bank of England was made independent in 1997. Interesting, one of the reasons for making the Bank independent was fear that if populist politicians were left in charge setting interest rates, they might be tempted to offer easy money to the voters. It turns out that independent central bankers have set rates far lower than even the most vote-hungry chancellor dared.*

To be sure, the Bank seemed to achieve price stability initially, meeting its target consistently in the first ten years after 1997. Inflation, which had averaged 12 per cent in the 1970s and 6 per cent in the 1980s, has averaged 2.1 per cent in the twenty years since inflation targeting began. Movements in interest rates by the Bank's Monetary

<sup>13</sup> Quoted in *The Bank: Inside the Bank of England*, Dan Conaghan, p 27.



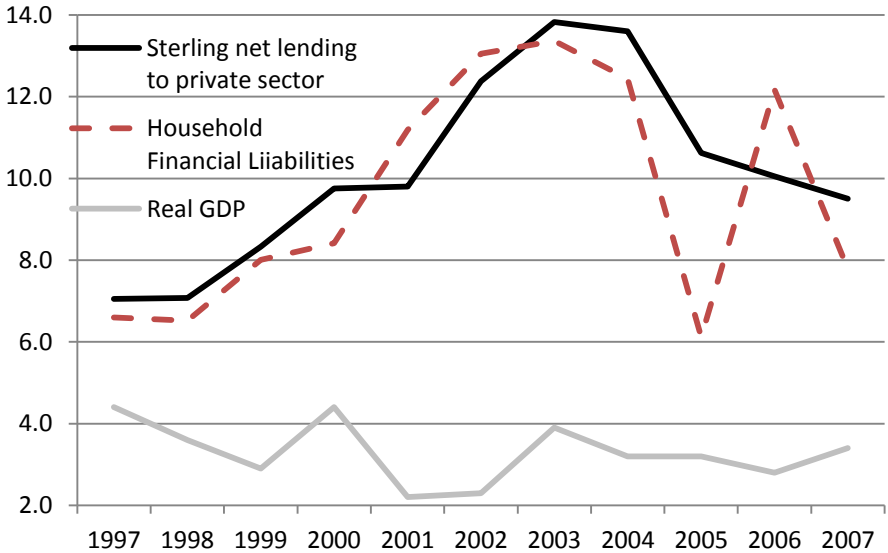
Policy Committee seemed to anticipate perfectly future changes in output, moderating the ups and downs. Interest rate targeting produced the longest period of sustained GDP growth in our history. The technocrats seemed to have found the perfect solution to the monetary policy question. And yet all was not well. Inflation did not turn out to be the ideal target after all.

Ancient mariners used to navigate by the stars. Constant and fixed in the heavens, a lodestar would show the captain which direction they were heading. Far from being a lodestar by which to navigate, inflation turned out to more of a planet. Rather than being a constant, reliable measure, it meandered. It did not tell you what you thought it was telling you. By targeting inflation, central bankers thought that they were able to work out how loose or tight monetary policy needed to be. Unfortunately, real life, unlike economic theory, turns out to be more complicated than that. Despite the conceit of central bankers, they simply were not able to assemble in one spot all the data they needed to be able to know how to set interest rates. The late 1990s saw a massive expansion in the industrial output of China and other countries. By 1999 – two years after the Bank of England was made independent – this was starting to have a significant effect on the UK economy. China's industrialisation meant a flood of cheap imports into the UK. While this might have been great news for consumers, it had the effect of pushing down the price of imports and meant that inflation was considerably lower than it might otherwise have been. Because inflation was lower than it might otherwise have been, the central banker targeting inflation kept interest rates lower than they might otherwise have done.

Worse, although the extended inflation measures, RPIX and CPI, accounted for increases in the price of household items, it did not properly factor in the price of houses. Nor indeed various other assets, the price of which was rising on the back of an asset bubble caused by low interest rates.

In other words, inflation was not telling the central bankers all that they subsequently discovered they needed to know in order to make the judgements about monetary policy that they were making. Indeed, they ignored evidence that suggested they might have got it wrong. While the MPC could see house prices rising relative to incomes, they chose to see this not as evidence of loose monetary policy creating an asset bubble, but as evidence that long term interest rates would, in future, be low. Mervyn King has since tried to suggest that the housing bubble formed because householders mistakenly extrapolated past increases in house prices into the future. If that was partly the problem, perhaps it was because technocrats in Threadneedle Street had sent misleading signals to millions of homeowners. However successfully RPIX and CPI were targeted before 2007, it did not prevent the building up of a lending and property bubble.

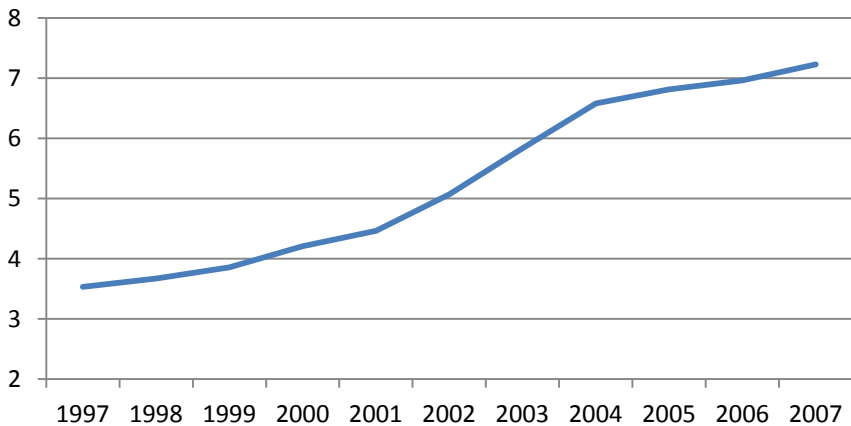
**The Brown Boom 1997 - 2007: Growth in lending and household financial liabilities exceeded growth in GDP**



*Between 1997 and 2007, lending and financial liabilities increased much faster than GDP*

**The Brown Boom 1997 – 2007; House prices increase relative to earnings**

**Median house prices / median earnings**



*Between 1997 and 2007, many asset prices rose. Most notable, perhaps, was the increase in house prices.*

An excessively loose monetary policy produced the Brown bubble. Between 2001 and 2008, asset prices soared. Output rose. Debt expanded. Convinced that the additional tax revenue pouring in was a permanent addition to the tax base, Gordon Brown went on a spending spree. Fiscal incontinence, combined with monetary madness produced a period of unsustainable growth and the Brown bubble. ‘But there was nothing wrong with inflation targeting’, I was once told by a Treasury expert. ‘It worked fine until 1999, and only started to go wrong because the CPI target was too narrow’. Too narrow?

Targets will always be too narrow. Those who believe in free markets ought to recognise that. Exchange rate targeting failed, according to some of those who defended it initially, because of the costs of German unification, or the unwinding of the Lawson boom. Advocates of inflation targeting tell us any flaws were down to Chinese industrialisation, or the fact that it was the wrong sort of inflation we were targeting. Perhaps the problem lies in having targets? A target is necessarily narrow, in that it is a specific measure. A target means a singularity of reference that fails, by definition, to try to incorporate all variables. That is what makes a target a target.

As we shall see, there are those who believe that central bankers should now widen the target from mere inflation, to take in range of variables. No groups of experts in a central bank, no matter how wise or knowledgeable, can ever assemble in one place all the information they need to take into account every factor. Whether it is German unification or Chinese industrialisation, there will always be some factors they overlook. Frederick von Hayek, who helped lay the foundations of free market thought, would have grasped this. How odd that so many contemporary conservatives struggle to.

### III

## Osborn Economics

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It started as a credit crunch. After years of cheap and plentiful credit, banks began to run out of credit. In early 2007, US firm New Century Financial, which specialised in sub-prime mortgages, filed for bankruptcy protection. Then on August 9<sup>th</sup> 2007, bad news from French bank, BNP Paribas, triggered a sharp rise in the cost of banks extending credit to one another. Banks began to stop lending to one another. In September that year, Britain had its biggest bank run in a century when depositors withdrew £1bn. By the end of the following year, banks had been bailed out, nationalised, or gone under in Britain, Germany, France, Italy, America, Iceland, Ireland and throughout much of the Western world. The credit crunch became a downturn. By the end of 2007, the US economy was in recession. Output fell sharply in many of the advanced industrialised countries over the months that followed.

### **Gordon Brown's response to the downturn**

Faced with the financial crisis, Gordon Brown's response was to bail out the banks and stimulate the economy by easing credit conditions. In September 2007, the government gave an undertaking to guarantee Northern Rock deposits. In April 2008, the Bank of England announced details of an ambitious £50bn plan designed to help credit-squeezed banks by allowing them to swap potentially risky mortgage debts for secure government bonds. Six months later, the government announced details of a rescue package for the banking system worth at least £50bn, and short-term lending support up to £200bn. In October, the government announced plans to pour billions of pounds of taxpayers' money into three UK banks Royal Bank of Scotland, Lloyds TSB and HBOS – to keep them afloat.

Like central bankers across the world, the Bank of England cut rates in December 2007 to 5.5 per cent, and then again in early 2008. And then again, and again. By November 2008, interest rates of 3 per cent were the lowest they had been since 1955. By January 2009, they were the lowest in the Bank's 315-year history, and have remained at 0.5 per cent. Unable to cut interest rates further, the Bank found a further way to give the economy more monetary stimulus; Quantitative Easing (QE). Between March and November 2009, the MPC authorized the purchase of £200 billion worth of assets, mostly UK Government debt or 'gilts'. The MPC voted to begin further purchases of £75 billion in October 2011 and, subsequently, at its meeting in February 2012 the Committee decided to buy an additional £50 bn. In July the MPC announced the purchase of a further £50bn to bring total assets purchases to £375 bn.

In QE the twin approach of bailing out banks and stimulating the economy came together. Normally, a central bank would buy or sell government bonds to keep market interest rates at a specific rate. QE, an unconventional approach borrowed from Japan, meant the Bank of England buying up various long term financial assets from commercial banks, thereby increasing the monetary base and lowering the yield

on those financial assets. Banks got a helping hand out, in effect, from the central bank, and money was injected directly into the economy to boost nominal demand. Through QE, the Bank of England electronically created new money, and used it to purchase gilts, i.e. government bonds held by private investors such as pension funds and insurance companies. Because these investors typically do not want to hold on to this money – it yields a low return – they tend to use it to in turn purchase other assets, such as corporate bonds and shares. That in turn tends to lower longer-term borrowing costs.

The first round of QE began under Gordon Brown. The second and third tranches took place when George Osborne was at the helm. The ‘monetary activism’ of which George Osborne speaks in fact began under Brown. Once he became chancellor, George Osborne not only continued with further rounds of QE but also with most of the key macroeconomic policies: these settings have remained unchanged. As in some other areas of government policy, the more one looks beyond the rhetoric that divides the parties, the more one realises how little economic policy has actually changed since 2008. Though different chancellors have held office, the basic Osbrow economic approach – to use monetary policy to stimulate output – remains the same.

