

## 2. Traditional monetary economics vs Keynesianism, creditism and base-ism

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How is the Great Recession to be explained from an intellectual standpoint? The argument here is that the heart of the problem is the lack of an agreed consensus among economists on answers to the questions, ‘what are the key determinants of the equilibrium values of income and wealth *in nominal terms*?’ and ‘if income and wealth are not in equilibrium, how do these determinants restore their equilibrium levels?’. In the following I will argue that banking developments – particularly such developments when they affect the quantity of bank deposits – are critical in answering these questions. I should say at the outset that my argument is not universally shared among economists and that, in my opinion, the absence of a consensus has itself been largely to blame for the monetary and banking fiasco suffered since mid-2007. Although I regard my position as rooted in traditional monetary theory, I am well aware that central features of my analysis are – for the moment at least – deeply unfashionable. Moreover, my conclusion is distant from the current mainstream. I reject the notion that privately owned commercial banks have been to blame for the macro-economic calamity of the last three years. These organizations patently do not control the recognized instruments of macroeconomic policy. On the contrary, the blame for the Great Recession lies with governments, central banks and regulators, particularly those in the English-speaking world. The bottom line is that, by punishing the banks, officialdom has punished everyone.

### MONEY, WEALTH AND EXPENDITURE

I take it for granted that attempts to determine the equilibrium nominal values of income and wealth *separately* are a mistake. After all, wealth is merely the capitalization of some notion of income. I regard the dominant

forms of wealth in a modern community as real estate, both residential and commercial, and corporate equity. Government bonds are not net wealth, and corporate bonds, while important, are not a dominant form of wealth.

In my view the equilibrium nominal values of income and wealth can be regarded as determined by the joint product of:

- i. the quantity of money, and
- ii. the desired ratios of money to income and wealth (and we can collapse this to ‘the desired ratio of money to income’ if the relationship between income and wealth is stable).

It follows that – if the desired ratio of money to income is also stable (as it is, pretty much) – the equilibrium nominal values of income and wealth can be interpreted as a function of the quantity of money. This may seem rather sweeping, but the logic is simple. The prices of all goods and services, and also of all assets, can vary. By contrast, the ‘price’ – in the sense of the nominal value – of money cannot vary, because the nominal value of the most basic type of money is fixed by law. So changes in the quantity of money cannot alter money’s nominal value. Instead – if changes in the quantity of money rupture an existing general equilibrium – equilibrium can be restored only by changes in the nominal values of income and wealth. Is it so startling to propose that the total nominal value of all those things with variable nominal values depends on the quantity of that thing (money) which has a fixed nominal value?

I have argued in my work that the relevant ‘quantity of money’ must be an all-inclusive one, that is, one that embraces all assets, the nominal value of which is given.<sup>1</sup> Unfortunately, there is a serious ambiguity here, that modern economies have both a central bank and commercial banking system.<sup>2</sup> The liabilities of the central bank are ‘the monetary base’ and include notes/cash, where legislation states that their nominal value is enforceable in the courts and is therefore (more or less) 100 per cent certain. On the other hand, the nominal value of the deposit liabilities of commercial banks is not 100 per cent certain, as banks can ‘go bust’. At any rate, institutional arrangements (a central bank plus banking regulation) are in place to ensure that bank deposits are always fully convertible into cash. For immediate purposes we can take it for granted that deposits, like cash, have the property of nominal value certainty.

My emphasis on the relevance of an all-inclusive (or broadly-defined) money measure arises largely from the kind of statement I am making, which is of course a theoretical statement about the general equilibrium of a modern economy. However, in my empirical work

on macroeconomic data I have also found broad money to be the least untrustworthy guide in thinking about ‘how money affects the economy’. Thus, the notion of drawing conclusions about asset prices from only one type of money asset (such as the base or sight deposits, M0 or M1), and excluding altogether time deposits (which are clearly a large part of portfolios), strikes me as bizarre.<sup>3</sup> If we are thinking in general equilibrium terms, we must embrace *all* assets with a given nominal value in our concept of ‘money’.

Further, nowadays not only are the deposit liabilities of commercial banks a much more important kind of money than the note issue of the central bank, but also deposits dominate commercial banks’ liabilities. Two points then follow:

- i. changes in the rate of growth of nominal national income are likely to be closely related (although not identical) to changes in the rate of growth of the commercial banking system, and
- ii. in episodes characterized by large fluctuations in the rate of growth of the banking system’s balance sheet and so of broad money, the resulting macroeconomic disequilibrium is likely to have particularly obvious symptoms in the prices of assets, that is, real estate and corporate equity.

