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How to stop the recession

PETER WILLIAMS LOOKS AT ONE AUTHORITATIVE ECONOMIST'S RADICAL MANIFESTO FOR EASING THE CORPORATE CREDIT CRISIS.

Executive summary

- In March the Bank of England's Monetary Policy Committee decided to undertake a £75bn programme of asset purchases financed by the issuance of central bank reserves to boost the supply of money and credit, and so raise the rate of growth of nominal spending to a level consistent with meeting the inflation target in the medium term. The £75bn would finance the Bank's private sector asset purchase facility and the purchase of medium- and long-maturity conventional gilts in the secondary market. It is likely that the majority of the overall purchases by value over the next three months will be of gilts.

What would governments give for a magic wand to sort out the current economic and financial crisis? In the absence of such a tool they have to rely on economic policy. But what should that economic policy be? The old joke about economists never being able to agree about anything seems as true today as it ever was, although perhaps not so funny at the moment.

One economist who thinks he knows the solution is Tim Congdon. In a new pamphlet, brazenly entitled How to Stop the Recession, from the Centre for the Study of Financial Innovation (CSFI), he argues that the UK's present recession can be stopped by large-scale government borrowing from the banks to create more money.

Congdon, an economic adviser to the last Conservative government and the founder of Lombard Street Research, is highly critical of the official UK line that banks must lend more to increase spending in the economy. In his CSFI pamphlet he seeks to demonstrate that if banks lend to companies and corporate bank deposits are unchanged, then the liquidity ratio of corporates falls. The likely result is a drop in spending because of corporates' greater balance sheet weakness: "An over-indebted private sector hit by a slump in house and share prices does not want to borrow more from the banks. The economy needs an increase in the quantity of money, not more bank debt."

The harshness of the cyclical downturn in demand in late 2008 and early 2009 has stimulated much discussion – in both the UK and elsewhere – about so-called quantitative easing. It is seen as a supplement, or even as an alternative, to more straightforward measures such as the reduction of interest rates. The phrase "quantitative easing" is bedevilled by ambiguities. The proposal that the government should borrow from the banks to increase the quantity of money is a kind of quantitative easing, but the term is often used to refer to actions by the central bank, not by the government.

According to Jamie Dannhauser, senior economist at Lombard Street Research, it is now widely accepted that "inflation is always and everywhere a monetary phenomenon" in the sense that rises in the level of domestic prices are ultimately caused by increases in the stock of money. However, there remains considerable disagreement about the role of money in explaining business cycle fluctuations.

Writing in the pamphlet's foreword, Dannhauser argues that current macroeconomic consensus has no place for money aggregates and that money has largely been swept under the carpet by the academic economists who have come to dominate central banks. Money is assumed to have no independent effect on real activity, nor to offer any incremental information on future demand or price pressure beyond that captured by market interest rates. The transmission mechanism of monetary policy is primarily concerned with the price of credit.

By contrast Congdon's argument is that national income can only be in equilibrium when the aggregate demand to hold money is equal to its aggregate supply. He also suggests that demand

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Box 1: What is money?

According to Tim Congdon, the phrases "the quantity of money" and "the money supply" refer to those assets that can be used to make payments. In a modern economy, there are three such assets: coin, notes and bank deposits. Nowadays, coin is so trivial that it is commonly bracketed with notes in "notes and coin", and together they are labelled "cash".

Cash has been given legal-tender status by the government and so cannot be refused as a means of payment. Bank deposits are money because an instruction to pay against a deposit (by cheque, standing order or whatever) is, strictly speaking, an instruction to move cash to someone else's account. As long as banks can carry out such instructions, bank deposits are "as good as cash" in the making of payments and therefore are money. The terminology can be confusing since "money supply" sounds rather like a bank supplying a loan, but a bank loan is not money.

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IT IS NOT NECESSARY FOR THE BANKS TO LEND MORE TO THE PRIVATE SECTOR FOR THE QUANTITY OF MONEY TO INCREASE. THE QUANTITY OF MONEY CAN INCREASE IF THE GOVERNMENT REPLACES THE PRIVATE SECTOR AND BECOMES A SIGNIFICANT BORROWER FROM THE BANKING SYSTEM IN ITS OWN RIGHT.

