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## Banks need way to stop inflation and deflation

Tim Congdon: Opinion

Credit and money are the inseparable twins of banking. When a bank extends a new loan, it adds identical sums to its loan portfolio and its deposit liabilities. The freshly created deposits are money.

In all economies, the amount of money in the system plays an important role in the determination of national income and wealth. As Mervyn King, the Governor of the Bank of England, said: "Few empirical regularities in economics are so well-documented as the co-movement of money and inflation." In 1963, Milton Friedman and Anna Schwartz showed that a 40 per cent collapse in the quantity of money was a significant causal influence on the Great Depression in the United States.

Money matters vitally to the determination of demand, output and the price level. For most of the past 50 years, banks have been keen to lend to the private sector and the private sector has been eager to borrow. Since the credit crunch escalated in mid-2008, however, this process has gone into reverse: banks have been reluctant to lend and the private sector has cut back on its debt. The result is that lending to companies and households has been declining by about 5 per cent at an annualised rate. In late 2008, money growth in the UK came to a halt, while deposits in companies started to fall, creating the monetary backdrop to the recession of today.

Given the almost umbilical link between bank loans and money, it is understandable that the fall in bank credit aroused alarm in policymaking circles and led to pressure on banks to extend more credit to the private sector. Indeed, some economists believe that it is bank credit, not money, that matters to spending and output. But the doctrine of so-called creditism, proposed by Ben Bernanke, the present Chairman of the US Federal Reserve, in an academic article in 1988, is questionable. Would all spending stop if new bank lending stopped tomorrow? Of course not.

After the Great Depression, bank lending to the private sector fell heavily in the US and in the UK, but money continued to grow and both economies made a good recovery. How could money grow and make these recoveries possible if credit was declining? The answer is that instead of acquiring new claims on the private sector, the banks bought more government securities. They expanded their deposit liabilities, and the quantity of money, by acquiring extra claims on the public sector. The amount of money kept rising, asset prices advanced and balance sheets strengthened. The same approach is open to policymakers today.

Too much monetary financing of the budget deficit would be inflationary and must be avoided. But there is a middle way, in which the increase in the banks' claims on the State offsets the decline in their credit to the private sector and delivers money supply growth consistent with economic stability. The Treasury and the Bank of England must do their best to achieve that and so prevent both inflation and deflation.

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