An End to Illusions

Alan Duncan

Foreword

Britain has had many booms and busts. But few have been quite as spectacular as the boom of the late 1980s and the subsequent bust. Millions of people became caught up in a euphoria of borrowing and spending as ministers announced that economic decline had been reversed. Many of the same people then found themselves stuck in a morass of debt as high interest rates were followed by sharply rising unemployment and business failures.

Historians will be poring over the details of this story for a long time to come. What makes this period of economic history so interesting is that the UK economy was being used as a giant laboratory for economic and social ideas. It was a test case not only for economics but also for an argument which linked economics to culture.

For Margaret Thatcher's Government sought not only to tackle the underlying causes of low growth and productivity, but also to create a culture more conducive to risk, enterprise and hard work. As Alan Duncan shows, there was indeed a major cultural shift. But it was not a straightforward shift towards an acceptance of the virtues of enterprise. Instead, it was a culture of easy money and easy spending which predominated, as Britain found itself on a rollercoaster of apparently limitless credit and irresponsible borrowing and as money generated the illusion of prosperity.

Now in another decade, we are soberly picking up the pieces. Millions have had a sharp lesson in economic realities and have become painfully aware that there are no short-cuts to prosperity. Home ownership, in particular, which seemed a panacea in the 1980s, has now clearly spread beyond its natural limits: tax incentives mean that many own homes who in a saner system would be renting, often with disastrous consequences.

Few can escape some responsibility. Government did little to contain the explosion of credit and made a succession of critical mistakes in monetary policy. Individuals chose to ignore the laws of economic gravity and spent far beyond their means. And financial institutions fuelled the boom, falling over each other in the rush to offer loans, mortgages and financial services.

As Alan Duncan points out these financial institutions bear a heavy responsibility. The clearing banks in particular, have had a singularly ineffective record in helping industry and understanding its needs. Instead they have swung from credit explosion to credit squeeze without any apology, and the institutions which claimed to be at the forefront of innovation and change in the 1930s now look inefficient and stale.

But the core of the argument here is that financial deregulation was imposed on a society and an economy with huge structural imbalances. As such it was bound to fuel inflationary expectations.

The most important of these structural imbalances were the subsidies for home ownership, the weakness of the central bank, tax distortions in favour of pension funds, and a business culture skewed to takeovers and short-termism. Together these guaranteed that Britain would remain stuck in its familar post-war cycle of stop and go.

Until these are addressed there is little prospect of Britain achieving stable and sustainable growth. Recovery in the mid-1990s will simply lead to overheating and recession in the late 1990s unless government has the courage to remove these distortions and imbalances. Now at the beginning of the upturn is the ideal time to act.

But there is also a moral dimension to all this. For during the 1980s the combination of what Alan Duncan calls a 'bastard Keynesianism,' and new financial opportunities in the personal sector, encouraged a culture in which borrowing was always a virtue and thrift a vice. It was a culture which seemed to favour the short-cut and the easy answer: it skewed attitudes towards illusion rather than reality.

In the changed climate of the 1990s, as we face many new demands for sacrifices to be made in the name of competitiveness, education or the environment, the swing of the pendulum towards greater austerity, responsibility and thrift is probably long overdue.

But the most pressing task is to ensure that the right lessons are learnt so that future generations are not condemned to repeat the mistakes which were made in the 1980s. That is the central, and timely, message of this pamphlet.

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Introduction

Money is a great generator of illusions. During the second half of the 1980s an apparently inexhaustible supply of borrowed money persuaded many people that the British economy was not merely growing but had undergone a fundamental transformation. For a time, as output grew by over 4% for two successive years, it seemed as if a single political and managerial generation had managed to halt one hundred years of relative economic decline. Speaking shortly after the 1987 general election the then Chancellor of the Exchequer, Nigel Lawson, summed up the hubristic mood of British politicians, business and consumers:

> As this upswing goes on, more and more people, at home and abroad, are realising that what we are seeing is much more than a recovery from recession, or than the operation of the normal cyclical pattern. For decades, observers both at home and abroad have been accustomed to a faltering performance from the British economy, with short spells of growth, usually accompanied by rapid inflation, interspersed with balance of payments crises, and damaging strikes. Not for nothing was this dubbed 'the British disease.' But now, it is becoming clear on all sides that that period is decisively behind us. And instead of wondering whether the recovery will last, people are asking what has caused this transformation.[1]

Six years later, at the tail-end of three years of austerity paralleled only by the 1930s, people are asking not what transformed the economy but what undermined and enfeebled it.