### **The cheap money delusion**

Having bought into the mistaken view that central bankers and low interest rates could conjure up prosperity, the Conservatives failed to offer any alternative as the Brown bubble ballooned. Few of them seemed even to recognise what was happening.<sup>14</sup> In the 2001 and 2005 manifestos, the party leadership made clear that they supported both an independent Bank of England and low interest rates. (It did not seem to the authors of either document that the policies contradicted each other: if you sought the former, you could not, by definition, claim to be able to guarantee the latter.) Like so many others at that time, they had come to believe that cheap credit was a cause, rather than a consequence, of economic success, and did not seem to trouble themselves too much with detailed consideration of monetary policy.

In the era of Alan Greenspan, central bankers were seen as omnipotent and wise. Capable of generating wealth by setting rates just right. With no principled, free market way of looking at monetary policy, a party that still paid lip service to the free market failed to recognise the warning signs once monetary technocrats, rather than market forces, allocated credit. But the warning signs were there.

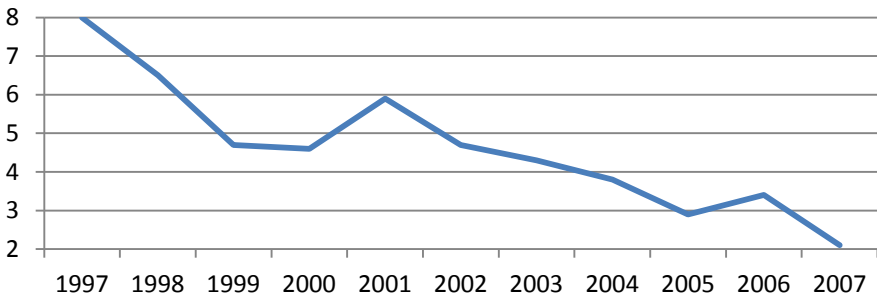
Cheap money and an excess of cheap credit caused a number of problems to build up between 2000 and 2007.

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<sup>14</sup> In fiscal terms, Conservative party policy was notable precisely because it did not differ much from Labour. In their 2005 General Election manifesto, the Conservative party promised to increase governing spending by 4 per cent a year – only marginally less than Labour was offering to do. As late as 2007, David Cameron as Conservative leader sought to compete with Labour by pledging to match their spending increases, especially on education and the NHS.

- **Malinvestment:** Holding interest rates down in the early noughties made it much harder for businesses and householders to assess risk. Removing the moderating influence of higher interest rates meant that everything started to look like a safe bet. As a consequence, a lot of bad investment decisions were made. Credit and other resources were misallocated.
- **Low savings:** Low interest rates also discouraged people from saving. With less interest paid on money sitting in a bank balance there is less reason to keep it there. So savings rates declined.
- **Over consumption:** Easy money encourages consumption. Excessively low interest rates meant excessive consumption relative to production.
- **Balance of payments:** With Britain over consuming and under producing, Britain's balance of payments in the noughties deteriorated. Low interest rates, just as they had done when Nigel Lawson was chancellor, had started to suck in imports faster than Britain was managing to export.
- **Asset bubble:** With the cost of borrowing so low, people had an incentive to take out loans and invest the money in assets, which they hoped would appreciate in value. And this is what started to happen with everything from houses to shares.
- **Zombie firms:** Malinvestment should be thought of as economic cholesterol. It builds up in the arteries, a diet of cheap credit laying down one layer upon another.

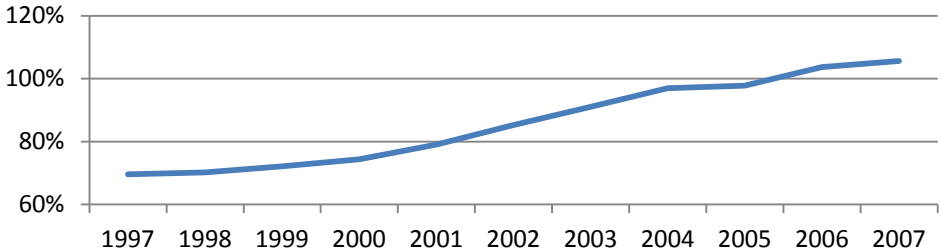
### *Falling savings ratio*



*With interest rates so low, there was less incentive to save (and less disincentive to accumulate debt). Savings rates fell precipitously during the Brown boom.*

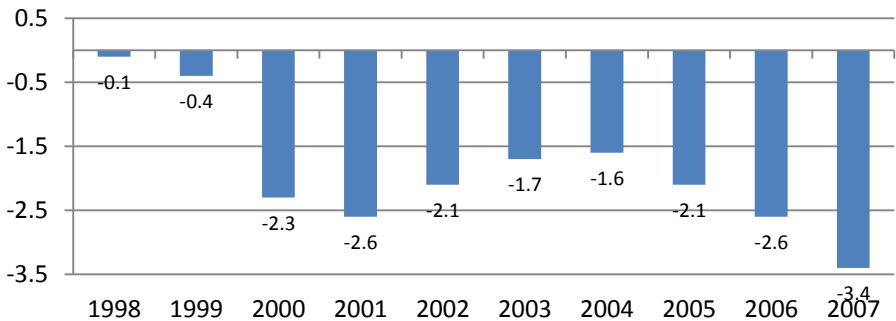
Again, this was a warning sign that was overlooked. Those who understood the role of price in allocating resources ought to have been able to see it.

**Household debt levels 1997 – 2007** As the Brown bubble grew, consumption increased and household debt rose. Britain consumed even more than she produced, and households spend money on maintaining lifestyles their incomes could not justify

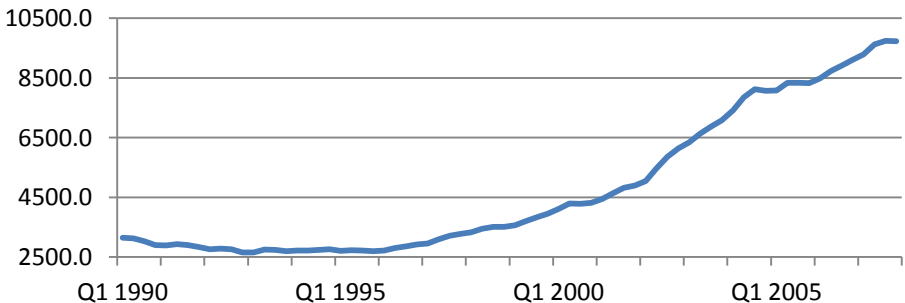


**UK balance of payments current account to GDP 1997 – 2007** UK balance of payments deficit increased between 1997 and 2007. This is a good indication of excessive demand within the economy.

Britain has not had a current account surplus since 1983 – shortly before we abandoned monetarism. Not only did things deteriorate during the Brown boom, the balance of payments situation deteriorated during the slump – yet another indication of the effect of malinvestment.



**UK House price index nationwide** As the value of assets increased, more folks borrowed cheaply believing that the value of what they were buying would increase faster than the rate of interest on their loan.



During the boom years, too many resources in the economy were channelled into producing things for which there are not in fact enough customers. Capital is tied up in businesses that cannot really make money.

This meant that there are now an awful lot of zombie firms – businesses with large debts that they are able to service – thanks to low interest rates – but cannot hope to pay off. A period of prolonged low interest rates traps these firms. They cannot prosper, and are doomed. Yet low rates prevent these ‘undead’ firms from folding, and the reallocation of resources that would follow from happening.

Thanks to the malinvestment, almost one in ten UK firms is now a zombie firm. According to a recent survey, 9 per cent of UK businesses are only able to service the interest on their debts, but not the debt itself.<sup>15</sup> That is 160,000 companies – able to keep out new competitors, but not grow.

### **Continuity Brown**

Had the Conservative party developed in opposition a sense of what a free market monetary policy might look like, they might have been able to read the warning signs. But that did not happen. So when the Brown bubble burst, they appeared to lack a convincing response. Had they formed a distinctive monetary policy when out of office, they might have implemented a different approach in government. They haven’t. Instead, the Coalition has picked up more or less where Labour left off.

Gordon Brown’s response to the downturn was to use cheap credit to try to reflate the economy. Mr Osborne appears also to have had the same approach. Low interest rates, he says, are the key to economic recovery. In his 2011 Mansion House speech, the chancellor spoke of low interest rates being part of a ‘huge stimulus’ to our economy. ‘Nothing would be more damaging for Britain’ he declared in November that year ‘... than an increase in mortgage rates for families and an increase in the cost of borrowing for businesses’. Under Mr Osborne, not only have interest rates been held down. But his newly appointed Governor of the Bank of England, Mark Carney, is a man committed to keeping things that way. Mr Carney’s predecessors – Eddie George and Mervyn King – were careful to determine monetary policy on a month-by-month basis. They avoided giving any long term undertakings about interest rates. Mr Carney, however, began in his new role with an undertaking to keep rates at the exceptionally low level of 0.5 per cent, unless the unemployment rate falls below 7 per cent.

Gordon Brown, having long ago exhausted conventional monetary policy as a stimulus tool, resorted to QE. As we have already seen, George Osborne followed suit. Both men pinned their hopes on the Bank of England printing enormous amounts of money. Under Mr Brown, the Bank of England began to buy up bonds. But under Mr Osborne there have been two further rounds of QE. In 2009, QE was justified as defence against deflation. A collapse in the money supply, it was feared, might cause

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<sup>15</sup> See report by the Association of Business Recovery Professionals



output to contract dramatically. Yet the continuation of QE can no longer be justified as a defence against deflation. It is a straight forward attempt to stimulate economic output. Together Gordon Brown and George Osborne have presided over an extraordinary 350 per cent expansion in Britain's monetary base since 2009.

And to QE, other economic policies have been added. In September 2008, Gordon Brown announced a one year rise in stamp duty exemptions, from £125,000 to £175,000. This was the first crude effort to kick-start the housing market. Since 2010, things have gone much further. The Treasury, under Gordon Brown, commissioned City banker, James Crosby, to see what more could be done, and his report recommended that the government should underwrite mortgages in order to kick start the housing market. Mr Crosby suggested that this be done with by having the state back mortgage bonds. In other words that the state would be one step removed from the process.

George Osborne has not only taken up this idea of state backed mortgages. He has gone a step further with government back mortgages, rather than mortgage bonds. Under the Help to Buy scheme, government either provides an equity loan for up to 20 per cent of the property value (the buyer only needing to find 5 per cent), or the government acts as a guarantor for a 5 per cent deposit mortgage. The Help to Buy programme is perhaps the flagship recovery policy of the current administration. Yet its genesis lay in a report Gordon Brown commissioned.<sup>16</sup> The chancellor's monetary activism has not stopped there. The Funding for Lending scheme, launched in 2012, applied the same principle of state backed lending both to mortgages and to business loans. Funding for Lending aims to incentivize banks and building societies to lend more to businesses. Initially, this was across the board, with most lending advanced as mortgages, but, since the end of 2013, confined to business lending. Even that was not enough, and the government launched its own British Business Bank, backed by government guarantees.

The Coalition may appear to have refined and developed many of the nascent ideas forming inside the Treasury under the previous government. But they are all based on a common objective of using subsidised credit to stimulate the economy. In pursuing such a course, the Coalition has carried on giving the patient more of what made it ill.

