The danger isn’t inflation, it’s lack of money

It may sound shocking in this bank-bashing era, but the only way to end the Great Recession is to go easy on banks

Tim Congdon

The past two years have seen almost zero interest rates and large fiscal stimulus packages in all the advanced nations, and yet central banks and governments are warning about a slowdown in growth. What is the cause of this blight?

Mervyn King, the Governor of the Bank of England, warned yesterday that the UK faced “a choppy recovery”, with growth in 2011 likely to be lower than previously expected. He expressed concern about possible above-target inflation for much of next year, but that is largely down to the increase in VAT to 20 per cent pencilled in for January.

As he said, high unemployment and ample spare capacity should ensure that downward pressure on UK prices persists, and the Bank rightly expects inflation to be below target in 2012. Indeed, for much of the world the big risk over the next few years is not inflation, but deflation.

Parallels have been drawn between the Great Depression of 1929-33 and the current Great Recession. Many commentators recall the active fiscal policies prescribed in John Maynard Keynes’s 1936 General Theory of Employment, Interest and Money. The word “Keynes” is now being used almost as a marketing jingle to justify extra public spending and large budget deficits. But the analysis of the data in America, where the Great Depression was particularly severe, was far more rigorous in Milton Friedman and Anna Schwartz’s 1963 classic Monetary History of the United States than in anything that Keynes wrote. One of Friedman and Schwartz’s key messages was that the dominant cause of the slump in output and employment was a fall in the quantity of money of more than a third between the autumn of 1929 and the spring of 1933.

They were perfectly clear what they meant by the phrase “the quantity of money”. Their definition was much broader than merely the money immediately available for spending. It saw bank deposits — savings balances as well as current accounts — as the largest element in the definition of money, because they are the principal means of payment in a modern economy. In a nutshell, it was the collapse in a broadly defined money measure that was responsible for the Great Depression.

A larger implication of their finding is that if banks are forced to stop growing or even to reduce their balance sheets, that can damage the whole economy. If the banking system has financial pneumonia, millions of companies and households will catch an economic cold. If banks have to call in loans and shrink their businesses, their customers have to sell off assets and shrink their businesses too. Often that is the only way they can have enough in their own bank balances to pay off their debts.

Friedman and Schwartz’s book remains relevant to understanding current conditions. The cause of the Great Depression in the 1930s was a big fall in the quantity of money, as the American banking system imploded and thousands of banks closed their doors; the cause of the Great Recession today is the stagnation of the quantity of money in several countries, because the world’s leading banking institutions have limited the expansion of their balance sheets.

In the US the nearest contemporary equivalent to Friedman and Schwartz’s concept of broad money is called M3. In 2006 and 2007 M3 increased by about 12 per cent a year and the economy boomed. By contrast, in early 2009 M3 stopped growing and in the year to June 2010 it had dropped by more than 5 per cent.

In the eurozone, in 2006 and 2007, this broad-money measure was increasing at the very high rate of about 10 per cent a year and the economy expanded rapidly. On the other hand, M3 growth stopped in October 2008 and the quantity of money has now been more or less unchanged for almost two years. In the UK the result is much the same. In 2006 and 2007 broad money was climbing at nearly a double-digit annual rate, whereas since early 2008 growth has dwindled to almost nothing. In short, a uniform pattern emerges.

In the so-called “leading” countries banks have stopped growing since 2008, and the quantity of money has been going sideways or falling slightly. Happily, the quantity of money is not collapsing as it did in the US in the early 1930s. But unhappily, the check on money growth has had a seriously negative impact on demand and output. It has undermined balance sheets in companies and the financial sector, and so prevented economies from achieving the above-trend growth that is needed to reduce unemployment.

Why, then, are banks so reluctant to grow? Part of the trouble is that they suffered losses in the various asset price meltdowns of 2008 and so have less capital than would otherwise be the case. They, of course, need capital to buffer themselves against the risks they take on when they make loans to the private sector. But that is far from the whole story.

Most of the leading banking systems have far more capital today than they had two years ago, despite the traumas they have been through. The problem is not that the banks are light on capital by past standards, but that governments and regulators are orchestrating — with the help of the Basle-based Bank for International Settlements — new and more onerous regulations. By demanding that banks hold more capital relative to their risky assets and that they borrow less from each other, the Basle regulations have made the banks shrink the quantity of money in the system.

This has policy implications that may seem shocking in this bank-bashing era. Politicians may enjoy being nasty to bankers and no doubt deserve much of what they get. Even so, by punishing the banks, governments have stopped the quantity of money growing and indirectly punished everyone.

The BIS rules should not hinder banks from growing, because that would prevent their customers also from expanding their businesses. If the Basle capital regulations are too anti-risk, they are also anti-growth and anti-enterprise. Bankers may be capitalism’s worst advertisement, but the market economy cannot flourish without a dynamic financial system. It is time to be a little nicer to the banking industry.

Tim Congdon was a member of the Treasury Panel of Independent Economists (the so-called “wise men”) that advised the previous Conservative Government.