This sense of nemesis, like the hubris which preceded it, is overdone. There was no economic miracle, but neither was there an economic catastrophe. There never is. Economic success and failure are not the work of a few years, or a decade, or even of a century, but a relentless and unending process of toil, invention and adaptation.

Economists, with their misplaced faith in the predictability of economic and financial phenomena, are apt to exaggerate the impact of public policy upon it. 'Economics,' wrote Keynes, 'deals with motives, expectations, psychological uncertainties … It is as though the fall of the apple to the ground depended on the apple's motives, on whether it is worthwhile falling to the ground, and whether the ground wanted the apple to fall, and on mistaken calculations on the part of the apple as to how far it was from the centre of the earth.'[2]

The role of government, therefore, is not to orchestrate and direct the millions of individual economic decisions that take place every second of every minute of every day, but to provide a sound financial framework within which people can make sensible choices. It must do this in the knowledge that the economics of money, and the demand for credit, are driven by a mixture of contradictory motives–thrift and improvidence, usury and benevolence, avarice and self-sacrifice, honesty and fraud, creativity and destruction, dependence and self-reliance, prudence and excess–which might serve as a list of the Smilesian virtues and their antonyms.[3]

It is because of these that the instruments controlled by government – interest rates, taxation, and public expenditure and borrowing – have only a limited impact on the ultimate fate of the real economy. But in the short term they can be used judiciously to manage the amplitude of the natural trade and credit cycles.

This is the supreme function of economic statesmanship: avoiding the twin extremes of wasteful adversity and unsustainable prosperity. 'Inflation,' as Keynes put it, 'is unjust and deflation inexpedient … It is not necessary that we should weigh one evil against the other. It is easier to agree that both are evils to be shunned.'[4] Yet as the British economy has descended over the past five years from a euphoric boom into a protracted slump, British economic policymaking has managed to inflict both of these evils upon the country.

The trade cycle cannot be abolished. It is the most well-attested of all economic phenomena. But there are now legitimate fears that, as the economy emerges from recession, Britain is merely in the early stages of yet another unsustainable boom.

The recovery has barely begun, but already the financial markets are anticipating a renewed bout of inflation.[5] The devaluation which followed the withdrawal of the pound from the Exchange Rate Mechanism (ERM) is undeniably injecting inflationary forces. Producer input prices, after falling in 1990 and 1991, rose by 0.4% last year. The underlying rate of retail price inflation – which excludes the effects of the recent sharp falls in base rates – has hovered stubbornly at 3.5% or so, and could rise to 4% by the end of the year. The balance of payments on current account, a crude but telling measure of the relative strengths of production and consumption in the British economy, has remained in deficit throughout the recession, and is now deteriorating further.

The fixed price culture, especially in the labour market, has survived the slump virtually unscathed with increases in average earnings ahead of price increases by a margin of around 3%, despite rising unemployment. This gap is almost bound to widen as soon as the economy begins to recover, and there is every reason to be concerned that, as the cyclical effects of the downturn recede, the apparently ineradicable British propensity to pay too much, to over-borrow, to consume and to inflate will reassert itself.

A revival of 1970s-style inflation, fuelled by a mixture of commodity price shocks, irresponsible trade unionism and weak management, a bloated public sector and excessive personal taxation, is not likely to recur. Sound modifications were made in all these areas during the 1980s. The confidence of management and the profitability of industry were restored; irresponsible trade unionism was tamed; three-fifths of the nationalised industries was returned to the private sector: the climate of personal and corporate taxation was transformed; and a deregulated and flexible economy attracted foreign investors, who have brought new managerial and production techniques to bear on the British economy.

But there is a clear danger of a revival of 1980s-style inflation. By the middle of the last decade inflation seemed beaten, touching a low of just 2.4% in July 1986. But it was then reignited by an unprecedented explosion of credit. According to the conventional wisdom, this was triggered by an irresponsible deregulation of finance. In fact, it was not caused by financial deregulation alone but by its superimposition on a society and economy so riddled with structural rigidities, distorting incentives and unwarranted subsidies that the abuse of this unaccustomed freedom of choice was almost inevitable.