### **The Osborne boom?**

Goldman Sachs has done it. The Office of Budget Responsibility has done it. So, too, have both the IMF and the OECD. All those venerable organisations that issue economic forecasts seem to be issuing upward revisions for UK growth. Having been in a prolonged downturn, the UK economy is now expected by many to grow rapidly. Indeed, some say we are set to grow faster than almost any other developed nation. We are the 'poster child' for recovery, apparently. If living standards have not actually

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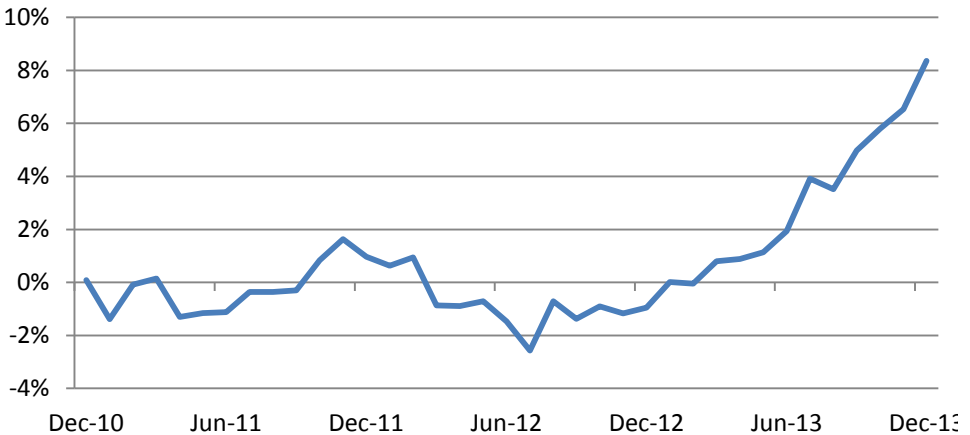
<sup>16</sup> See the Treasury-commissioned report on how to revive the mortgage market produced by James Crosby and others. Published in July 2008, it provides much of the intellectual framework for the Help to Buy scheme. James Crosby was stripped of his knighthood in 2013.

started to rise yet, the political narrative certainly has started to be more upbeat. Instead of downbeat pieces about how dire things are, newspapers are full of articles saying what a miraculous turnaround there will be. This upswing already looks good, and will, in time, make us feel richer, too. In that, it will be like so many recoveries of the past.

But not all is quite as healthy as it might at first appear. Private consumption has risen, but so too has private debt. Meanwhile, investment has fallen. The rise in output thus far has been largely driven by consumer spending. Household spending rose by 0.8 per cent in the three months to the end of September 2013, according to the Office of National Statistics. Household spending was 2.4 per cent higher at the end of 2013 than it had been a year before. UK household debt has increased to a record £1.43 Trillion. That is higher than it was in 2008 when Lehman Brothers collapsed. Car sales have grown for nineteen months in a row, according to recent reports. Yet three out of four of them were bought with borrowed money.

While consumption is up, total private and public investment has fallen dramatically. Gross fixed capital formation measures how much of our economic output is being invested, rather than consumed. At just 14 per cent of GDP, it is the lowest in the OECD.

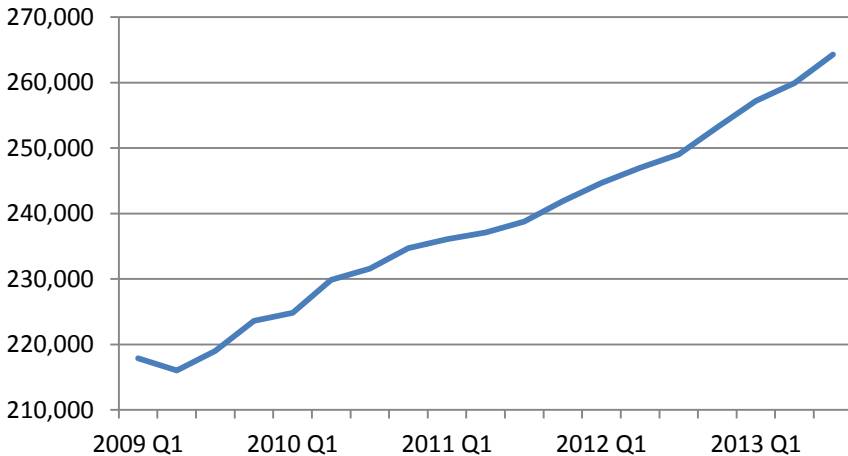
***Percentage change in house prices since 2010***



‘The rebound’ says Michael Saunders of Citi ‘is led by demand rather than supply-side improvements, and is not rebalancing the economy towards investment and exports’. Fuelled by government backed mortgages, house building has seen some of the strongest growth for a decade or so. By late 2013, the number of housing starts

was up 60 per cent on a year ago. House prices are rising by over 8 per cent a year.<sup>17</sup> According to the Office of Budget Responsibility, residential property prices will rise by 27 per cent between 2014 and 2018, which would take house prices way above their previous peak. Mortgage approvals are at the highest level since the credit crunch began.<sup>18</sup>

### *Final household consumption expenditure since 2010 (£m)*



The surge in output is emphatically not export led. In late 2013, one report indicated a 2.4 per cent fall in exports, with the trade deficit widening in the third quarter to £8.9 billion. In 2012, the trade deficit was 3.8 per cent of GDP. In the first quarter of 2013, it was as high as 5.5 per cent. The already low savings rate has fallen to its lowest level since early 2009, at just 4.9 per cent. UK output might be rising. But it appears to be another bubble displaying such characteristics as:

- Over consumption and rising debt levels
- Rising house and asset prices
- Deteriorating balance of payments and relatively poor export performance
- Low savings

This is yet another debt induced boom, as artificial as the last one.

We therefore appear to have gone from the Brown bubble to the Osbubble, yet learned nothing. Under the current administration, we are in danger of repeating the easy

<sup>17</sup> According to the Nationwide House price index the average cost of a home rose by 1.4pc in December 2013, the biggest monthly jump since August 2009. This brought the year-on-year increase to 8.4pc.

<sup>18</sup> The British Bankers' Association's latest lending statistics show the number of approvals for house purchase was 39pc higher in November than a year earlier and the number of remortgaging loan approvals was up 20pc.

money folly of the last one. And indeed the one before that, and the one before that, too.

### **Like Brown, Lawson and Barber...**

The chancellor and those who defend the monetary policies over which he presides would disagree. ‘We have learned the lessons of the past’ they would insist. ‘And it is precisely because we have that we are doing things differently now’. The Bank of England, they might say, is far more sophisticated, avoiding those over simplistic errors of the past when monetary policy was determined on the basis of narrow measures of inflation. Or before that the exchange rate or even crude money targets. Inflation targeting, as I was told by a fellow Member of Parliament in the tea rooms of the House of Commons, does what monetarism failed to do. It controls the money supply in a way that works. Or rather would have worked, if the old CPI target had not been ‘too narrow’.

But that has been solved now, he went on to explain. The Bank of England no longer looks at just one target, but at a broader range of indices.<sup>19</sup> That might stop short of targeting all output – nominal GDP – but it certainly meant looking at things besides inflation, such as unemployment. Lots of things, it would seem, but not especially the supply of money.

In his Mansion House speech in 2010, the chancellor suggested the crisis was due to a ‘regulatory system [that] utterly failed to identify let alone prevent’ problems brewing. He therefore decided on a more extensive regulatory system. An independent Financial Policy Committee at the Bank of England was established. It would sit alongside the Monetary Policy Committee, with ‘responsibility to look across the economy at the macro issues that may threaten economic and financial stability and take effective action in response.’ Monetary technocrats might have failed to factor in enough indices in order to make the right decisions and meet their targets. But fear not. They have been given more power to take into account more variables in order to strike an even broader range of targets. This time things will be different, they appear to insist.

The chancellor’s economics do not merely repeat the factors leading to the Brown boom. They repeat the mistakes made by Nigel Lawson and even Anthony Barber before that. Since 1971, there have been four recessions in Britain; from Q3 1973 to

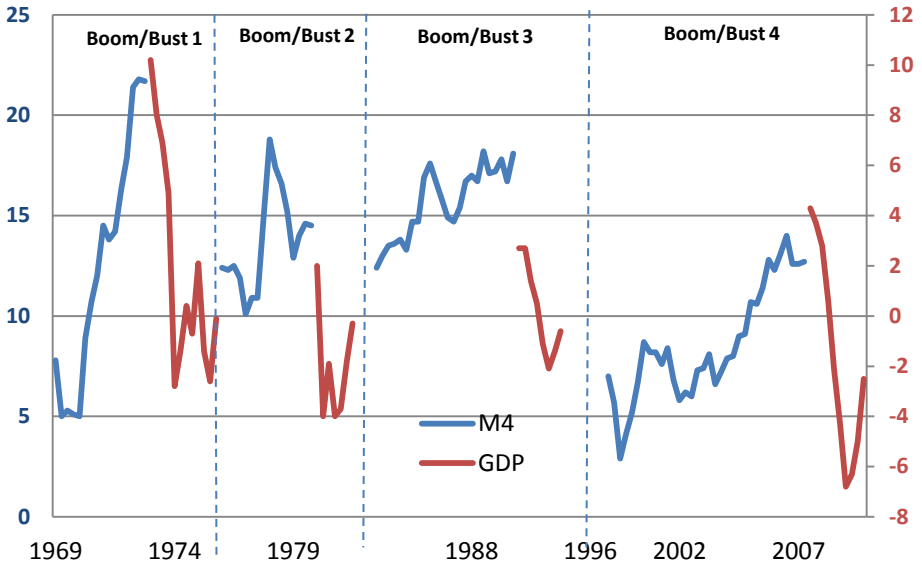
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<sup>19</sup> The claim that the Bank of England failed to stop the bubble forming because they were focused excessively on one target should be treated with caution. The reality is that they got distracted by other factors and considered a wider range of indices as the bubble was building.

Speaking in October 2012, Mervyn King claimed that the MPC started to take into account the “not entirely explicable” rise in Sterling in the late 1990s. He seems to suggest that the MPC started to set interest rates lower than they might otherwise have done so in order to offset the serious “imbalances” in the economy that Sterling’s strength was creating. Far from narrowly focusing on CPI, the MPC was already factoring in exchanges rates and other variables, not just inflation. Perhaps it is because they were distracted by the value of Sterling, they could not see the bubble forming?

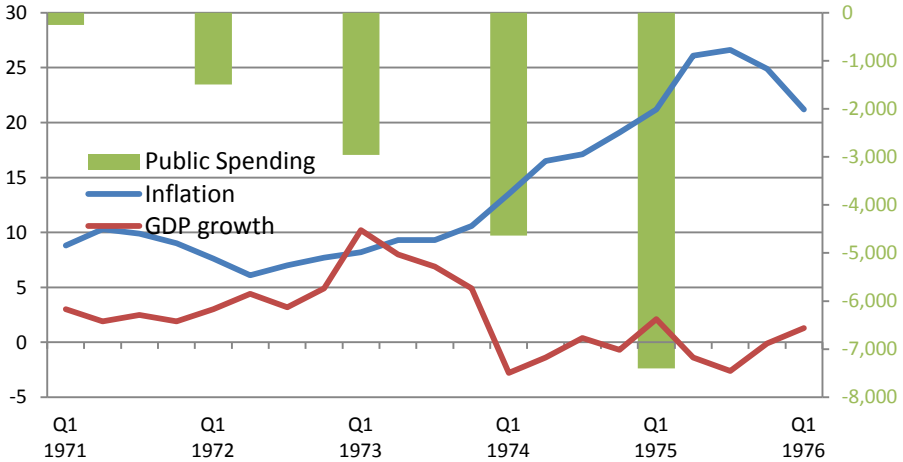
Q3 1975, then from Q1 1980 to Q1 1981, again from Q3 1990 to Q3 1991, and then from Q2 2008 to Q3 2009. Each one of them was preceded by a sharp rise in the money supply.

