THE UNNECESSARY RECESSION

A flawed economic doctrine led Gordon Brown and Alistair Darling to plunge Britain into its worst postwar crisis

BY TIM CONGDON

Keynes once described the work of Friedrich Hayek as "an extraordinary example of how, starting with a mistake, a remorseless logician can end up in Bedlam". Since September 2008 the world economy has been closer to Bedlam than at any time since the end of the Second World War. Turmoil in stock exchanges and commodity markets has been accompanied by almost constant public wrangling between politicians, financial regulators and bankers. Even worse output and employment have been on a drastic downward slide, causing many comparisons to be drawn with the Great Depression of the early 1930s.

Is there an intellectual mistake that, by the remorseless logic of events, has ended up in the international financial Bedlam of late 2008 and early 2009? Of course, the current crisis is complex and multi-faceted, and has many causes. However, the argument here is that one particular line of thought has to carry a large share of the blame for what went wrong. Only now is a rather different set of ideas being heard, perhaps foreshadowing a radical move to better policies and a sharp improvement in the economic situation.

Our starting point is a recondite article in the May 1988 issue of the American Economic Review, on "Credit, money and aggregate demand" by Ben Bernanke and Alan Blinder. Both authors later became prominent in the Federal Reserve, with Bernanke receiving the ultimate accolade when he was appointed chairman of the board of governors in February 2006. The article's emphasis was on "the special nature of bank loans". Following the lead of the Harvard economist, Professor Benjamin Friedman (not to be confused with the redoubtable Milton Friedman of Chicago), Bernanke and Blinder referred to "new interest in the credit-GNP relationship". By "credit" they meant bank lending to the private sector.

The 1988 article received numerous citations in other economists' journal articles, the key metric of academic stardom. In 1995, Bernanke was encouraged by this success to write a further article, with New York University Professor Mark Gertler, on "the credit channel of monetary policy transmission". The heart of their argument was that "informational frictions in credit markets worsen during tight-money periods", with the difference in cost between internal and external funds to companies enhancing "the effects of monetary policy on the real economy". The remark on "informational frictions" were a dutiful allusion to Joseph Stiglitz, awarded the Nobel Prize for economics in 2001, who had written on "asymmetric information" as a cause of imperfections in financial markets. Bernanke and Gertler further differentiated between so-called "balance sheet" and "bank lending" channels "to explain the facts", although - curiously - they added a warning that comparisons of actual credit aggregates with other macroeconomic variables were not "valid tests" of the theory. (We shall return to this later.)

Bernanke, Blinder, Gertler, Benjamin Friedman and Stiglitz are American, and all of them have had teaching spells in the great East Coast universities (Harvard, Columbia, Princeton, Yale, NYU). They are a motley crew, and are far from sharing the same politics or agreeing about everything. However, in economics as in other walks of life branding makes a big difference to the marketability of what is produced. To non-economists - and indeed to most economists - the intellectual output of the East Coast universities more or less defines the latest and best in the subject. With all these distinguished names writing about credit and its importance, isn't it a fair deduction that credit - and, more specifically, bank lending to the private sector - must be vital to the health of an economy?

Such is the influence of the top East Coast universities that, when the financial crisis broke in autumn 2007, a universally-held view among policy-makers was that everything possible must be done to sustain the flow of new bank lending to the private sector. The lending-determines-spending doctrine was accepted without question. Few clearer statements can be found than those from the UK's own Prime Minister and Treasury ministers. As the crisis escalated last September and October, Gordon Brown emphasised that official action was needed to sustain extra bank lending and that his government's approach went "to the heart of the problem". In his view, banks had a "responsibility" to maintain credit lines to small companies and family businesses.

But there is a problem with bank lending to the private sector. Because borrowers may not be able to repay, lending is risky. Banks must therefore have capital to absorb possible losses in their loan portfolios. So, the remorseless logic proceeds, not only is bank credit central to the nation's economic well-being, but public policy must concern itself with the quantity and quality of the banking system's capital. Because bank lending to the private sector matters so fundamentally to the economy, the government is entitled to interfere with the banks, and to tell them how much capital they should have and what form it should take.