Some analysts believe it was an unrepeatable experience, from which deregulated borrowers and lenders have emerged more sober and realistic. They are too sanguine.

The institutions and imbalances that permitted the irresponsible use of credit in the 1980s are still in place. Now in the 1990s a weak central bank, excessive owner-occupation, damaging tax incentives, inefficient high street banks and a short-sighted business culture have again become threats to Britain's prospects of achieving sustained, non-inflationary growth. Unless they are tackled, British politicians, bankers, business and consumers will soon be living in a new age of illusions.

This pamphlet identifies the sources of those illusions and prescribes the reforms which are now needed so that the British economy, as it emerges from recession, can steer a surer path between boom and bust in the 1990s and beyond.

PART ONE: ANALYSIS

The Authorities

Any change, as the new chaos theories suggest, can have unforeseen effects. Financial deregulation, introduced as a supply side reform rather than an aspect of demand management, was no exception. It was an endogenous process, in which every act of liberalisation tended to undermine the controls which remained. In his memoirs, for example, Nigel Lawson identifies ten specific acts of deregulation, each of them in isolation a relatively small change, but in aggregate sparking a chain of events which reverberated throughout the financial system.[6]

Because many of its most impressive effects were malign, it is often supposed that financial deregulation was introduced for dogmatic reasons. The Conservative government elected in 1979 was certainly committed to lifting the controls and regulations which were stifling enterprise and distorting the price signals on which a successful market economy depends. But in reality financial deregulation was driven as much by underlying developments in the national and international economies as by ideological considerations.

The Abolition of Exchange Controls

The abolition of exchange controls, achieved in three stages between June and October 1979, was the classic instance of this.[7] Though abolition was undertaken partly for ideological reasons, it was also driven by the fact that Britain had become a major oil producer for the first time. North Sea oil was producing a generous dollar income which, if not balanced by a countervailing outflow of capital, would have led to a massive balance of payments surplus, an over-valued pound and a sharp deterioration in the competitiveness of British exports.

But abolition also had a series of unforeseen secondary effects. One was to render ineffective any quantitative control over the creation of credit. To escape domestic credit controls imposed by the Treasury or the Bank of England, banks had merely to shift their sterling lending activities to an offshore location. This began to happen almost immediately. The so-called 'Corset,' which curbed the creation of credit by requiring banks which exceeded prescribed lending limits to make interest-free deposits with the Bank of England, was abolished in June 1980 partly because it was diverting loans from London to offshore financial centres.[8] The retention of the Reserve Assets Ratio requirement, under which banks had to keep at least an eighth of their deposits in a specified range of liquid assets, was abandoned for the same reason in August 1981. By the early 1980s, the financial forces that the abolition of exchange controls unleashed had made quantitative restrictions over the growth of credit unworkable.

Another unforeseen effect, which the subsequent abandonment of exchange controls by every other developed economy greatly exacerbated, was the transformation of the foreign exchange markets. Under the Bretton Woods system of semi-fixed exchange rates, flows of capital across the foreign exchanges were associated largely with underlying trade transactions and the value of the pound was determined mainly by the balance of payments on current account. Today the international value of the pound is determined not by the movement of goods but by the movement of capital, some imported to finance the balance of payments deficit but much of its speculative.

At times these flows of capital can – in the syndrome known to currency speculators as 'the trend is my friend' – become self-fulfilling. The prolonged misalignments of both the dollar and the yen during the 1980s, and the recent orchestrated speculations against the pound and other currencies within the ERM, are vivid demonstrations of the pressure international investors and speculators can now exert on domestic economic management. The currency instability which results – though often wholly unrelated to economic fundamentals – greatly complicates the task of managing domestic monetary conditions.

The Liberation of the Building Societies

The second major act of financial deregulation was not initiated by the government either. In the first half of the 1980s the interest rate cartel operated by the building societies gradually disintegrated. Traditionally, building societies relied on retail deposits to fund their mortgage lending business. The cartel, by obliging all building societies to offer much the same rates of interest to depositors and borrowers, prevented one society poaching deposits from another. The practical effect of reliance on retail deposits – which could not, under the legislation then extant, be boosted by borrowing in the capital market – was to restrict the ability of the building societies to lend. Mortgage credit was rationed, by the notorious 'queue.'[9]

However, in the early 1980s the clearing banks began to bid aggressively for the retail deposits on which the building societies depended, partly by offering more generous terms on deposit accounts, but mainly by agreeing to pay interest on current accounts. Banks poached not only building societies' deposits but their assets as well [see Table 2]. After losing hundreds of millions of pounds on lending to Latin America, banks saw mortgage lending as a much safer asset. By the middle of 1982 they were providing over a third of net new housing finance. Competition for mortgage business was further increased by the entry into the market of foreign (and especially American) banks and by specialist mortgage lenders, which raised finance in the capital markets for on-lending at a higher rate to house buyers.