***Credit boom followed by economic bust; every downturn since 1971 has been preceded by an expansion in M4***



When Anthony Barber was chancellor (1970-1974) in Edward Heath’s Conservative Government, he unveiled a budget in 1972 explicitly aimed at reflating the economy in order to win the next General Election. This ‘dash for growth’, Barber promised, would add 10 per cent to UK growth within two years. Fiscal stimulus, monetary expansion and regulatory reform led to an explosion of credit. Fiscal stimulus was used to raise output. Taxes were cut and public spending increased. The public sector borrowing requirement rose. Yet the Barber boom was as much a credit induced boom as a fiscal one. He unleashed a wave of monetary expansion, too. In September 1971, Barber introduced Competition and Credit Control (CCC). Until then, the extent to which banks could lend to private sector borrowers was limited by a form of rationing. After the CCC was introduced, credit was allocated on the basis of price. While supposed to control monetary growth, the CCC had a quite different effect. There was an explosion in the amount of credit and lending. Regulatory reform led to a surge in the supply of credit. Low interest rates failed to hold down demand. Rates were held at 5 per cent until mid 1972, before being raised dramatically into double digits after it was too late. Barber told the House of Commons ‘I do not believe that the stimulus to demand will be inimical to the fight against inflation’. He could not have been more wrong.

### Getting it wrong 70s-style: output, inflation and spending deficits 1970 – 75



*In the first quarter of 1973, it might have seemed that the government's monetary and fiscal policy was working. Growth was up, inflation was steady and – as a percentage of GDP – the deficit was falling. What could possibly go wrong? Three years later, it was clear that spending was not under control, inflation was out of control and earlier growth had been unsustainable.*

Again in the mid 1980s, similar mistakes were made – albeit on a less gargantuan scale. The Treasury and Bank of England might have had a different set of demand-for-money aggregates, but in the mid 1980s they once again mismanaged the money supply. At the same time that credit reforms made lending more easily available, Nigel Lawson held interest rates down too low for too long. They were cut from 14 per cent in early 1985 to below 8 per cent in the first part of 1988. The effect of this was another credit induced boom, followed in turn by bust.

This happened again under Gordon Brown. Of course the demand-for-money aggregates were different and the target was inflation, not anything else. But once again there was a massive overextension of credit, combined with low interest rates. From over 7 per cent in early 1998 to less than 4 per cent in early 2004, rates were never raised over 6 per cent before the boom went bust.

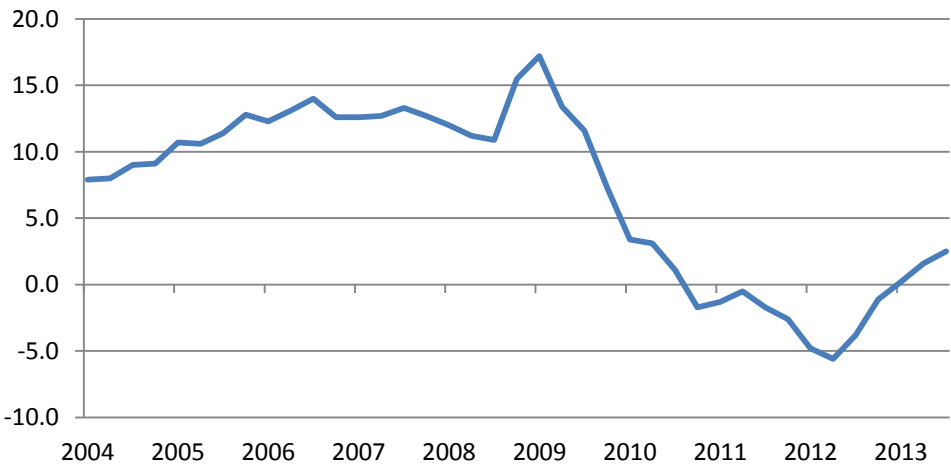
Today interest rates are effectively zero. Instead of paying banks to lend money, with interest rates on the floor, banks are in effect paying people to borrow. Perhaps unsurprisingly, banks are thus less willing to lend – which is why the chancellor has introduced a whole range of credit incentive schemes to do the job instead.

### ... Another credit induced boom

The nascent Osborne boom is yet another credit induced bubble. It will end the way all bubbles end. ‘Wrong, Carswell!’ the government’s defenders will say ‘The money measures are falling now. How can this possibly be a credit induced bubble when M4<sup>20</sup> is contracting?!’ Far from having created a credit induced boom, they say, the government has got it spot on. For the first time in a generation we finally have a monetary policy that works. It is not only more sophisticated, but, thanks to the Bank’s ‘forward guidance’ provides much more than month-on-month analysis. Banks, they point out, are deleveraging. In the process the money supply has been contracting. Yet thanks to our super duper way of managing the money supply now, we have avoided deflation. All that QE, they go on to insist, has been exactly what was needed. As deleveraging and regulatory tightening reduced the money base, QE added to it. The management of the money supply has never been handled better.

If the measure used is just M4, then they seem to be right.

#### *M4 growth*



*From 2009-12 M4 growth fell dramatically and M4 then contracted, partly for regulatory reasons, with banks less willing to extend credit. M4 has, however, started to grow sharply since mid 2012.*

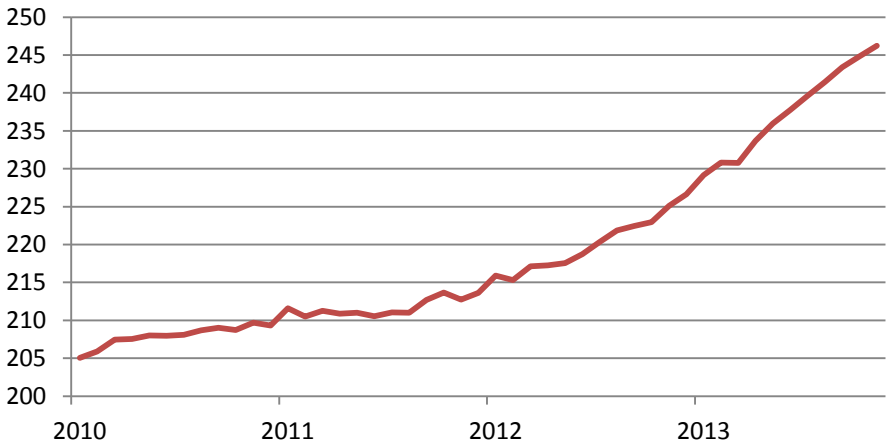
Yet that is the trouble with any target. A narrow set of data – which is what makes a target a target – by definition excludes other variables. During the time of CCC, the

<sup>20</sup> M4 is a measure of money. Money can be measured in many different ways. M4 includes not only cash that people have (known as M0), but also includes, for example, money in your bank accounts. It is regarded as a broad measure of money. The Divisia measure of money looks not merely at M4 money, but the ease with which M4 money can be spent, by, for example, holding money in a current, rather than a long-term deposit account.

authorities thought they had a reliable demand-for-money target.<sup>21</sup> Between 1980 and 85, again, officials believed that they had a money target by which they could steer policy. And so, too, between 1987 and 1992, when monetary policy was steered not by any demand-for-money aggregates, but by exchange rate targeting. From the mid 1990s until the Brown bubble burst, monetary authorities thought they had a reliable lode star in inflation. Again and again, it turned out that the target by which we were steering policy did not tell us all that we needed to know.

Although the traditional broad money aggregates such as M4 are growing steadily, other measures tell a different story. What is happening to M4 today no more gives us a complete picture by which to direct monetary policy than M3, or exchange rates or CPI once did. Divisia Index measures money more widely since it gauges not only broad money, M4, but factors in how useful-or easily accessible- money is to spend. For this reason, Divisia is considered a better indicator of likely future spending, than just M4.

***Broader measures of money: Divisia household index (£m)***



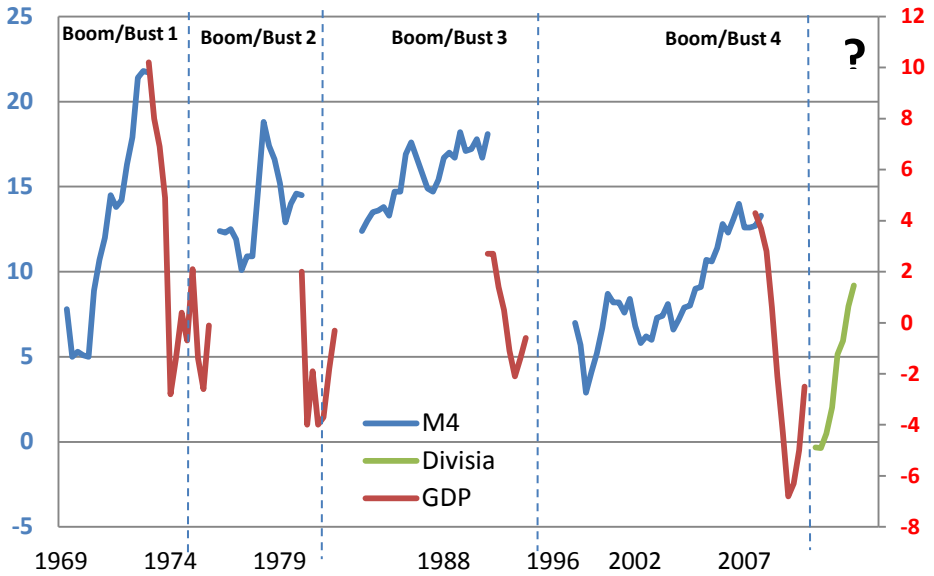
*The Divisia household index of money, which takes into account the accessibility of deposits, shows a growth in the supply of money.*

Far from stabilising the money supply the way that the monetary authorities imagine they are doing, they have been presiding over a rapid increase. Other measures of broad money ‘reveal that the money supply in October 2013 jumped to a growth rate of 12.99 per cent compared to October 2012’ according to Dr Anthony Evans of the ESCP Europe Business School. We are indeed at the start of yet another credit induced boom.

<sup>21</sup> CCC introduced so-called “liability management” in banking. That meant that instead of bank deposits determining lending, lending determined deposits. In effect, it extended banks ability to conjure up credit, via the money multiplier.



**Boom/bust again?**



*A credit boom preceded each previous bust. The Divisia index is an early indication that we are seeing yet another credit induced boom.*

The monetary activism of which the chancellor speaks is not that of simply maintaining the appropriate money base as banks deleverage. That might have been plausible to maintain when QE began. Easy money is now a form of stimulus, designed to raise output. On Gordon Brown’s watch, the monetary authorities failed to control the money supply. And so too on Nigel Lawson’s, and on Anthony Barber’s before that. Perhaps the key point is that on each occasion that officials failed to control the money supply properly, they did not, at the time, appreciate that they were failing. As the Brown bubble ballooned, monetary authorities thought they had things under control. When shadowing the Deutschmark, they thought so. Even Barber and Heath had little idea how bad things would turn out without stricter controls. Free market Conservatives must now ponder how even ardent monetarists did not seem to properly master how to manage the money.