If the reports and accounts prepared by tens of thousands of internal and external auditors are to be believed, in the first half of 2008 Britain's banks were profitable and solvent. Indeed, not only was their capital in positive territory, but also it was sufficiently positive to comply with regulations agreed with the Financial Services Authority. However, in late September and early October a number of officials at the Treasury, the Bank of England and the FSA got it into their heads that the economy was in deep trouble and that the banks were at risk of failure.

It was certainly true that the closing of the international wholesale money markets in August 2007 had cut off the flow of funds for some banks, notably RBS and HBOS. With these markets shut down, the banks were having difficulty rolling over their inter-bank borrowings and so were restricting new credit. However, the problem could have been tackled easily enough, either by loans (at a penalty rate) from the Bank of England or by state guarantees on inter-bank borrowing (with an appropriately high charge for the guarantee fee). A large body of precedent from earlier crises suggested that answers on these lines ought to be made available and would work.

The package put together by UK officials did include guarantees on inter-bank borrowing. But that was only one element. The lending-determines-spending doctrine was so strongly and widely held that the authorities added a major qualification. The guaran-
"D'oh!" Gordon Brown and Alistair Darling
tees would be available only if banks had sufficient capital to continue lending during the downturn. Whereas two banks (RBS and Barclays) issued press releases saying they were not seeking extra capital, officialdom insisted that large amounts of new capital had to be raised. Further, if private shareholders would not cough up the money, the government would subscribe the money instead. Against the banks’ protests that macroeconomic conditions were not too bad and a recovery could be envisaged in a few quarters, the Bank of England put together a planning scenario with a deep, long-lasting recession. This scenario implied that large amounts of extra bank capital had to be made obligatory.

In days (and often nights) of ferocious bargaining last October some of the world’s largest financial organisations—some that have been household names in this country for decades, and had long been widely admired around the world for their efficiency and expertise—were bullied into raising capital that they themselves did not think was necessary. The British government brushed aside such niceties of market capitalism as shareholders’ rights and management independence. The East Coast economists applauded Brown’s effort. The Nobel Prize-winner, Paul Krugman of Princeton, said in his New York Times column that Britain was “playing a leadership role”, with Brown’s bank recapitalisation programme being superior to the US Treasury’s plans to buy up toxic assets from the banks. Brown claimed that he was “rescuing the world”. Intriguingly, press reports suggested that Bernanke at the Fed was instrumental in persuading US Treasury Secretary, Hank Paulson, that American policy should move in the British direction.

A few months later, at the World Economic Forum in Davos, Darling described the underlying rationale for official policy in two sentences: “We have got to recapitalise first. You’ve got to get the expansion of lending.” It was the imperative of “more lending” that justified the intimidation of the banks. As Marcus Agius, the chairman of Barclays told his shareholders, the banks had faced “an existential threat”.

Almost nine months later, the questions have to be asked, “Was the government right in its views on the economic outlook?” and “Has the case for large-scale and rapid capital raising in the banking industry been validated?” On the face of it, the shocking deteriora-

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ition in economic conditions and the recent announcement of large losses in banks’ loan portfolios vindicate the stance taken by the government and its regulatory agencies. But that conclusion is too hasty. Banks are unique and rather odd institutions, which occupy such a central position in a modern market economy that their behaviour can interact with the business cycle in unexpected ways.

In a 1933 academic article in Econometrica one of the USA’s most influential economists, Irving Fisher, proposed “the debt-deflation theory of great depressions”. Starting from a boom in which people had borrowed heavily, he suggested that an unforeseen deterioration in business conditions might cause large repayment of bank debt. The repayment of bank debt would reduce the amount of money in the economy (which he called “deposit currency”), which in turn would cause a fall in prices, with a disproportionate effect on profits, the value of businesses and asset prices, leading to further repayments of debt, another round of reductions in bank deposits, a further fall in prices and so on. The disaster was rather like the capsizing of a ship. In Fisher’s words, under “normal conditions” a ship is always near “a stable equilibrium”, but “after being tipped beyond a certain angle” it “no longer has this tendency to return to equilibrium, but, instead, a tendency to depart further from it”.