The increased competition for deposits placed the interest rate cartel under strain. By 1985 it had broken up completely, without any direct intervention by the government. Thereafter mortgage finance was restricted not by rationing but by price alone. This new competition persuaded some of the bigger building societies that their concentration on deposit-taking and mortgage lending alone was an inadequate basis for growth, and they developed strategies to compete with banks on a wider front. They lobbied the Treasury to allow them to borrow in the capital markets and to offer cheque books and unsecured loans, and the Treasury gradually acceded to these claims, in a series of largely technical changes.

In 1983 building societies were freed to borrow in the wholesale money markets; in 1984 they were given access to the sterling bond markets and in 1986 the Building Societies Act allowed them to enter the markets for cheque books, guarantee cards and unsecured personal loans. They rapidly became a powerful force in the creation of credit, increasing their holdings of unsecured assets from zero to a total of £743 million in just five years [see Table 3]. The government's desire to see greater competition in retail financing services was largely a retrospective justification of changes imposed upon it by the building societies' lobbying.

The Castration of the Bank of England

As formal constraints on the creation of credit – exchange controls, the Corset, the Reserve Assets Ratio and the building societies' interest rate cartel – were eroded, the importance of informal regulation increased commensurately. Unfortunately, financial deregulation coincided with a marked diminution in the Bank of England's moral authority. The relationship between the Treasury and the Bank of England was unusually tense and difficult in the early 1980s, and the appointment in 1983 (and reappointment in 1988) of Robin Leigh-Pemberton as Governor was widely interpreted as detrimental to the Bank's independence.

The Johnson Matthey debacle of 1984 exposed the Banking Act of 1979 – initiated after the secondary banking crisis of the early 1970s – as a poor instrument for regulation. Its replacement, the Banking Act of 1987, not only obliged the Bank to bolster its supervisory capability but for the first time rooted its authority in statutory provisions rather than the proverbial raising of the gubernatorial eyebrow. The Bank was also unable to prevent or satisfactorily resolve a series of scandals and disasters at the Lloyd's insurance market, and a string of imprudent and unseemly corporate takeovers. The reform of the securities market, known to posterity as the Big Bang, further diminished the standing of the Bank by transferring some regulatory responsibilities to the newly created Securities and Investments Board (SIB) and its satellites, the various self-regulatory organisations (SROs) which supervise each financial market. The influx of foreign banks and securities houses in the wake of Big Bang, some of them unimpressed by the weight traditionally accorded to the Bank of England's views, further diluted its authority.

These various embarrassments and legislative changes created a climate in which credit suppliers felt uninhibited by traditional restraints and were prepared to experiment without the fear of being carpeted by the Governor. Competition for business on price alone – among foreign as well as domestic banks – became the sole discipline over the creation of credit.[10] When the Governor asked banks at the beginning of the 1980s not to by pass the Corset by booking business offshore, few took much notice and foreign banks took none at all. The Bank absorbed the lesson.

By the end of the decade, the Bank of England was not so much the watchdog of the banking system as the poodle of Lombard Street. It pressed the government to accelerate the breaking up of the building societies' interest rate cartel; it resisted Nigel Lawson's plans to impose a tax on consumer credit;[11] and it removed its mortgage lending 'guidance' in 1986 which precipitated the explosion of lending on mortgage in the last years of the decade.

Despite promptings from the Chancellor, the Bank of England was reluctant to dissuade banks from expanding their balance sheets as precipitately as they did. Officially, the Bank argued that calls for restraint in mortgage or unsecured personal lending would merely divert banks into less secure activities. Though it did warn periodically about the scale of lending secured on residential and commercial property in the 1980s the Bank did not, at bottom, consider that its supervisory responsibility for ensuring the continued viability of the banking system entitled it to question the quality of particular loans. On only one occasion, when an Australian brewing company devised a bank-financed bid for a major public company in 1985, did the Bank specifically overrule a transaction because its financing was dangerous.