## IV

### What Was Wrong With Monetarism?

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Did monetarism fail, or was it simply abandoned? The row that came to a head between Nigel Lawson, the chancellor, and Alan Walters, the economist who advised Mrs Thatcher, in 1989 marked the moment after which it became impossible to pretend that government economic policy aimed to set money targets.

However the practice of money targeting had been ditched by stealth some time before. Nigel Lawson, the chancellor since 1983, had felt, perhaps as early as 1985, that setting interest rates to meet money targets was no longer working. Policy makers had perhaps tended to assume that monetary policy largely revolved around the quantity of money. Increasingly, however, they seemed to recognise the importance of the velocity of money – or how easy it was for any given quantity of money to be spent.

In March 1987 Mr Lawson began surreptitiously to shadow the Deutschmark. Did he decide to do this because monetarism was not working? Or, as some involved in the debate at that time have speculated, was he disposed towards new ideas, drawn towards the idea of exchange rate targeting for that reason? We cannot be sure. What we can be sure of is that the UK government deliberately and explicitly targeted money growth for what, with hindsight, appears, a remarkably short period of time

Conventional monetarism was explicit policy from 1980 to 1985 – or possibly early 1987.<sup>22</sup>

#### **Trying to control the money supply**

The incoming Conservative government's Medium Term Financial Strategy in 1980 was an explicitly monetarist proposal to reduce inflation and achieve growth and the need to curb inflation was put ahead of any perceived need to curb unemployment. The Financial Strategy set out targets for the growth of M3 the following year. By 1981, Britain was in a serious economic downturn. The Budget that year, however, reaffirmed this monetarist approach. That was to alarm 364 economists, who wrote a letter to *the Times* criticising monetarism. Output was falling and unemployment rising, many conventional economists noted. Yet the chancellor, Geoffrey Howe, was looking to increase taxes by about £4 billion, while seeking to hold down spending. This was, maintained all those expert economists, the wrong thing to do.

Using fiscal policy to take money out of the economy during a downturn flew in the face of Keynesian orthodoxy. If anything, these 364 critics implied, the government should be using fiscal tools to do the opposite, and put money in the economy – either through tax cuts or spending increases.

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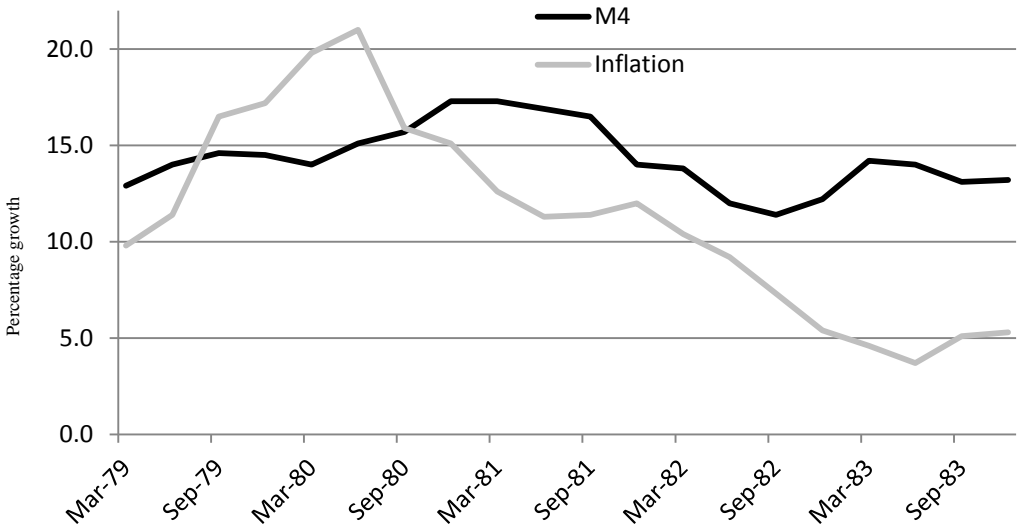
<sup>22</sup> Tim Congdon, *Reflections on Monetarism*, Edward Elgar Northampton USA 1992; *Monetarism Lost*, CPS, London, 1989.

Monetarists, by contrast, placed much less emphasis on fiscal policy. They were much less vexed by the idea of a fall in aggregate demand. Some monetarists saw tax hikes as essential to get a grip on public finances.<sup>23</sup> Only after sorting out government debt could long term interest rates be reduced. And, they maintained, lower interest rates – not fiscal stimulus – was the key to recovery. Indeed, Howe argued at the time that lower government borrowing allowed lower interest rates.

Was Howe’s monetarism a success? It was a subject of controversy and debate at the time, and has remained so ever since.

Howe, to some, seemed entirely vindicated in ignoring his 364 anti-monetarist critics. Although some of the money targets outlined in the 1980 Medium Term Financial Strategy were not met, inflation fell rapidly. The economy began to return to equilibrium and was well on the road to recovery by 1983.<sup>24</sup>

**M4 growth restrained and inflation curbed 1979 - 83**



**Between 1979 and 1983, M4 growth was curbed and inflation fell sharply**

<sup>23</sup> See Chancellor Howe's defence of tax increases at the time, in both Commons speeches and in media reports

<sup>24</sup> Tim Congdon, *Reflections on Monetarism*, Edward Elgar Northampton USA 1992; *Monetarism Lost*, CPS, London, 1989

Geoffrey Howe was not the first chancellor to try to control the money supply. As is widely recognised, the policy of setting money targets began in 1976, under previous Labour government – and the watchful eye of the International Monetary Fund (IMF). The previous Labour government set a target to limit what was then called Domestic Credit Expansion. What is much less widely appreciated is that attempts to control the money supply had come even earlier than that. In 1964 and 1965, the IMF had insisted that the government pay far more attention to monetary policy as a condition for various loans. Indeed, in the decade after World War Two, the authorities had tried to control the money supply with a series of restrictions and controls on bank lending.

Sterling became a floating fiat currency in 1971, with the end of the Bretton Woods currency system. Once Britain was no longer on a fixed exchange rate, the question of how to manage money was posed anew. In September that year, the CCC removed many of the restrictions on bank lending, and attempted to control a broader monetary aggregate. The Bank of England, in essence, believed it had identified a way of measuring a monetary objective, and would be able to control money supply by manipulating interest rates. Well before Mr Howe's 1980 budget, therefore, the Bank even had an unpublished M3 objective. In 1972, the then chancellor Barber accepted a 'target rate of growth of money supply of 20 per cent in the financial year 1972-73'.<sup>25</sup> Given that only a tiny handful of people were even aware of this 'target', the extent to which it represented a serious commitment to controlling the money supply is questionable. The point, however, is that well before Howe and the heyday of monetarism in the early 1980s, there had been attempts made to control the money supply.

It was not until Mr Howe's period as chancellor that the need to control the money supply took precedence over other considerations, however. And it is not that governments have somehow ceased to control the money supply since the mid 1980s either. It is just that other considerations have taken precedence over the need to meet specific monetary targets. M3 targets were downgraded in their importance, before being scrapped in 1987.

### **Failing to control the money supply**

The problem with monetarism, some maintain, is that it was never really properly tried for very long. When it was explicit policy, briefly between 1980 and 1984, it worked. Once other considerations took precedence over the need to meet money targets, it ceased to be as effective. But it ceased to be effective not because it did not work, but because it was not being properly attempted.

There is some truth in that. And yet attempts to control the money supply did not simply fail because of a lack of effort on the part of policy makers. Between 1971 and

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<sup>25</sup> *Britain's money supply experiment, 1971-73*, Duncan Needham, p.14 (Cambridge).

1973, the authorities had money objectives.<sup>26</sup> No longer seeking to control the money supply with crude restrictions on bank lending, they initially envisaged using interest rates to do the job. Low interest rates, however, were regarded by the prime minister, Ted Heath, as vital to help stimulate business and the economy.<sup>27</sup> He ruled out raising rates, knowing that in doing so the money objectives would be missed. Prevented by Heath from using interest rates to control the money supply, the authorities used special deposits, which had the effect of squeezing banks' reserve ratios. In other words, rather than pricing people out of wanting to borrow from banks, they curbed the ability of banks to lend. Finally, the authorities resorted to open market operations to rein in the money supply, before abandoning the CCC in late 1973. As a proto monetarist experiment, the CCC failed comprehensively. The (unpublished) M3 objective for 1972/73 was twenty per cent. It grew by 31 per cent, overshooting by 11 per cent. By the time the CCC was ditched, M3 had grown by 72 per cent. Two years later, inflation hit 27 per cent.

The failure to control the money supply was partly due to the unwillingness on the part of Mr Heath to raise interest rates. But the CCC also failed to hold down the money supply precisely because it swept away many of the older restrictions on lending that had the effect of rationing credit. It is instructive that the authorities in the early 1970s resorted to using special deposits to try to rein in the ability of banks to lend.

Controlling the money supply is not simply a question of raising interest rates. Nor, it seems, may it be possible effectively to control the money supply if banks have free rein to conjure up credit. Special deposits were used to curb the money supply precisely because they – albeit crudely – reined in the ability of banks to extend credit. After the CCC was abandoned, further efforts were made to prevent bank lending to the private sector ballooning. Banks were required to limit their Interest-Bearing Eligible liabilities. This 'Corset' was yet another crude form of proto-monetarism. Another effort designed to curb the supply of money through something other than interest rate movements. Yet as happened under Heath, the efforts were ineffective. Banks simply re-categorised deposits.

Perhaps controlling the money supply necessarily means curbing the ability of banks to create money and credit? Before 1971, Sterling was pegged to the US dollar, which was itself linked to gold. Bretton Woods provided some external constraint on the ability of the banking system to create money and credit. Since 1971, the authorities seemed to be grappling with a problem of how to manage the money once it was a 100 per cent fiat currency. Without any external restraint on the ability of banks to conjure up money and credit, it seemed very difficult to control the amount of money in the economy. The restraining mechanism under Geoffrey Howe was interest rates. The Thatcher government did not – in the early years – balk at raising interest rates the

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<sup>26</sup> It is, suggests Duncan Needham, too strong to call them targets.

<sup>27</sup> *Britain's money supply experiment, 1971-73*, Duncan Needham, p.13. See reference to December 1971 conference, and views of Ted Heath and Jim Slater.

way Heath had done, in order to meet money targets. While this had the effect of bringing inflation down, the reality is that yet again the M3 targets were not all met.

Why? Raising interest rates priced people out of wanting to have credit. It suppressed the demand for lending, rather than the ability of banks to supply credit. When Howe used short term interest rates to rein in M3 growth he was dampening down demand for borrowing. But he was not directly controlling the supply of lending. For all the talk about controlling the supply of money, monetarism boiled down to controlling the demand for it. As long as banks were able to in effect 'make' M3 and M4, the government could not properly control it. Both Barber boom and Lawson boom were preceded by credit liberalisation – extending the ability of banks to create money and credit – and not just lax interest rates. CCC made it easier for banks to lend, and there was a very rapid increase in lending and the money supply. Similarly, in the mid 1980s, credit and lending market regulations were removed, increasing the ability of banks and building societies to lend. So they lent more. And all that extra lending increased the money supply, too.