The problem with last October’s bank recapitalisation exercise was that it capsized the British economy. (The same comment is true of similar exercises in other economies, but there is no space here to go into details.) The warnings of a big recession were particularly foolish and counter-productive, since they caused an abrupt step downwards in business expectations. The shock to the banks
Guilty parties (clockwise, from top left): Benjamin Friedman, Ben Bernanke, Joseph Stiglitz and Paul Krugman

was so sudden and severe that they reacted not by increasing the availability of credit, as officialdom had intended, but by restricting it further. (The Bank of England publishes a monthly series for “sterling unused credit facilities”. It had started falling in mid-2007, but the pace of decline accelerated in the immediate aftermath of the bank recapitalisation exercise.)

Just as Irving Fisher warned over 60 years ago, a restriction of bank credit stops the growth of households’ and companies’ deposits. The lack of money in the economy hits spending, profits and asset prices, and asset price falls lead to an unexpectedly high level of losses on banks’ loan assets. The result is a self-feeding and unstable downward spiral of retrenchment. In the 1933 article Fisher emphasised the sometimes paradoxical nature of this downward spiral. People repay bank debt in order to improve their financial circumstances, but—if everyone does so at the same time—the resulting fall in bank deposits (ie, in the quantity of money) causes a drop in prices and possibly an increase in the real value of the remaining debts. To quote from him again, “the mass effort to get out of debt sinks us more deeply into debt”.

The October 2008 bank recapitalisation package did not protect the economy against a deep recession. On the contrary, it accelerated the onset of recessionary forces and intensified them. By February this year Britain’s policy-makers were desperate. In October they had put together a package that they regarded as clever in conception, and appropriate and proportionate in its implementation. Indeed, their efforts had been praised by trend-setters of international opinion, including the Financial Times which judged that the UK’s measures created “a global template”. Many leading economists recommended programmes similar to the UK’s for their own countries. But demand, output and employment were deteriorating more rapidly after bank recapitalisation than before. Although interest rates had been slashed almost to zero, banks were still cutting back on credit lines and stock markets continued to decline. This year would be the worst year for the UK economy since the early 1980s.

As usual in cyclical downturns, some economists urged fiscal reflation—higher government spending unmatched by extra taxes or outright tax cuts—in order “to boost demand”. This is an ancient tribal custom of Keynesian economists who believe that the mere invocation of their hero’s name can overwhelm experience and logic. Careful tests of the effectiveness of fiscal policy are needed, comparing changes in the cyclically-adjusted budget deficit with concurrent or subsequent changes in total demand. The results of such tests are disappointing and show, quite simply, that fiscal policy does not work. Japan exemplifies the argument. Since the early 1990s, it has been the target of constant criticism from foreign economists who assert that the answer to its chronic demand weakness is fiscal expansion. In fact, over the last 20 years, Japan has had prolonged phases in which the budget deficit has increased and demand grown at a beneath-trend rate or fallen, and prolonged phases in which the budget deficit has decreased and demand has grown at an above-trend rate. Although Darling mentioned Keynes at the time of the 2008 Pre-Budget Report, the idea of a discretionary fiscal boost had been forgotten when the Budget itself was announced in March 2009.

At this point a major policy rethink seems to have started at the Bank of England. (If public statements are to be taken at face value, nothing comparable occurred at the Treasury.) In his 1988 paper, the “lending-determines-spending” doctrine had been proposed by Bernanke as an alternative to “standard models of aggregate demand” (as he termed them), which paid more attention to money.
than to loans. In fact, Bernanke saw the “money-only framework” as “traditional” and regarded his own work as an innovation. He even coined the word “creditist” to describe a central bank with a special attention to credit developments. Implicitly he was contrasting “creditist” with “monetarism”, where monetarism is understood as the claim that the quantity of money—nowadays dominated by bank deposits—is crucial in the determination of national income. Bernanke declared that in some circumstances “a credit-based policy” would be “superior” to “a money-based policy”.