It is hard to avoid the conclusion that the authority of the Bank of England was so diminished that banks felt they could safely ignore its strictures anyway. This collapse of the moral authority of the public agency responsible for the day-to-day management of the monetary system coincided with the erosion of formal limitations and the intensification of competition for business in the financial markets. It left the authorities only one weapon with which to combat the credit boom: raising the cost of borrowing through higher interest rates. Unfortunately, both personal and corporate borrowing proved remarkably insensitive to increases in the real rate of interest until it was far too late.

The Personal Sector

Consumers were not slow to take advantage of increased competition in a deregulated financial marketplace. By the time the building societies began to compete with the banks in the market for unsecured personal loans, cheque books and credit cards at the beginning of 1987, borrowing by the personal sector was already careering out of control. Personal credit ballooned from a mere £91 bn at the end of 1980 to nearly £442 bn a decade later, a near three-fold increase in real terms. Credit of all kinds increased. The abolition of hire purchase controls in July 1982, after a vigorous campaign by motor manufacturers, was seen at the time as a technical change affecting only the small minority of consumers who lacked a bank account. In fact it sparked frenetic competition for business between the clearing banks and their finance subsidiaries, finance houses, mail order firms, retailers and even manufacturers themselves.

By the mid-1980s, consumers found new offers to borrow money available in every chain store, arriving with every post and tumbling like confetti from magazines and newspapers. When it peaked at the end of the decade, consumer credit outstanding amounted to well over £50 bn, three and a half times the level ten years earlier and an increase of over 100% in real terms [see Table 3]. Credit cards, though more akin to cash than credit, also boomed in the 1980s. The number of credit cards issued by banks alone climbed from fewer than 10 million in 1979 to a peak of nearly 30 million in 1990 [see Table 4]. To attract customers banks offered free gifts to new cardholders and, in perhaps the most shameful promotion of all, devised a system in which heavy credit card users could accumulate points which counted towards the acquisition of yet more free gifts. The amount of debt outstanding on credit cards increased nine-fold in nominal terms, and three-fold in real terms, during the same period. In the 1980s credit, once seen as a disagreeable way of acquiring necessities, became little more than a convenient way of shopping.

The Malign Influence of Owner-Occupation

However, the principal culprit in the explosion of personal indebtedness in the 1980s was not financial deregulation, irresponsible promotion by the banks or even changing social attitudes towards debt. It was home ownership. Owner-occupation grew especially rapidly in the 1980s, from 56% of the housing stock in 1979 to 69% today. Though this proportion is similar to other Anglo-Saxon societies – the United States, Canada and Australia – it is far higher than any other European country.

Home ownership has important virtues. It provides people with a congenial place to live, a valuable asset and a palpable stake in society. But in the 1980s the easy availability of credit enabled too many house buyers and owners to treat their house not as shelter or a form of saving but as a speculative investment or a store of wealth which they could raid at will. This turned home ownership into the main vehicle for personal borrowing and consumption.

A number of influences fuelled the growth of owner-occupation in the 1980s. The most obvious was the general increase in average earnings, which never failed to rise by less than 7.5% in any single year, well ahead of inflation. Despite the fact that real interest rates were sharply positive- between 1982 and 1989 the real cost of borrowing for house purchase, the mortgage rate less inflation, averaged 7% [12]- homeowners were prepared to pay such high real rates of interest because they believed surging house prices would easily eclipse the cost of borrowing.

This was not an unreasonable assumption. The ratio of the average house price to average income rose from between 3 and 3.5 in the early 1980s to 4.5 at the peak in 1989. Apart from dips in the mid-1970s and early 1980s, real house prices had risen continuously since the war. In only nine years out of those between 1954 and 1989 did inflation outstrip them. They were rising strongly when the Conservative government came into office in 1979 and continued to rise, at least in nominal terms, throughout the recession of 1980-81. The price of the average house in Britain then rose from £25,249 at the bottom of the market in 1981 to £64,843 at the top of the boom in 1989, a compound increase of about 11% a year [see Table 5], comfortably ahead of retail price inflation and average earnings.