I am unsympathetic to the restriction of discussions of portfolio choice to the choice between money and bonds, as in Keynes’s *General Theory* and much subsequent work. The relationship between money, on the one hand, and the prices of real estate and corporate equity, on the other, is crucial to the economy. By contrast, the relationship between money and the price of long-dated bonds (and so of bond yields and what Keynes called ‘the rate of interest’) is secondary. Attempts have been made by some economists to understand large-scale movements in *nominal* asset prices without reference to the dynamics of the banking system. If the Great Recession (like the Great Depression before it) has shown anything, it is that these attempts are misconceived, even ridiculous. If developments in the banking system are relevant to asset prices, they must also be of huge importance in the determination of national expenditure and income.

## SOME IMPLICATIONS

The message of the above is surely clear, that public policy must be concerned

- i. to maintain the full convertibility of deposits into cash (i.e., keeping the value of all types of money stable *in nominal terms*), and
- ii. to ensure that the growth of the banking system's balance sheet, and particularly of its deposit liabilities (i.e., the quantity of money), is at a steady rate over time to avoid instability in asset prices and expenditure, and also at a steady rate which is appropriate (neither too high nor too low) for preserving the value of money *in real terms* (i.e., keeping the price level of goods and services fairly stable over time).

I know that a whole host of objections can be raised to the second of these points. All I would say is that my statement contains at least two strong and very plausible warnings:

- i. that wide fluctuations in the rate of growth of the banking system are likely to be attended by macroeconomic instability, and
- ii. that a large reduction in the size of the commercial banking system is likely to cause not a fall in the ratio of bank liabilities to national income, but a deflation of asset prices and the prices of goods and services.

Further, deflation will inevitably be associated with high unemployment and lost output.

## PUBLIC POLICY IN THE LEADING NATIONS AT PRESENT

Given the above, it may seem astonishing that public policy in the leading nations could ever be intended to enforce a large reduction in the size of the commercial banking system. But that is exactly what was intended by the governments and leading regulatory agencies of North America, Europe and Japan in the early stages of the Great Recession. The President of the USA openly said that he wanted to see the banking system undergo 'shrinkage'. Large increases in banks' capital/asset ratios were mandated, with the undoubted purpose of limiting or even reducing banks' risk assets.

It is true that the deflationary impact of the shrinkage of banks' *risk* assets could be offset by the expansion of banks' *safe* assets (i.e. their cash and government securities), since the expansion of safe assets ought to be matched on the other side of the balance sheet by extra deposits (i.e. money). But only in the UK was this policy adopted in a deliberate fashion, with the Bank of England's programme of quantitative easing (QE). (I say 'deliberate', but I don't think the policy has been chosen

with much enthusiasm or even understanding by most of the key relevant individuals in officialdom. It was adopted in February/March 2009 from despair that everything else was failing.<sup>4</sup>

[Note that this chapter was written in February 2010. In November 2010 the Federal Reserve announced a programme of purchases of government securities which was very similar to the Bank of England's March 2009 exercise in both structure and rationalization. It was labelled 'QE2' in financial markets. This label implied that the Fed had undertaken an earlier quantitative-easing operation. However, the Fed's previous asset purchases – notably those of commercial paper in late 2008 and of mortgage-backed securities in 2009 – were not intended to increase the quantity of money. They were instead supposed to 'ease credit conditions' and lower 'credit spreads'. Indeed, Bernanke specifically said that they should be characterized as 'credit easing'. They did in fact often boost the quantity of money, but this was one of their by-products, not their central purpose.]

Programmes with a similar impact to the Bank of England's QE have been undertaken in the USA, but not – in any substantive way – in Europe or Japan. However, in the USA the statements accompanying these programmes make no meaningful reference to the quantity of money and, in my view, do not reflect a well-structured and credible theoretical account of how the economy works. In the Eurozone the sensible conduct of policy has been obstructed by the wording of an international treaty. The founding document, the Maastricht Treaty, was written in the assumption that banks would always be able to expand their balance sheets by increasing loans to the private sector. The treaty therefore discouraged government borrowing from commercial banks and proscribed government borrowing from the central bank(s). Of course, in a period when bank lending to the private sector is on a falling trend, government borrowing from the banking system is the correct method of maintaining a positive rate of money growth. Indeed, if bank lending to the private sector is on a falling trend over several years, as may be the case in such countries as Spain and Ireland, government borrowing from the banking system must also be pursued over several years. Such government borrowing should not be viewed as a special or emergency response to a supposedly unique challenge in monetary management.

