Money, Banking and Deficits

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The British economy continues to be buffeted by a range of forces, some of them the direct result of government policy. However, there is scope for learning from past policy mistakes. In other words it does not have to be like this, but to learn from mistakes requires rethinking how the economy is analysed. Here we raise questions about the way fiscal and monetary policy have been understood by government and propose a different analysis.

This alternative analysis suggests that the dominant problem for the UK continues to be a lack of demand which translates into discouragement from investing enough in productive capacity for the future and also from employing enough additional workers. This argument is based on Keynes's principle of effective demand, which has been pushed aside in recent decades by policy aimed instead at improving the capacity to supply. It is good to promote increased productivity, but supply capacity is no use if there is inadequate demand, and indeed inadequate demand discourages efforts to expand supply capacity.

The banking crisis was an international phenomenon. However, earlier UK policy on financial deregulation and the focusing of central bank action on an inflation target were major contributors to the UK experience. Crisis was not inevitable. Not all banking systems succumbed to the crisis; Canada and Australia are examples of banking systems which had retained enough regulatory control to ensure that they emerged relatively unscathed. While the past cannot be undone, lessons can be learned for policy now to address the fallout of the banking crisis and the resulting economic crisis. The continuing policy of fiscal austerity is also one from which lessons can be learned.

What can be learned in particular is the way in which financial markets in general, and banks in particular, work and how they interrelate with the real economy of production and employment. The policy of fiscal austerity was introduced in the UK partly to appease the financial markets, which were expected by the government to devalue public debt because of the rising fiscal deficit (as happened in Greece, Spain, Ireland and Portugal). Rather than challenging this market view, the government validated it.

Consumer spending and the housing market have eventually started to rebound in spite of austerity. Contributory factors have included the uneven burden of austerity policies, which have had the greatest impact at the lower end of the income scale, but also some expansionary measures, like the Help to Buy scheme, which contradicted the austerity rhetoric. But continued weak business investment shows the low confidence in this rebound, and thus in sustained employment prospects. Without austerity policies the economy would have rebounded more strongly and earlier, which itself would have improved the budgetary situation. As aggregate demand rises due to expansionary fiscal policy, revenues also rise and expenditures on benefits fall. An examination of history would suggest that the best way to cure a deficit is to promote economic growth, so stimulus rather than austerity is called for.

The worsening fiscal situation had been the result of the banking crisis and its effect on demand. Falling asset values (and thus wealth) combined with a high level of uncertainty about the future discouraged spending by firms and households. Past deregulation of the banking system had allowed banks to divert attention from their traditional functions of providing a safe, reliable basis for holding money and making payments on the one hand and providing credit to finance investment in productive capacity on the other. Because of the crisis, there was now uncertainty among the public about the safety of bank deposits and among the banks about the viability of new loans.

The current policy focus on banks is intended to address both issues. New regulation is being designed to make high street banks safer by limiting the activities they can be involved in. This policy recognises that the crisis arose from allowing high street banks to become involved in excessively risky activities, with the Bank of England effectively required to provide backup which proved to be very costly and also seemed to condone the risky activities. Banks are also to be required to hold more capital. However, it is not clear whether lack of capital as such was a critical factor in the crisis, as opposed to the impetus given to the massive growth in markets in structured products by the banks' attempts to avoid the existing capital requirements.

Banks are also being encouraged to increase loans. Reducing official interest rates did not work, so various programmes have been tried to encourage a significant increase in direct lending. Otherwise the main plank of monetary policy has been quantitative easing. This includes the Bank of England buying some corporate bonds, but overwhelmingly the policy has consisted of the Bank buying government bonds from the market. Since 1997, the Bank of England has not been allowed to lend directly to the government or to issue government bonds. So quantitative easing is in effect using the old measure of open market operations to finance the fiscal deficit, but indirectly, with bond traders pocketing a turn on purchases and sales. A shift in fiscal policy away from austerity could similarly be financed by the Bank of England until growth started reducing the deficit.

In any case, much of the public discussion of quantitative easing has been based on a misunderstanding of the banking system, which the Bank of England has recently attempted to correct. It has been widely believed that the banks are waiting for an increase in their reserves (from bonds being bought with 'new money' from the Bank of England) before they can increase lending. However, it is a very long time since banks have been held back from lending by a shortage of reserves. The way in which the Bank of England makes sure that the money market interest rate keeps to the official rate is to lend in the interbank market when rates threaten to rise and borrow when they threaten to fall. The money supply rises as the banks make loans by adding to the borrowers' accounts. Only then do the banks look for new reserves. If there is not enough liquidity for them in the market, the Bank supplies it to stop interest rates rising. However, if the banks do not wish to lend, they do not. Instead, like firms and households, they build up liquidity as best they can to protect themselves from being exposed to high risk in a continuing uncertain environment. There may be more reserves in the system, but the money supply does not necessarily rise.

The economy is now growing again, but later and more tentatively than if austerity had not been pursued. What has been argued here is that the primary issue is a lack of demand which worsens the fiscal situation and discourages firms from investing and banks from lending. It has been argued here that this should be addressed by a reversal of the fiscal austerity policy, financed effectively by the Bank of England. This reversal could range from shovel-ready capital projects to reversing cuts in benefits to vulnerable members of society and to support for charities already providing social services. This would encourage growth, encouraging firms to invest and banks to lend, while reversing the growth in disparities between the different groups in society.

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