It was this compelling arithmetic – that the average house was increasing its earnings faster than the average person – which persuaded people to devote an ever-increasing proportion of their earnings to house purchase. When the housing boom finally peaked in 1989, the average mortgage bill accounted for between two-fifths and one half of average gross earnings. This was a large proportion of household income but, as long as house prices kept rising faster than mortgage indebtedness, it appeared to cost nothing to service the debt.

Lack of Houses for Rent

Rising house prices also reflected a mismatch between supply and demand. After nearly eighty years of rent controls and excessive security of tenure for leaseholders, private rented housing (including housing associations) accounts for less than a tenth of the total housing stock in Britain. As recently as forty years ago it was a half, and a century ago it was nine tenths. Almost the whole of the responsibility for supplying houses to rent now falls on local authorities-one-fifth of the housing stock is publicly owned – but the number of new houses built by local authorities and government departments fell continuously throughout the 1980s, from over 35,000 in 1983 to just 4,400 in 1992. Private sector construction firms and housing associations were not able to make up all of the shortfall. The shortage of new houses was further exacerbated by planning constraints, which reduced the supply of land for new housing. This problem was especially acute in the overcrowded south-east of England where, by the end of the housing boom in 1989-90, land alone accounted for over two-fifths of the cost of building a new house. In Greater London, the average price of a hectare of building land rose from £390,000 in 1981 to over £3 million at the end of the same decade.

The shortage of public and private housing for rent coincided with demographic and social changes which increased the demand for houses and flats. The baby boomers of the 1960s began to enter the labour market in the 1980s, and tended to live away from home at an earlier age than previous generations of young people. The growing incidence of divorce added to this demographic bulge an unprecedented number of single parents in need of separate housing. The number of people under pensionable age living alone, and the number of single parent families, have both tripled since the early 1960s and continued to rise throughout the 1980s.[13] Unfortunately, the structure of the housing market presents most young people and single parents with the choice of staying at home, joining the waiting list for a council house or buying a place of their own. Unsurprisingly, most choose to buy. One of the most extraordinary facts about the British housing market is the remarkably high level of owner-occupation among people aged under 25, who now account for 16% of all home-buyers.

However, these secular trends were reinforced by public policy. One crucial decision was to allow all council tenants to buy their homes, usually at a steep discount. Some 1.4 million former council tenants have taken advantage of the right to buy since 1979. But easily the most important political contribution to the housing boom of the 1980s was the layers of tax relief and subsidy, ranging from housing benefit to mortgage interest tax relief and exemption from capital gains tax on the sale of a primary residence. Even the Business Expansion Scheme (BES), in its final guise, was diverted into the provision of tax breaks for investors in residential accommodation. For a time in the early 1990s, the community charge removed the last remaining tax on private housing. In no other country in Europe is investment is housing treated so favourably by the tax system, and it is not surprising that houses constitute such a large proportion of personal wealth in Britain. By the end of 1988 the British people had over £1,000 bn tied up in residential housing, which accounted for over half of their total net assets. This has given house prices a quite disproportionate influence over personal spending and borrowing decisions.

Equity Withdrawal

The rapid rise in nominal house prices during the 1980s was the mechanism by which the easier availability of credit was translated into increased consumer spending and borrowing. By increasing the sense of material well-being, rising house prices encouraged consumers to bring forward the purchase of expensive items like cars, television sets, washing machines and camcorders,[14] in many cases borrowing against the security of property. First-time buyers borrowed more than they needed to buy their house and spent the rest. Established owner-occupiers re-mortgaged their house and spent the money. Elderly home-owners who had paid off their mortgage took out new ones on which the interest was rolled up and subtracted from the value of their estate at death. As early as September 1982 the Bank of England warned that 'a substantial part of mortgage lending does not ultimately finance new or improved housing but is available for the acquisition of other assets or other spending.'[15] This process, known to economists as 'equity withdrawal,' enabled consumers to turn their most valuable asset into ready cash. They were not slow to recognise that, unlike other forms of credit, mortgages had the dual advantage of relatively low rates of interest and tax relief on the monthly payments.

The Bank of England has estimated that 'equity withdrawal' of this kind increased twenty-fold, from £1.3 bn in 1980 to £24.5 bn in 1988, and amounted to £114 bn over the decade as a whole. It is believed that between 1987 and 1989 alone consumers borrowed £60 bn more on mortgage than they invested in housing. Most of this seeped into consumer spending, mainly on imported goods, and led directly to the deterioration in the current account of the balance of payments.[16]

Some of it was reinvested in the stock market where booming share prices reinforced the 'wealth effect' of rising house prices and encouraged consumers to borrow still more, even using shares as collateral.