Even more alarming have been policy developments relating to

- i. the size of budget deficits, and
- ii. the financing pattern of such deficits.

Naive commentators have persuaded finance ministries to raise government spending and to increase budget deficits 'in order to boost demand', when the evidence for the effectiveness of fiscal policy is almost everywhere

unconvincing. (The name of ‘Keynes’ is used as a slogan to justify these mistakes.) The long-run effects will be a higher ratio of government expenditure to GDP and larger public debts, while it is already clear that the short-run effects on *net* demand (i.e. private and government spending combined) have been disappointing.

If governments must run budget deficits, it is important in a deflationary context that the deficits be financed at the short end from the banking system, in order to expand the quantity of money. Indeed, monetary financing of deficits is a much simpler means of expanding the quantity of money than central bank purchases of assets from non-banks (i.e. than programmes such as QE). But, throughout the Great Recession, finance ministries have tended to finance budget deficits as far as possible at the long end from non-banks. They are doing so in the belief that they are acting responsibly and avoiding potential difficulties in rolling over debt in the next few years. (In the UK, policy decision-making in this area is still bedevilled by remnants of the ‘full funding rule’, which dates back to 1985. When introduced, this wholly misguided precept tried to prevent the financing pattern of the budget balance having any effect on broad money. Officialdom therefore dispensed with a valid means of influencing macro-economic outcomes by adjusting the terms, instrument composition and maturity composition of public debt.)

The correct course of action is two- or three-fold:

- i. to reduce budget deficits as soon as possible by as much as is politically feasible,
- ii. to finance the remaining deficits (and to refinance maturing debt) at the short end from the banks in order to ensure that money growth is positive at a moderate rate, and
- iii. if (ii) isn’t sufficient, for the government to borrow from the banks in order to purchase its own long-dated debt from non-banks in order again to ensure that money growth is positive at a moderate rate.

Any future difficulty in rolling over debt as it matures is reduced if the size of the public debt is kept under control. It is deplorable that, across the industrial world, the topic of public debt management is currently viewed as distinct from that of monetary control. Part of the problem undoubtedly is an over-interpretation of the notion of ‘central bank independence’. If the leading countries face a period of several years in which banks’ claims on the private sector will be falling (as seems possible), central banks – whether ‘independent’ or not – must work with finance ministries to ensure that money growth remains positive. If that involves monetization of public debt, so be it. Let the Maastricht Treaty be damned.

## THE INTELLECTUAL DRIVERS OF CURRENT MISTAKES IN PUBLIC POLICY

Ultimately, the current mess in policy-making arises because economists do not have an agreed theory for the determination of national income and wealth. I have sketched out above my own views about the correct theory. I will now refer – very quickly and briefly, and perhaps a little unfairly – to three alternative approaches. In my view all three are wrong, to a greater or lesser degree, for reasons I will explain.

1. Keynesianism: the central principle of Keynesianism is that output depends on expenditure and that expenditure can be viewed as a multiple of investment, including public investment, so that changes in public investment/‘the budget deficit’ boost demand and output. There are many mistakes here, but the most obvious is that the income–expenditure story overlooks that expenditure on current goods and services (i.e. expenditure that determines output) can be financed by the sale of assets and/or by running down a money balance. Agents’ attitudes towards their wealth and portfolios, and the role of money in portfolio-balancing decisions, are fundamental. Ironically, Keynes himself regarded the integration of money into such portfolio-balancing decisions as essential to the understanding of macroeconomic fluctuations. I argued in my 2007 book on *Keynes, the Keynesians and Monetarism* (Congdon, 2007) that the Keynesians had betrayed Keynes’s intellectual legacy.
2. Creditism: the main idea in creditism is that ‘credit’, and specifically bank lending to the private sector, has an important role in the determination of national expenditure and/or asset prices *independently of the quantity of money*. This idea had no place in traditional monetary theory. It has developed since the late 1980s, mostly in American East Coast universities, since academic articles were written by Bernanke, Benjamin Friedman (not Milton Friedman) and others about a supposed ‘credit channel’ in the monetary transmission mechanism. The thought behind creditism seems to be that the proceeds of a new bank loan enable an agent to spend above income and hence to boost aggregate demand. In fact, virtually all bank loans have the purpose of allowing the borrower to purchase an *existing* asset and do not have any first-round effect on the income–expenditure circular flow. The value of new bank loans to the private sector is a tiny fraction of the value of payments in a modern economy. (The value of such payments – nearly all mediated by money – is typically about 50 times national income.) Except through its effect on the quantity of money, new bank