As it became easier for financial institutions to produce credit, it is hardly surprising that it became harder for a monetarist government committed to controlling the supply of money to do so.

### **What was wrong with monetarism?**

Monetarism's demise is usually told as a story of missed targets. But missed money targets explain *how* monetarism ended, not *why*. Perhaps the real difficulty for monetarism is that it is almost impossible for a government meaningfully to control the supply of money when banks and others can produce it at the stroke of a pen.

Money comes from two sources; government can print it, or commercial banks can conjure it up. What Gordon Pepper and Michael Oliver, rather quaintly describe as 'printing press money' or 'fountain pen money'. Okay, perhaps banks do not create money with a fountain pen anymore, but they can still conjure it out of nothingness.

Imagine, for a moment, that you pay £100 into your bank. The money does not simply sit there, in a vault. The bank lends it on to someone, who lends it on again, to someone else who in turn lends it on.

For many years, the bank would have been required to hold as a cash reserve a fraction of that £100 that you paid in. Assuming, say, that the bank was required to hold on to 7 percent of the cash paid in as reserve, it could have lent on £93 of the £100 you paid in.

Your £100 thereby injected into the banking system has the power to increase deposits to £2,219 after 36 cycles of deposit and lending. This is what is known as the 'money multiplier' – and banks' freedom to multiply the money explains why government attempts to control the money supply have not ultimately worked.

In fact, reserve requirements were removed. Banks today are required by regulators to hold instead a portion of the loans as equity or capital. These capital requirements under the Basel III rules require capital ratios of 9 per cent. If anything, the switch from reserve requirements to capital ratios as the basis for regulation meant even less restraint upon the money multiplier than there was previously.

If you wish to control the supply of money you can do one of two things. You can raise the price of credit, to try to price people and businesses out of borrowing. Or you can try to rein in the money multiplier.

Perhaps one way of looking at the history of monetary policy in the 1970s is to see it as the story of policy makers exhausting various attempts to restrict the money supply in way that did not simply rely on interest rate rises, until Geoffrey Howe in 1979. Various governments might have toyed with restrictions on the ability of banks to produce ‘fountain pen money’, but none succeeded. In fact the history of monetary policy has been a history of being defeated by a failure to rein in the money multiplier.

In the early 1970s, Ted Heath sought to restrict the ability of banks to issue their ‘fountain pen money’. His administration attempted to do this through special deposits, which squeezed banks reserve ratios. Yet he was defeated since his own CCC reforms introduced the idea of ‘liability management’ in banking, meaning that bank deposits no longer determined lending. Rather lending determined bank deposits. The money multiplier let rip, even with special deposits. In the late 1970s, a Labour administration used ‘the corset’, for much the same purpose as Heath’s special deposits. It, too, proved ineffective since banks could evade the restrictions, and carried on creating credit from nothing. In the mid 1980s, Nigel Lawson removed tighter asset reserve ratios, thus making it easier for banks to extend credit – and also failed to control the money supply. Lawson was left to use interest rates to dampen down people’s appetite for credit – albeit very belatedly.

This prompted (an elderly) Ted Heath to refer to Nigel Lawson as a ‘one club golfer’ for trying to control the money supply through interest rates alone. Heath himself, of course, had unsuccessfully tried to use a whole bag of different clubs (except for interest rate club he forswore) and still not managed to do so. But that surely is the point. Every UK government since 1971 that has wanted to control the money supply has been a ‘one club golfer’. Even when they have used interest rates appropriately, they have had no way of dealing effectively with the money multiplier. Of course they have fallen below par. Without controlling the money multiplier, one cannot control the money supply.

It was precisely because they recognised this that the German Bundesbank insisted Britain adopt tighter reserve asset ratios and money target before joining ERM. Without curbing the ability of banks to conjure up money and credit, there could be no monetary discipline. The money multiplier was not reined in, and we know what

happened next.<sup>28</sup> With no real sense of how one might rein in the money multiplier, monetarism became virtually synonymous with using interest rates to curb the country's appetite for credit, rather than reining in the ability of banks to create it.

'But' insist many monetarists 'if governments failed to control the money supply, it was because they failed to raise interest rates when they should have. Heath failed to raise rates in the early 1970s. Lawson cut them recklessly in the 1980s. Brown and his independent bankers did much the same in the 'Noughties'. Indeed. But can any group of central bankers, however wise, know all that they need to know to set the right rates? Maybe that is the real problem with monetarism.

### **Monetarism is dead**

'We are still monetarists' a member of the Treasury team once told me. 'Government still controls the money supply, but just does so in a more sophisticated way that we did in the 1980s'. Any pretence that what the Bank of England is doing today is monetarism is absurd.

Monetarists talk of 'controlling' the money supply. Control, for them, means managing the supply of and demand for money to ensure output expanded in line with trend growth. What the monetary authorities have been doing for the past thirty years has less to do with equilibrium, and more to do with stimulus. What was once a tonic, used intermittently to perk up economy, has become a drug, to which we have become addicted.

In the early 1980s, monetary theorists recognised that raising interest rates up or down was not a simple mechanism. They appreciated the time lag between lowering rates and raising the demand for money, and as a result many monetarists baulked at the idea of moving interest rates to deal with economic ups and downs, preferring to focus on long term trend growth.

Yet from 1997 onwards, the Bank of England was not merely using interest rates to respond to ups and downs. They were trying to pre-empt ups and downs, and doing so with only cursory regard to any money targets. Both in Britain and America, interest rates were lowered at the first sign of economic trouble. Rates were lowered during the first Gulf War; again after the Long Term Capital Management hedge fund collapsed; again after the dot com bubble burst; and again after 9/11. Whatever the problem, low interest rates seemed to be the answer.

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<sup>28</sup> It is the money multiplier effect explains why the Germans today are insisting that in order to save the Euro, Euro member states accept banking union. Banking union means each Euro member needs to accept German-style limitations on the ability of banks to conjure up money and credit. In many Euro member states, the banking sector was able to conjure up far more credit and money than was wise, which – alongside government profligacy – helped cause the Eurozone crisis. Whether a German-type money multiplier extended over the whole Eurozone – with all its implications – is sustainable is the great question the Eurozone faces.



In theory, the Bank of England was being asked to set interest rates in order to manage inflation. In practice the Bank was conjuring up cheap credit as a form of economic stimulus. Monetarism has therefore been dead for nearly three decades. The question now for UK economic policy is whether it should be revived. And if not, what should a post-monetarist monetary policy look like?

## V

### A Post-Monetarist Alternative

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How should we manage the money? The question remains unanswered.

For more than a generation we seem to have grappled with the problem, never quite producing a convincing answer. Early 1980s Monetarists discovered that they could not control the *supply* of money as long as banks can conjure money and credit out of nothing. So instead they ended up using interest rates to try to curb people's enthusiasm for borrowing. That came to an end when a case was then made that interest rates should be set in order to target the exchange rate or inflation, not to manage demand for money and credit.

Failure to find a convincing answer to the question of how we should manage the money suggests that there has been, above everything, a failure to consider the fundamental question.

A quarter of a century ago, Conservative policy makers abandoned the idea of managing the money in accordance with monetary targets. Then we drifted along with the idea of pegging our currency to the exchange rate. When that did not work, we latched on to the idea of inflation targeting. Neither prevented a property and lending boom – followed by bust. Now we edge towards the notion of nominal GDP targeting. Targets. Targets. Monetary policy has always seemed to be about targets. But why? Having seen monetary managers and target setters get things wrong repeatedly, what about a free market alternative?

How we manage the money is one of the most fundamental questions in economics. So why have those who believe in free markets not come forward with a market alternative to having money and credit allocated by monetary technocrats?

#### **A systemic problem**

Rather than asking how we might manage the money, perhaps we should first ask if one can manage the money when banks are free to conjure it out of thin air? Since 1971, Sterling has been a 100 per cent fiat currency. That means that Sterling is no longer pegged to the value of either the US dollar, and through it, gold, or before that, directly to gold.

Might there be something about the money multiplier – the ability of banks literally to make money and credit – coupled with Sterling as a fiat currency, that makes it difficult to curb credit? Something which makes it all the more likely that we will see a succession of credit induced booms, followed by bust? In most areas of economic activity, the supply of something is constrained by the costs of production, and other factors. Yet when it comes to the supply of money and credit, the money multiplier means that supply is much less constrained. Because the amount of money and credit in circulation does not have to be offset by – or justified by – a holding of US dollars,

or gold, or someone else's savings, perhaps credit bubbles have become inherently more likely since 1971?

Actually a pretty good way of looking at monetary policy since 1971 is to see it as a story of failing to prevent the emergence of credit bubbles. From the arrival of Competition and Credit Control to Mark Carney as Governor of the Bank of England, the fundamental problem has been the same. Credit and money have been created when they should not have been created. Under Barber, then Lawson, then Brown and now Osborne, the consequences of a credit induced bubble have been the same. 'The credit cycle,' wrote Nigel Lawson 'is endemic and unpreventable'. It certainly is if you do not figure out a way of reining back banks ability to issue credit on the back of credit.

So the post-monetarist alternative needs to begin with bank reform.

### **Bank reform**

Interest rates are not enough. Raising or lowering them influences the appetite for credit in the economy. It does not actually control the *supply* of money. To do that, we need to deal with the money multiplier. Even if we had the wisest central bankers, able to anticipate every variable, their management of interest rates may not be enough. We need to curb the money multiplier if we are to prevent the sort of credit expansions that sowed the seeds of destruction not only in the 1970s, 1980s and 'noughties', but the 1920s, too.

To be clear, we need fractional reserve banking. The ability of banks to conjure up credit is not necessarily bad. It is difficult to see how modern, free market capitalist economies would function if banks were unable to allocate credit – even speculative credit wagered on expected future earnings. But fractional reserve banking can be too much of a good thing. Unrestrained, the ability of banks to conjure up credit can cause a destructive bubble.

Each period of falling output in the UK economy since 1971 has been preceded by a credit induced bubble, which built up because of the money multiplier. Monetarism was born, in part, in response to the wild expansion in the money supply in the 1970s. Again in the 1980s, the ability of banks to generate credit saw another lending bubble form. Again in the noughties, despite the vigilance of the central bank in keeping CPI low, a lending and property bubble developed. By 2007, banks such as RBS had extended such enormous amounts of credit, that the collapse of the credit cycle not only caused output to fall. It caused a banking crisis.

The question of how the rein in the money multiplier cannot be separated from the issue of bank reform. How might we rein in the ability of banks to generate such harmful credit bubbles? 'Tougher rules and international supervision', suggest many. 'Tighten the Basel capital requirements', demand others.