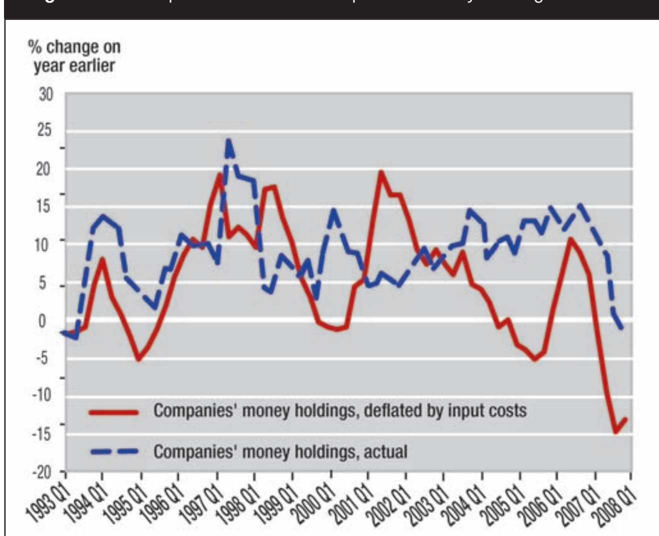
adjustments to money supply do not happen passively; rather, shocks to the money supply from the banking system or the funding choice of the government can be significant, independent sources of macro-economic volatility. In the UK in recent decades in each boom-bust phase the economic upswing has been characterised by excessive monetary growth, followed by buoyant asset prices and above-trend output growth. The subsequent recession sees a collapse in monetary growth, leading to a significant decline in asset prices and economic activity.

Congdon argues that the Bank of England has more or less ignored the recent high rate of money growth. Inflation was low and impressively stable in the 13 years to the end of 2005, and demand and output grew without interruption, but by mid-2006 the monetary data signalled that, once again, "policymakers were playing with fire".

The broadly defined M4 measure of money went up by 14.0% in the year to the third quarter of 2006 and continued to advance at a double-digit annual rate in early 2007. Given the UK's history of monetary mismanagement, the Bank of England ought to have paid closer attention to this development and taken action to restrict it.

Congdon's argument is that financial innovation clouded the issue over money growth, with banks bypassing the Basel rules on their capital requirements by setting up artificial vehicles (conduits) into which they channeled business. Congdon says that these conduits were not standalone financial institutions at all, but quasi-banks with interbank loans on the liabilities side of their balance sheet.

Figure 1: The squeeze on British companies' money holdings



Congdon believes that the severity of the present downturn can largely be attributed to a drastic change in monetary conditions. In early 2007 British companies had 15% more money in their bank accounts than a year earlier. But in the second half of 2008 their money balances fell by almost 5% – an annualised rate of almost 10% – and it is this that is the immediate cause of the credit squeeze.

British companies, particularly small- and medium-sized companies, are suffering from a severe cash squeeze. Companies are holding up payments to each other in order to protect their own bank balances, while insurance companies are demanding high premiums for guaranteeing intercompany credit. Each individual company believes that, by clinging on to the money in its bank deposit, it is improving its own position.

According to Congdon, the plight of companies can be demonstrated by measuring their sterling money balances, mostly banks deposits, as a ratio of their bank borrowings – in other words, the corporate liquidity ratio. This ratio presently has "slumped" to 45% compared with a "normal" range of 55-60%. Values of 40-45% were seen in the corporate cash crises of 1974, 1981 and 1990.

The government and the Bank of England must act to halt and reverse the crash in company money holdings shown in Figure 1. Congdon believes that the government should borrow from the banks to create more money. His proposal is that the government should borrow £100bn from the banks and spend it gradually over the fiscal year to cover the budget deficit and debt maturities, or suddenly in a large-scale buyback of government securities now held by the non-bank private sector.

It is not necessary for the banks to lend more to the private sector for the quantity of money to increase. The quantity of money can increase if the government replaces the private sector and becomes a significant borrower from the banking system in its own right. The advantage of doing so is that there are negligible solvency or liquidity constraints on bank lending to government.

If £100bn of government securities were bought back in one major operation in the first quarter of 2009, the quantity of money (that is, the private sector's banks deposits) would jump by about 5%. If the operation were then repeated in the second quarter, there would be another 5% jump, giving a total boost to the quantity of money of 10%.

Companies are only one of three types of money-holding agents in the UK economy, and their money balances (£237.3bn at Q3 2008) are overshadowed in terms of size by those of households (£981.8bn) and financial institutions (£620.2bn). Nevertheless, companies are the dominant employers and the characteristic form of productive unit in our economy. Because companies' money holdings are more volatile than money in the aggregate, their money holdings ought to increase by 15-20%, taking the corporate liquidity ratio back to its normal levels and so ending the corporate cash squeeze.

Evidence from recent cycles is that companies respond quickly to changes in their financial positions. Congdon is therefore confident that large-scale and deliberate action to expand money would stop the recession quickly.

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