- lending to the private sector has no definite and necessary relationship with national expenditure.
3. Base-ism: the key notion in base-ism is that the relationship between the monetary base itself (i.e. the liabilities of the central bank) and the economy is the same as (or dominates) the relationship between the quantity of money and the economy. (By the ‘quantity of money’ I mean of course an aggregate mostly represented by bank deposits, that is, the liabilities of commercial banks.) An implication of pure base-ism – which is closely related to the school of New Classical Economics centred in American Mid-Western universities, including nowadays the University of Chicago – is that the banking industry is no more worthy of macroeconomic analysis than, say, the car industry or oil refining. According to base-ists, the central bank’s decisions matter to the economy, but the rate of expansion or contraction of commercial bank deposits is of no relevance to macroeconomic outcomes. Both the Great Depression and the current Great Recession demonstrate that this claim is preposterous. A milder form of base-ism contends that changes in the level of bank deposits are regulated by changes in the monetary base. This milder form has been refuted in the last two years by the large rise in the monetary base made necessary by the breakdown since August 2007 of the international inter-bank market, which had much the same effect on banks’ cash position as a run on their customer deposits. In accordance with principles that were clearly stated in Bagehot’s 1873 *Lombard Street*, central banks should respond to such runs – when they are on solvent banks that have complied with regulations – by expanding the monetary base and ensuring that deposits remain convertible into cash. The ratio of money as a whole to the monetary base may change radically while the central bank is helping the commercial banks in this way.

It is very important, in interpreting the current mess, for non-economists to understand that most economists do not accept a single, shared theory on the determination of asset prices and national income. The majority of the profession – if economists can be said to constitute ‘a profession’ – is to be placed in one or another of the three schools just discussed. To be frank, the so-called ‘discipline’ is an extraordinary jumble. I believe that my own position – that the nominal levels of both asset prices and national income should be understood as a function of an all-inclusive quantity of money – is analytically correct, relatively easy to understand and corroborated by a great deal of evidence. But most economists do not agree with it.

The theoretical confusions lead to extraordinary divergences on policy. Roughly speaking, the Keynesians believe that the best antidotes to weak demand are increases in the budget deficit (or, at present when budget deficits are unsustainably large, by the postponement of actions to reduce them), while the creditists favour an increase in bank lending. Some creditists in the UK seem to think that more bank lending should be engineered by official arm-twisting to force banks to raise more capital or, in the extreme, by brute administrative fiat. (In late 2008 the Governor of the Bank of England pronounced, 'Lend more or we'll nationalize you'.) The Keynesians and the creditists virtually all agree that, at present (i.e. February 2010), the looming danger for the world economy is continued beneath-trend growth and more deflation. I agree with them on this, although not with their policy prescriptions.

By contrast, the base-ists now worry that the large increases in the monetary base in the USA, the Eurozone, the UK and so on will be inflationary, and are concerned to specify an early 'exit' from allegedly excessive monetary stimulus.

Many members of the three schools do not think that the quantity of money (i.e. as I keep on emphasizing, nowadays the quantity of bank deposits) is of any importance in macroeconomic analysis. They are indifferent if public policy has the effect of shrinking the banking system balance sheet and the quantity of money. In fact, they often assert the unimportance of the quantity of money in macroeconomic processes and refuse even to mention it in their analyses. If this seems incredible, may I mention the latest commentaries from the International Monetary Fund by its chief economist, Professor Olivier Blanchard, formerly of Harvard University? In these commentaries Blanchard uses the words 'liquidity' and 'credit' dozens of times, but not once does he mention 'money' or 'the quantity of money'. The contrast between the Blanchard commentary and the IMF database speaks volumes about the chaos in modern macroeconomics. As the IMF requires all its members to prepare data for different money aggregates, its database is in fact the best single internationally available source for long-run monetary statistics. But why should the IMF collect all these data if 'money' does not matter, as its chief economist clearly believes?