But all those top down controls were in place when the credit bubble formed. The Basel rules did nothing to stop massive banking failure. Far from preventing the

problem, as Forrest Capie and Geoffrey Wood suggest, the culture of compliance made things worse. Banks started to comply with capital ratio requirements, rather than assess the risks for themselves.<sup>29</sup> To be clear, the Basel rules seek to ensure that banks have enough capital relative to the risks that they take. Even if we assume that the new Basel III rules, and the Vickers proposals, which together will require banks to increase their capital ratios to 15.5 per cent and then 17 – 20 per cent respectively, were to work, they would not really solve the problem we are trying to address.

Increasing capital ratios does not properly control banks' ability to lend. We would still see bubbles. Ted Heath tried to rein in the money multiplier with special deposits. The Labour administration that followed used 'the corset'. Neither worked. What, then, might work in the future?

Some have suggested an arbitrary 30 or 40 per cent reserve requirement. In other words, yet another series of arbitrary targets. But why impose the same reserve requirements on a well run bank as on a badly run bank, such as Northern Rock? In the 1950s, UK banks held reserves of over 30 per cent. Today they have reserves of around 3 per cent. Are we so certain that the 30 per cent reserve ratio is right? Are we certain that we want to emulate the 1950s approach to lending? Others have written about the need for Monetary Base Control. Instead of simply setting interest rates, central banks would control the money supply by targeting the deposits that banks held at the central bank as lender of last resort.

Would central banks be better at determining how much cash reserves banks should have than they are at working out the price of credit? It is odd that free marketers should put so much faith in technocratic guess work when the evidence is that central banker bureaucrats are not very good at wielding the controls they already have. It is not clear that monetary base controls really would rein back the money multiplier. Rather than producing a tighter monetary supply without high interest rates – as proponents suggest – seeking to arbitrarily fix the supply of money and credit could lead to wild, unpredictable fluctuations in the cost of money – interest rates. Nor is the idea of credit controls desirable. Again, technocrats who could not set the right interest rates are hardly likely to be able to know how much credit each bank should be allowed to issue.

### **Reserve ratio reform**

What if there were a way to determine each bank's cash reserve ratios through the free market? What if we could rein in the ability of banks to conjure up credit organically? There is.

A clear legal distinction needs to be made between money paid into a bank as a loan – which the bank can lend on – and money paid in as a deposit – for safekeeping. When

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<sup>29</sup> For an economic discussion of the implications of the current regulatory obligations, see Kent Matthews, 'Banking, the Law and the Free Economy' pp 8-13 and Patrick Minford, 'The Financial Sector, the Banks and the British Economy, Markets, Money and Mistaken Regulation' pp 14-23, *The Financial Sector and the UK Economy: The Danger of Over-Regulation* (Politeia, 2013).

opening a bank account, customers should have to make it clear whether the account they are opening is a loan account or a safekeeping account, as proposed in the Financial Services (Deposits and Lending) Bill. Instead of the vertical separation between retail and institutional banking proposed by the Vickers report, this reform would mean a horizontally split between the kinds of money paid into a bank – and what a bank could do with it. The more customers put more money into loan accounts, relative to the amount of money in safekeeping accounts, the more credit that that bank could generate. It would have, in effect a higher money multiplier. If customers – perhaps growing less trusting of the bank – started to put more money into safekeeping accounts, relative to the loan accounts, that would reduce the bank's ability to generate credit.

The cash reserve ratio of each bank would be determined for it by its customers. A trusted bank would find more money placed in loan accounts, rather than deposit accounts. The ability of the bank to extend credit would grow. A badly run bank, without transparency or sound management, would find less money placed in loan accounts relative to deposit accounts. The ability of that bank to extend credit would be curtailed. A bank's lending, as happened before the CCC reforms of the 1970s, would therefore be a function of its deposits. No more would its deposits be a function of its appetite to lend.

This idea is not so radical.

Building societies made almost this precise same distinction in the past, with two tier accounts; share account (against which the society could issue credit to others) and deposit accounts (which it could not).<sup>30</sup> Deposit accounts historically provided a far greater level of security than the share accounts, since deposit accounts would get their money back first if the building society ran into trouble. In effect, the credit that the building society was extending to borrowers was made against the share account holders' money, rather than that of the deposit account holders. Share account holders, unsurprisingly, earned more than deposit account holders as a consequence.

The 2007 Building Societies (Funding) and Mutual Societies (Transfers) Act more or less ends legal distinction between the two type of accounts when it comes to preferential treatment of creditors in the event of a bankruptcy. Deposit insurance schemes have in fact made the distinction far less important already. The kind of bank reform envisaged in this paper would need to be accompanied by changes to the deposit insurance system that is in place.

The Financial Services Compensation Scheme that took effect in 2007 means that all bank and building society deposits are guaranteed. Savers would be entitled to 100 per cent compensation on the first £85,000 in their bank account. Before then, insurance only extended to 100 per cent cover on the first £2,000 and 90 per cent on amounts between £2,000 and £35,000.

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<sup>30</sup> Depositors, of course, were not members of the building society, and had no say in its running.

Investment, as even trainee bankers once knew, is all about the correlation between risk and reward. The higher the risk, the higher the reward. Investments that carried lower risks, yielded – or ought to have yielded – less interest. Take away an element of risk on deposits in any bank of up to £85,000, and why would a bank rationally pay out much interest? Not surprisingly, perhaps, since 2007 banks have not paid people with less than £85,000 in their accounts great interest returns.

If there were to be a system of two tier bank accounts – loan accounts and deposit accounts – there could not be 100 per cent insurance protection on both. Under such a scheme, deposit accounts would be safekeeping accounts anyhow. A bank that extended credit against them would be guilty of fraud. Loan accounts might need some insurance protection – say 90 per cent for the first few thousand pounds, and fifty per cent on amounts up to £85,000. The risk – and thus the reward – for allowing banks to extend credit against money paid into loan accounts would be with the bank customer. ‘But it would be an appalling system to inflict on the public’ the proposal’s detractors might say. ‘People would be forced to make massive decisions about the security of their savings’. People make those kinds of choices already all the time.

There is a two tier legal distinction, for example, between owning and renting a home. Or between freehold and leasehold. People manage. Every day, people make choices about what kind of ISA account to invest their savings in. They are able to buy stocks and shares. Having a two tier system of banking that recognised a difference between loan accounts and deposit accounts would mean that people would better enable people to plan their financial security than they are able to today. The bank into which they placed their savings would be less likely to go bankrupt. At the moment, bankers’ enthusiasm to extend credit is curbed mainly by regulation. With two tier banking, it would be tempered by deposits, and the actions of depositors. Most important of all, there would be some external restraint on the ability of banks to conjure mountains of candy floss credit out of thin air. The money multiplier would exist, but we would be far less likely to see the sort of runaway increases in the supply of credit that we saw in the 1920s in America, and in Britain in the 1970s, 1980s and in the noughties.

And indeed, less chance of the devastating contractions in the money supply that did followed.

Today we rely on regulators to spot an excess build up of credit and to act counter cyclically in response. Their record of doing so has not been distinguished. If millions of customers – the free market – were able to act either counter cyclically or pro cyclically, there would not cease to be any further credit cycles. There would. Irrational behaviour and market exuberance can never be abolished. But the wisdom of the crowd – of millions of account holders – is likely to be greater than that of central bank bureaucrats.

### **Break up the banks**

Banking in Britain is a cartel. It needs to be broken up. We cannot be certain if being part of a cartel makes banks more likely to extend credit recklessly, but the cartel has

undoubtedly behaved recklessly. Starting with RBS, in which the state has a very large shareholding, the banks need to be broken up. Perhaps even banks that are not owned by government should be considered for a break up. Germany, where the money multiplier does not seem to have blown monetary policy off course quite the way it has in Britain, has 2,000 banks. Perhaps having smaller banks, acting as utilities serving local businesses and householders, makes bankers inherently less likely to extend credit against deposits that are not theirs?<sup>31</sup>

Perhaps more important than breaking up the stodgy oligopoly, is the need to reform banking regulation to allow in new players. Metro Bank is Britain's first new high street bank in 100 years. That in itself helps explain the problem. But of course banking is no longer about the high street. Might Google, or O2, or PayPal not start to offer banking services? It might seem logical that they should. They already have tens of thousands of customers, and take payments. They know a great deal about us as individuals. Why not let them become banks, too? A regulatory framework is needed that would allow them to give it a go should they so decide.

### **Partnership banking?**

We cannot be certain that having a lot of smaller banks would make them less prone to over extend credit. Human greed and folly happen in organisations of all shapes and sizes. Opening the sector to other, more reliable banks, so customers can switch banks would be helpful. Partnership banking might be yet another way to rein in the worst excesses of fractional reserve banking. At present there is a disconnect between those who own banks, and those who manage them. The senior management of several top British banks took risks with other people's property, yet were remunerated as though they owned the businesses they managed.<sup>32</sup>

Banks like Berenberg, a small German bank, have a very different corporate governance structure. The bank is owned by a partnership, and if there are losses, those first in line to take them are the partners. The interests of the bank's management and the bank's owners are much more closely aligned. Partnership banking might not be a panacea, but a serious rethink about the corporate governance structures in banking is long overdue. Any such rethink needs to look seriously at the partnership model.

The way Britain's banks are structured today encourages them to extend credit. Indeed, they had to over-extend credit. They have done so under various governments, with or without higher interest rates, repeatedly over the past four decades. On good

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<sup>31</sup> For a discussion of these issues, including the breaking up of the banks and the reform of rules governing senior management of commercial banks, see David B Smith, 'Financial Regulation and the Wider Economy' pp47-58 in *The Financial Sector and the UK Economy: the Danger of Over-Regulation*, (Politeia 2013) and *Crisis Management? How British Banks Should Face the Future*, (Politeia 2009).

<sup>32</sup> The MP for High Wycombe, Steve Baker, recently introduced a Bill in Parliament on this theme, which interested readers can find out more about here: <http://www.stevebaker.info/campaigns/the-financial-system/financial-institutions-reform-bill/>

days, this model has meant enormous profits. On bad days – most notably in the 1970s and more spectacularly between 2007-09, it meant some staggeringly large losses.

The success that the Bank of England has had in reducing inflation seems to have come at a terrible price; booms and busts in the banking system and credit markets. Reining in the worst excesses of fractional reserve banking would ensure more stability. We might have lower inflation without credit booms.

Introducing the three reforms outlined above, critics might argue, would seriously curtail the ability of banks to lend. The money multiplier would be restrained. That is the point. Bank reforms that curb the money multiplier would help prevent wild credit bubbles and the destruction they bring. How might we clear up the mess created by the last one?

### **Auflockerung<sup>33</sup> – an unlocking?**

As well as bank reform, we need ‘Auflockerung’ – a great unlocking of the system.

Years of cheap credit hosed at the economy have caused malinvestment to clog up our economic arteries. The sheer size of this problem can be quantified, to some degree, by looking at the way in which M4 lending has outstripped M4 bank liabilities by around £400 billion. That means a sum equivalent to about a third of GDP is investment in the economy without a corresponding amount of someone else’s savings, or deferred consumption. Malinvestment was accompanied by low savings rates and high levels of debt. There have been years of over consumption and under production. We have built a lot of shopping malls, but perhaps not as many factories.