The overall effect of equity withdrawal was to cause a drastic decline in the personal sector savings ratio (personal savings as a proportion of personal disposable income) which fell from over 10% in 1985 to a low of 5% in 1988. It took three years of high interest rates – and redundancy payments – to increase it to over 10% again. Britain is unique in Europe in the facility with which owner-occupiers can withdraw large sums of money from housing and spend it on imported consumer goods. This is because it is a process at which the banks and building societies willingly connive.

The Financial Sector

The banks and the building societies bear a large share of the responsibility for the explosion of credit in the personal sector in the 1980s. They encouraged the removal of the restraints on the amount which could be lent on a first mortgage in 1986. They lent 100% of the value of a house to first-time buyers, and the old rule of thumb in mortgage lending – that a mortgage should not exceed two and a half times gross earnings – was conveniently discarded. First-time buyers were even tempted to buy a house with a 'low-start' mortgage which guaranteed that their debts would increase irrespective of what happened to house prices and interest rates. As a result, net advances for house purchase by all lenders increased throughout the 1980s at a compound rate of nearly 17% a year, from £7.3 bn in 1980 to a peak of £40.1 bn in 1988. Net lending rose by nearly 30% in 1987 and 40% in 1988. The total amount of mortgage debt outstanding has increased from £52.4 bn in 1980 to a high of £336.2 bn today, an increase in real terms of 221% [see Table 2].

These were radical breaks with the past. Until the mid-1980s it was difficult for a home owner to borrow more than was needed to buy or repair a house. To get a mortgage at all, the borrowers of the 1960s and 1970s had to save with a building society on a regular basis for a long period. Their total secured debt was rarely allowed to exceed four-fifths of the value of a property. These prudential rules were abandoned in the 1980s.

Irresponsible Corporate Lending

But irresponsible lending was not confined to the personal sector. British banks, accused by the Labour government in the 1970s of lending too little to industry, over-compensated disastrously in the 1980s. Bank balance sheets – in which lending to the private sector accounts for two-thirds of total financial assets – ballooned from £314 bn in 1980 to £1,265 bn a decade later, a doubling in real terms.[17] This was partly because the banks were caught up in the general economic euphoria of the time. It was in June 1988, the very month that base rates began their sharp upward climb towards 15%, that Barclays raised £921 million in a rights issue for the specific purpose of expanding its loan book.

Misplaced optimism was not the only factor at work. Having spent much of the early part of the 1980s writing off loans to developing countries, especially in South America, the banks were anxious to increase their share of domestic lending. Their entry into the residential mortgage market was one aspect of this. Increased corporate lending was another. However, the blue chip corporate clients on which they had relied in the past were now able to borrow more cheaply in the capital markets. Lower inflation and reduced government borrowing had led to a modest revival of the corporate bond market and the abolition of exchange controls had encouraged the growth of the offshore Eurosterling bond market. Companies were also meeting their short term borrowing needs in the securities markets, by issuing short-dated commercial paper directly to investors. The banks, in the jargon of the financial markets, were being 'disintermediated.' It forced them to turn to less creditworthy companies, which found it difficult to borrow in the capital markets.

Over-exposure to Commercial Property

Foremost amongst the less creditworthy were the dozens of property development companies which had sprung up to take advantage of the booming markets in office space, shops and industrial estates. The clearing banks lent eagerly to them, increasing their loans to the property sector between 1985 and 1991 at twice the rate they were expanding credit to the private sector as a whole [see Table 8]. Bank lending to property companies rose from less than £7 bn in 1985 to a peak of £45 bn in 1991. At its peak in 1989 bank lending to property accounted for over a quarter of all loans to the private sector, and the amount outstanding is still worth £37.97 bn. This is equivalent to a tenth of total sterling bank loans and three times the sum – in real terms – which was outstanding at the time of the last property crash in 1974, when it took three years for bad debts to be flushed from the banking system.