I have referred to Blanchard and the IMF partly because the IMF has been vocal in the last couple of years in issuing warnings about high levels of bad debts in the leading nations, alleging that banking systems are insolvent or nearly insolvent, and then urging banks to raise ever more capital. In my opinion the quality of the IMF's recent analyses has been unsatisfactory, with its analyses undermining national regulators' attempts to buttress confidence in their banking systems.

## POLICY CONCLUSIONS

All being well, very low interest rates ought in due course to ensure that banking systems stabilize and start to grow again. But there is a possibility – certainly in the Eurozone – that the quantity of money will fall despite low interest rates. The falls in the quantity of money will be largely due to banks' shrinkage of risk assets, in response partly to genuine loan losses and inadequate capital, but mostly to foolish regulatory bullying. The bullying can in turn be attributed largely to the misunderstanding that, because banks are safer the more capital they have relative to their assets, any rise in banks' capital/asset ratios is socially desirable. This is not so. The more capital that banks have relative to their assets, the more they must charge for their loans in order to deliver a particular return on capital. In other words, the safer the banking system is in appearance (i.e. the higher its capital/assets ratio), the more expensive are the services it provides to non-bank customers. Of course the more that banks charge for their services, including their loan facilities, the lower is the equilibrium ratio of bank lending to national income. Paradoxically, the official drive for ever-higher ratios of bank capital to assets may be contributing to increases in the cost of bank services and motivating falls in bank lending. Officialdom may believe that its efforts are making banks safer, when in fact these efforts are to a significant extent responsible for the shrinkage of risk assets and the stagnation or contraction of the quantity of money.

I have two main policy recommendations to ensure that the quantity of money continues to grow despite the pressures from regulators, asset price weakness and so on. First, suppose that the contraction in banks' risk assets has a few years yet to run. Then the state – either the government or the central bank (or in fact both working together) – must conduct its own financial transactions so that increases in its borrowings from the banking system sustain banks' balance sheet totals. The UK's QE experiment is an example of what can be done, but the deliberate monetization of public debt by the government (i.e. with the initiative being taken in finance ministries) should also be considered. Secondly, decisions about financial regulation and the management of the public debt have monetary effects. Financial regulation and debt management therefore need to be integrated with monetary policy decision-making. Because of the inescapable interdependence of these aspects of public policy, the notion of 'central bank independence' can be over-interpreted. Central banks must work with finance ministries and regulatory agencies on public debt management and banking regulation, just as finance ministries and regulatory agencies must work with central banks on the monetary consequences of public debt management and banking regulation.

Unhappily, the politicians and officials now prominent in policy-making have little understanding of the relationship between money aggregates and macroeconomic variables. Further, many of their most senior economic advisers have an allergic reaction even to the mention of phrase ‘the quantity of money’. (The IMF’s Blanchard is a good example of this problem.) In November 2008 Queen Elizabeth II asked on a visit to the London School of Economics, ‘why did no one see the crisis coming?’ A few months later a seminar at the British Academy tried to provide an answer, but apparently did not agree on one that satisfied any of its attendees. Non-economists need to appreciate that economics – or, at any rate, the macroeconomic component of the subject that calls itself economics – is an intellectual shambles. The Great Recession is to be blamed not on inherent weaknesses of liberal capitalist economies, but on economists’ failure to agree on how liberal capitalism works.

## NOTES

1. See, for example, the final two essays in Congdon (2007), particularly pp. 301–7 and footnote 33 on p. 314.
2. In a recent paper, ‘Monetary policy at the zero bound’ (Congdon, 2010), I explained that, because modern economies have two types of monetary asset (i.e., bank deposits in ‘the quantity of money’, as usually understood, and the monetary base), macroeconomic analysis ought to recognize (at least) two concepts of ‘liquidity trap’: one relating to a deposit-dominated money concept and the other to the base. Modern economists – like Keynes in *The General Theory* – have overlooked this ambiguity.
3. The argument is developed in, for example, Congdon (2005). See, particularly, pp. 133–4.
4. I advocated ‘quantitative easing’ in a February 2009 pamphlet for the London-based Centre for the Study of Financial Innovation, *How to Stop the Recession* (Congdon, 2009). The pamphlet was jointly financed by the CSFI and Lombard Street Research.

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