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Restrictive banking policies lead to low growth

By Steve Hanke

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We are still in the grip of the Great Recession. Economic growth remains anaemic and below its trend rate in most parts of the world. And what's more, this state of subdued economic activity has been with us for more than seven years.

True to form, central bankers have steadfastly denied any culpability for creating the bubbles that so spectacularly burst during the panic of 2008-09. What's more, they have repeatedly told us that they have saved us from a Great Depression.

To understand why, we need look no further than Milton Friedman.

In a 1975 book of essays in honour of Friedman, Gordon Tullock wrote: "On several occasions in my hearing (I don't know whether it is in his writing or not but I have heard him say this a number of times) Milton Friedman has pointed out that one of the basic reasons for the good press the Federal Reserve Board has had for many years has been that the Federal Reserve Board is the source of 98 per cent of all writing on the Federal Reserve Board."

Subsequent research found that, in 2002, 74 per cent of the articles on monetary policy published by US economists in US-edited journals appeared in Fed-sponsored publications, or were authored (or co-authored) by Fed staff economists.

The explanations of the Great Recession have been all over the map and surprisingly incoherent.

The literature – from Alan Greenspan's 2013 book The Map and The Territory to the 2009 tome Animal Spirits by George Akerlof and Robert Shiller – is punctuated with a great deal of conjecture about changes in investors' animal spirits and how these wrecked havoc during the Panic of 2008-09 and the ensuing Great Recession.

Much of this is borrowed from a recent fashion in economics – behavioural finance – but goes back to earlier theories of the business cycle that stress the importance of changes in business sentiment.

For example, members of the Cambridge School of Economics, which was founded by Alfred Marshall, all concluded that fluctuations in business confidence are the essence of the business cycle. John Maynard Keynes put great stress on changes in confidence and how they affected consumption and investment.

But this approach falls short of a full explanation of why economic activity remains so depressed. The monetary approach fills this void.

Tim Congdon – a master of the high theory of monetary economics and all the knotty practical details of money and banking, too – supplies a comprehensive analysis.

His approach posits that changes in the money supply cause changes in nominal national income and the price level (including asset prices).

In this analysis, post-crisis growth is low because growth in broad money is well below its trend rate.

Divisia M4 is only growing at a 2.7 per cent annual rate because policies affecting bank regulation and supervision have been massively restrictive.

By failing to appreciate the monetary consequences of tighter, pro-cyclical bank regulations, bank money, which accounts for between 70 per cent to 90 per cent of broad money in most countries, has contracted or failed to grow very much since the crisis.

Even quantitative easing (QE) has been unable to fully offset the tightness that has enveloped banks.

Looking at the United States, there is a ray of hope as credit to the private sector has finally started to grow above its trend rate.

But the picture in the euro zone has been dire because, until recently, the European Central Bank refused to use QE to offset the regulatory-induced tight monetary policies imposed on banks. That is now changing and credit to the private sector is about ready to become positive for the first time since 2012.

Mainland China, the last of the Big Three, also has a monetary problem (as well as others). Broad money has been growing at below its trend rate since 2012, and it's becoming weaker with each passing month.

In an attempt to pump it up, the People's Bank of China has cut interest rates twice since November and lowered reserve requirements for banks. But so far, it has proven to be too little, too late. Not surprisingly, official forecasts for mainland GDP growth this year have been dialled back.

This monetary approach offers a coherent theory of what is happening. It explains the Panic of 2008-09 and the ensuing Great Recession with ease. It reigns supreme.

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