As a country, we have lived beyond our means. Not since 1983 has our balance of payments current account been in surplus. We have seen an endless series of asset bubbles, with credit and resources locked up in unproductive ways. Great news if you are a London-based estate agent. Not such great news if you are a Midland manufacturer. Perhaps those great ‘imbalances’ in the economy that ministers claim they will correct are as much a consequence of how we have mismanaged the money?

Chronic malinvestment perhaps also accounts for poor export performance and productivity growth, too? An estimated one in ten UK firms is a ‘zombie firm’. That is to say they are able to pay the interest on their debts, but will not be able to pay back the actual debts themselves. Think about that. Perhaps some businesses are ‘undead’ enough to keep out any new, less debt saddled competitors? Yet not alive enough to venture into new markets and expand? Might this help explain why we have seen such a surprisingly sluggish export performance? ‘Insolvencies in the UK’ says John Moulton, the business recovery specialist ‘are running at approximately one third of the rate of 1993. Companies are being saved by low interest rates, banks not recognising loans losses because of capital concerns and ease of refinancing

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<sup>33</sup> The term is German, and was used by Austrian School economists to denote the sweeping away of factors that prevent production and innovation.



options.’<sup>34</sup> ‘We don’t just have zombie companies but zombie banks and countries too. Normally the good thing about recessions is that you clear out bad structures, right now we are not.’

Perhaps malinvestment, and its distorting effect helps account for poor productivity growth, too? Between 2007 and 2012, economic output fell, yet the number of those in work rose. Was each worker really producing less per capita than before? Or did malinvestment artificially overstate actual output in the first place? Perhaps as the inflated financial sector unwound, it appeared that productivity was falling, not because workers were actually producing less, but because output had never been quite what it appeared in the first place? We cannot be sure.

What we do know is that a tightening of money and credit conditions would flush out an awful lot of malinvestment. Raising rates half a percentage point every few months would make debt gradually more expensive to hold. Those with debts would begin to clear them. Businesses with debts that stood no chance of being able to clear them – and who are in effect only being kept alive by monetary subsidy – would be forced to fold. A critic might suggest that wanting to raise interest rates made no sense. That would cut demand, further weakening output. We would be caught in a trap!

Britain is already ensnared in the trap. Should it struggle on, tangling itself even further into a web of malinvestment, or look for a way out?

‘Sooner or later foreign [traders] will work out that the only thing we can do with our debt is inflate it away’ Moulton continues. ‘The day they realise that, rates will start to rise’. Besides, tightening monetary conditions might not be as painful as some imagine. One of the curious things about this downturn is how employment has risen, despite all the dire warnings, from many economists – including former members of the MPC. Tighter monetary conditions would, however, mean a period of painful readjustment. Precisely because so much credit has been allocated on things it ought not to have been allocated to, there are no pain free alternatives. It is a case of the least worst thing to do. Only by unlocking all the misallocated credit can we hope to rebalance the economy. Higher interest rates would increase the savings ratio. Debts would be paid down. Those that can never be paid down, written off.

42 per cent of UK households own their homes outright. In probability, most of them are likely to be net savers. Higher interest rates may hurt some people, but savers would gain.

Over the years, an enormous amount of credit and capital in Britain has gone into bricks and mortar. Mortgage debt now accounts for three quarters of the stock of British sterling loans to the non-financial private sector. Mortgage lending dwarfs business lending.

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<sup>34</sup> Quoted in *Daily Telegraph*, May 5<sup>th</sup> 2013

Perhaps a tighter monetary policy might change that? Capital might also be diverted away from consumption, towards those things that actually increased production. More real credit would begin to flow into the system. Raising the price of credit might actually mean more credit in the system. Not the confected, candy floss credit issued by government fiat, but real people's savings and deferred consumption.

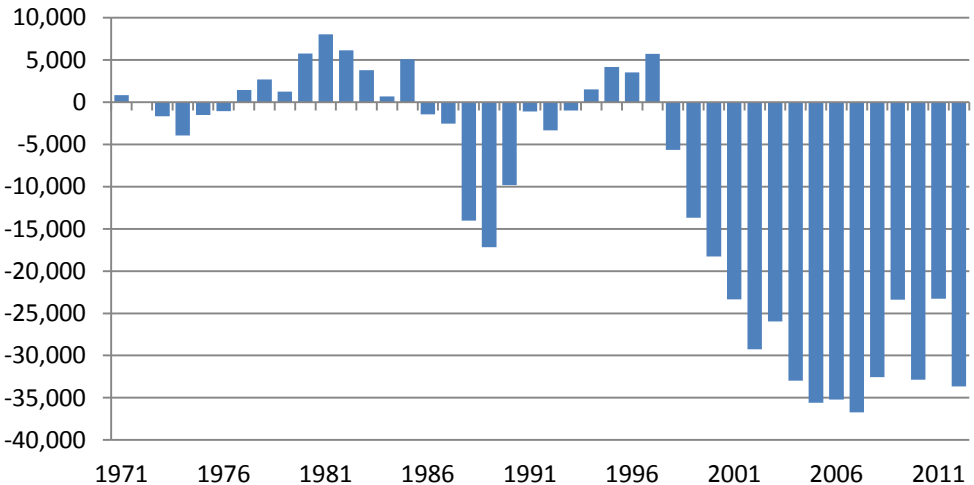
Tighter monetary conditions would force us to confront the biggest single form of malinvestment of all; a chronic, long term overinvestment in government, which has produced a massively bloated, inefficient state. There has been a massive rise in the share of GDP spent by government. This in turn has produced disequilibrium and imbalances. Resources – including credit – that might be available to other agents in the economy, are directed towards government. Big government crowds out enterprise and innovation. It distorts the trade deficit.

Today, even with record low interest rates, the government spends more each year servicing its debts than it does on defence. Even a modest increase in rates would see the government spending more on debt repayments than on education. This situation is not sustainable.

### **Monetary policy and fiscal responsibility**

For a generation, monetary policy in Britain has been subservient to the needs of fiscal policy. It is this which helps explain why both are such a mess. We have failed to maintain a sound pound because of the desire to spend. Government has not wanted a tight monetary policy because a lax monetary policy helps enable government to grow big.

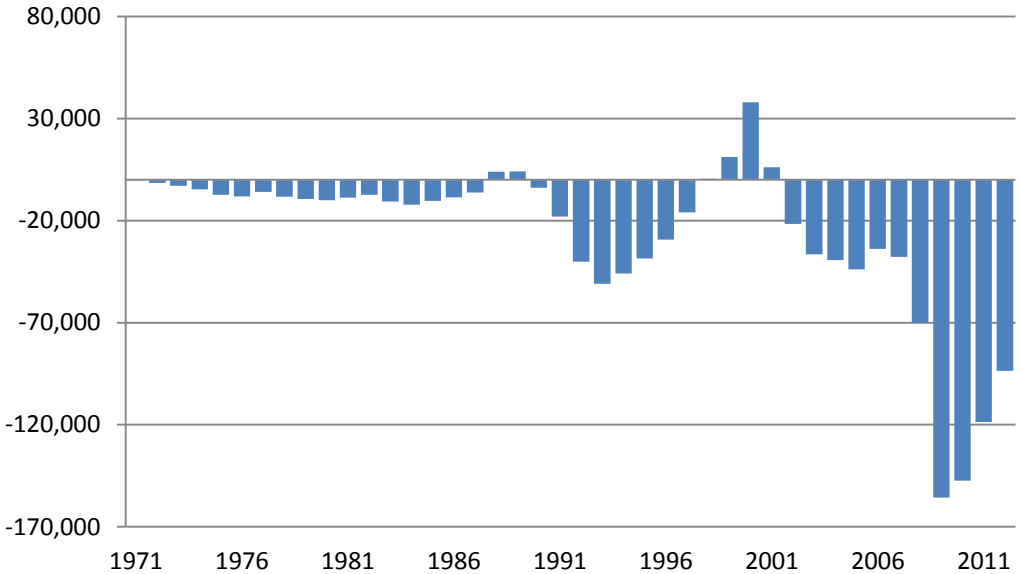
#### ***UK trade and budget deficits since 1971 (£m)***



Historically governments have debased currencies when they wanted, or were forced, to overspend. From Romans diluting the silver content of the denarius, to the United States severing the link with gold in the 1970s, government have debased the value of the currencies as a means of making fiscal irresponsibility pay.

Monetary policy in Britain has been lax precisely because it suits government that things are run that way. Since 1971 Britain has been living beyond her means. The British government has, at the same time, been living far beyond the tax base. In the forty years before 1971, Britain seldom ever ran a current account deficit in peacetime. Britain has only run a current account surplus in 14 of the 42 years since 1971. The government has spent more than it takes in tax in 36 of the past 42 years.

**UK government budget deficits/surpluses since 1971 (£m)**



When a chancellor describes himself both a ‘monetary activist’ and ‘fiscally conservative’, he is suggesting that he is a responsible chancellor. Monetary indiscipline today – like that of every administration since 1971 – is what helps facilitate such extraordinary fiscally profligacy. Monetary policy today is made to meet the needs of fiscal overspend. QE conjures up billions of pounds to ensure that someone, somewhere, will take all those IOU bonds that the government keeps issuing each year. When politicians talk of the need for low interest rates, they have in mind not only the needs of business. They are thinking too of the state sector, and that £100 billion annual deficit that it needs to keep financing.

Government cannot be expected to close the cheap money merry go round as long as government is one of the principle beneficiaries of it. 'If only governments would balance the budget' some say. 'If only they could learn to spend less in proportion to how much they take in tax, monetary policy could be tighter'. The answer is not simply to say that government must balance the budget. They have not done so successfully for decades, and it is motherhood and apple pie to suggest that without any external constraints that they might. The solution is to remove the easy money machine that allows governments to avoid having to balance the budget. And in doing so, impose restraint.

For a decade, Euro-zone states shared a common currency, but not the same bank rules. The lax money multiplier in Greece, Spain, France and elsewhere not only allowed governments in those countries – indeed whole countries – to live beyond their means. Cheap credit was hosed at the economy, causing unsustainable boom and bust. We now recognise the serious imbalances that this caused. The money multiplier has been doing something similar in Britain for a generation.

There is nothing free market or small state about monetary policy today. On the contrary, monetary policy is made to enable big government to remain big. Until free market thinkers grasp this, and contemplate a coherent, market based alternative, government is going to remain big. At the heart of our capitalist system, capital is increasingly allocated not by the free market, but by rationing. It is a paradox that will not hold.

For too long, conservative policy makers have been content to regard monetary stimulus as a solution, a tool to engineer and drive prosperity. The economics of the Treasury under Gordon Brown and George Osborne - Osbrowne - is testing that proposition to destruction. Once it has done so, the UK needs a policy approach founded on recognition that the take up of credit is not a cause of economic growth, but a consequence of it.



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Britain's economy appears to be recovering. Growth is back, unemployment falling and output rising. But all is not what it seems, says Douglas Carswell. In *After Osbrown: Mending Monetary Policy*, he warns that the deficit is still too high and savings and investment too low. Worse, the country is still living on cheap credit. The Coalition appears to be following the same approach to economic policy as its Labour predecessor, and the increase in the money supply through quantitative easing is a particular cause for concern.

Failure to manage the money supply, the author explains, has been a fundamental failing for successive chancellors. Mr Carswell, Member of Parliament for Clacton, goes on to propose a new approach to monetary policy.

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