Throughout the financial crisis of late 2007 and 2008, the monetary alternative to the “lending-determines-spending” doctrine had always been there. For many years, the Bank of England had been agnostic over major theoretical issues. It may have veered towards the creditist side in the creditist/monetarist debate, but it had not made formal commitment. With base rates down to a mere 0.5 per cent, further significant cuts in the price of money were out of the question. The Bank decided to refocus on the quantity of money. On 5 March, it announced a programme of so-called “quantitative easing”, in which enormous purchases of gilt-edged securities, mostly from non-banks, would deliberately add to the level of bank deposits (i.e. the quantity of money).

Credit and money are often confused, and confusions in a subject as arcane as banking theory are understandable enough. However, credit and money are distinct. Lending to the private sector is a totally different entry on a bank balance sheet from the figure for deposits. Increases in banks’ loan portfolios add to assets and require extra capital to anticipate the risk of default; increases in bank deposits expand liabilities and may not need any more capital at all. The point is that banks can grow their deposit liabilities by acquiring assets with a negligible risk of default. These assets are of two main kinds, claims on the government (Treasury bills and gilt-edged securities) and claims on the central bank (their so-called “cash reserves”). When the quantity of money increases as a result of banks’ acquisition of such assets, no new bank capital is required.

Reports about quantitative easing in the media have been muddled. Many journalists remain imprisoned in the “lending-determines-spending” box and believe that the purpose of quantitative easing is to stimulate more lending. Again, the mistake is understandable, as the phrase “the quantity of money” and “the money supply” are used interchangeably, and the second of these gives the impression that banks are “supplying money” (that is, “making loans”). However, it must be emphasised that “the money supply” consists of deposits, not loans. The money supply and bank lending are different things.

The intention of the Bank of England’s programme of quantitative easing is to increase the quantity of money by direct transactions between it and non-banks. Strange though it may sound, monetary expansion could occur even if bank lending to the private sector were contracting. In its essence, the mechanism at work is very simple, that the Bank of England adds money to the bank accounts of holders of government securities to pay for these securities. (The details can be of mind-blowing complexity, but need not bother us now.) Roughly speaking, the quantity of money in the UK is about £2,000 billion. Gilt purchases of £150 billion over a six-month period would therefore lead by themselves to monetary growth of about seven-and-a-half per cent or, at an annual rate, of slightly more than 15 per cent. This is a very stimulatory rate of monetary expansion.

The objection is sometimes raised that the major holders of gilts are pension funds and insurance companies, and they will not “spend” the extra money in the shops. But the big long-term savings institutions are reluctant to hold large amounts of money in their portfolios, because in the long run it is an asset with negligible returns. At the end of 2008 UK savings institutions had total bank deposits of about £150 billion. They will be reluctant to let the number double, but—if the £150 billion were allowed to pile up uselessly—that would be the result.

What is the likely sequence of events? First, pension funds, insurance companies, hedge funds and so on try to get rid of their excess money by purchasing more securities. Let us, for the sake of argument, say that they want to acquire more equities. To a large extent they are buying from other pension funds, insurance companies and so on, and the efforts of all market participants taken together to disembarrass themselves of the excess money seem self-cancelling and unavailing. To the extent that buyers and sellers are in a closed circuit, they cannot get rid of it by transactions between themselves. However, there is a way out. They all have an excess supply of money and an excess demand for assets, which will put upward pressure on equity prices. If equity prices rise sharply, the ratio of their money holdings to total assets will drop back to the desired level. Indeed, on the face of it a doubling of the stock market would mean (more or less) that the £150 billion of extra cash could be added to portfolios and yet leave UK financial institutions’ money-to-total-assets ratio unchanged.

Secondly, once the stock market starts to rise because of the process just described, companies find it easier to raise money by issuing new shares and bonds. At first, only strong companies have the credibility to embark on large-scale fund raising, but they can use their extra money to pay bills to weaker companies threatened with bankruptcy (and also perhaps to purchase land and subsidiaries from them).

In short, although the cash injected into the economy by the Bank of England’s quantitative easing may in the first instance be held by pension funds, insurance companies and other financial institutions, it soon passes to profitable companies with strong balance sheets and then to marginal businesses with weak balance sheets, and so on. The cash strains throughout the economy are eliminated,
Taking stock: markets reacted badly to the creditist policies of the Federal Reserve and other central banks

output as to reduce it. If there are more output-raising than output-reducing companies, the recession will be over.

The debate about quantitative easing, and the larger debate between creditism and monetarism to which it is related, will rage for the rest of 2009 and probably for many years to come. Much will depend on events and personalities, as well as on ideas and journals and articles. But there is at least an argument that Bernanke’s creditism was the mistaken theory which, by a remorseless logic of citation, repetition and emulation, spread around the world’s universities, think tanks, finance ministries and central banks, and led to the Bedlam of late 2008. The monetary approach—which Bernanke himself saw as standard and traditional—argued that measures such as quantitative easing, rather than bank recapitalisation, were appropriate in September and October last year. Why were large-scale expansionary open market operations—operations targeted directly to increase bank deposits—not adopted at that stage? And would not hundreds of thousands of jobs, and thousands of businesses, have been saved if the Treasury and the Bank of England had bought back vast quantities of giltsp instead of bullying the banks? (This is not to propose that the banks are perfect and angelic. They had been silly, naughty and greedy in the years leading up to the crisis of 2008. But they tend to be silly, naughty and greedy in the years leading up to most crises, and recessions as severe as the current one are not normally visited on innocent bystanders.)

The academic prestige attached to the “lending-determines-spending” doctrine and other credit-based macroeconomic theories is puzzling. As noted earlier, Bernanke and Gertler included in their 1995 article an observation that comparison of actual credit magnitudes with macroeconomic variables was not a valid test of their theory. One has to wonder why. They claimed that bank lending was determined within the economy and so was “not a primitive driving force”. (In jargon, bank lending was endogenous and determined by the economy, not exogenous.) Bernanke and Gertler must have known that the relationships between credit flows and other macroeconomic variables were weak or non-existent, casting doubt on their whole approach.

In the event, their reservations about the predictive power of credit aggregates were neither here nor there. In late 2008 policy-makers were bossy and crude in their demands that the banks lend more and have enough capital to support the new loans. More bank lending was deemed to be good, without ifs or buts. To repeat Darling’s words, “We have got to recapitalise first. You’ve got to get the expansion of lending.” Bluntly, the statistics justify neither official policy nor Darling’s hectoring and aggressive tone, while Brown’s claims to be “rescuing the world” have come to look ridiculous. In no economy are there real relationships between bank lending to a particular sector and activity in that sector or the wider economy. In that sense the bank recapitalisation exercises were sold on a false prospectus.

Another enigma here is that the alternative view—that in the long run, national income is a function of the quantity of money—has clear and overwhelming substantiating evidence from all economies at all times. Both evidence and standard theory argue that the expansionary open market operations that are the hallmark of quantitative easing, not bank recapitalisation, should have been policy-makers’ first priority last autumn. In the next crisis they must accept that money, not bank credit by itself, is the variable, which matters most to macroeconomic outcomes. 

The important variable for policy-makers is not the level of bank lending to the private sector, but the level of bank deposits. (Remember Irving Fisher’s reference to “deposit currency”.) Indeed, because companies are the principal employers and the representative type of productive unit in a modern economy, bank deposits in company hands need to be monitored very closely. If these deposits start to rise strongly as a by-product of the Bank of England’s adoption of quantitative easing, the recession will be over.

Is quantitative easing working? Lags between economic policy and its effects are unpredictable, and celebration would be premature. Nevertheless, the first two months of quantitative easing have seen startling improvements in several areas. Most obviously, the UK stock market has soared by 30 per cent and corporate fund-raising has been on a massive scale. Anecdotally companies are saying that cash pressures are less severe. Business surveys have also turned upwards, with a key survey of the services sector suggesting earlier this month that almost as many companies planned to raise

asset prices recover, and demand, output and employment all revive. So the monetary (or monetarist) view of banking policy is in sharp contrast to the credit (or creditist) view. Contrary to much newspaper coverage, the monetary view contains a clear account of how money affects spending and jobs. The revival in spending, as agents try to rid themselves of excess money, would occur even if bank lending were static or falling.