Many of the most imprudent loans were made by foreign (especially Scandinavian and Japanese) banks which were active in the London and provincial property markets during the latter part of the 1980s. They were driven less by profit than by a desire to acquire market share, even if that meant extending credit to enterprises which even the clearing banks felt it was best to avoid. The effects of irresponsible lending on this scale are apparent today, in the massive provisions all of the major banks have had to make for bad and doubtful loans to property companies. Barclays, which increased its exposure to the property sector by nearly 30% a year in the six years to 1991, wrote off £1.95 bn in bad loans last year. Two-fifths of them, or £780 million, was made to property companies.

Yet it was because property seemed to offer such rock-solid security for loans that the banks were prepared to lend so much against it. They simply failed to understand the economics of the property development industry. A £100 million building financed by £90 million of bank loans and £10 million of equity will increase dramatically in value as rental income rises and interest rates fall, but plunge in value equally quickly when the conditions are reversed. Empty buildings produce no income, interest goes unpaid and the building is unsaleable, making it impossible even to realise the value of the collateral.

To this intrinsic risk, the banks added some twists of their own. Loans were made to off-balance sheet subsidiaries on a 'non-recourse' basis, leaving them with resort to the developed property only and not to the full assets of the company that owned it. In some cases, interest on the loan was rolled up and became payable only when the property was sold or fully leased. Ironically, the entry of the banks into the residential mortgage market further lowered the quality of their corporate loans. Once interest rates began to rise in the summer of 1988, consumers struggling to keep up with their mortgage payments had little left to spend in the shops. Retailers, and their suppliers, could no longer afford the ever-rising rents which had sustained the property market in the late 1980s. The total provision for bad debts by the big four clearing banks in 1992 was £5,869 million.

The true magnitude and significance of this overexposure to property became public when the Bank of England revealed in May 1993 that it intended to make provision of £115m in its accounts for bad loans to peripheral banks. In the course of the previous two or three years, the Bank had judged it necessary to conduct a clandestine support operation in which hundreds of millions of pounds of public money were lent to financial institutions to avert a collapse of confidence in the banking system.

Leveraged Buy-Outs

As the economic boom careered towards its peak in the late 1980s the banks discovered a form of lending which was even riskier than property. This was the leveraged buy-out or LBO. These transactions – usually the purchase of an unwanted subsidiary by its managers, but sometimes of a whole company by a group of outsiders – are wholly dependent on the easy availability of credit. The market in them grew rapidly amid the corporate restructuring of the 1980s, from fewer than 20 transactions worth just £14 million in 1979 to well over 500 worth £7.5 bn at the peak of the boom in 1989 [see Table 10].

One of the earliest was the privatisation of the National Freight Company in 1982. The Woolworths retailing chain was the subject of a £310 million private sector buy-out in the same year. At the height of the takeover boom in the late 1980s financiers adapted the technique to mount bids for under-valued companies with borrowed money, in what became known as 'management buy-ins.' Bids of this kind were rarely mounted because the target company was badly run, but aimed rather to extract fees and capital gains for the principals involved. By the end of the decade easy credit was not so much seeking out opportunities as creating them.

The most notorious example in Britain of an opportunistic bid facilitated by banks was the abortive £13.4 bn bid James Goldsmith and a group of his friends and associates made for BAT Industries in the summer of 1989. That bid eventually lapsed but a number of others succeeded, sometimes at the cost of jeopardising the survival of the company. Lowndes Queensway, the carpet retailer acquired in a £450 million leveraged buy-out in 1988, eventually collapsed under the weight of its own debt. The Gateway food company, the subject of a £2.37 bn leveraged takeover in 1989, is still struggling with £1.3 bn of debt even after a series of disposals.

All buy-outs replace equity with debt, adding to the instability of the financial system and increasing the viciousness of the credit cycle. They were facilitated by the availability of bank finance and by a tax system which treats interest as a pre-tax expense but dividends as a post-tax expense. Leverage was also integral to the success of a transaction for the principals. The managers or financiers organising buy-outs not only lacked the resources to finance them prudently, but actually sought to reserve the bulk of the rewards for themselves by borrowing most of the purchase price. Often they even borrowed the money they needed (sometimes against the security of their home) to buy the equity in the company making the bid. The balance of the purchase price was then made up exclusively of various classes of interest-bearing debt. Fortunately, Britain never developed a 'junk' bond market like that which emerged in the United States, in which any company could borrow provided it was prepared to pay a high enough rate of interest. But so-called 'mezzanine' financing – high yield, high risk, unsecured debt, whose sobriquet derives from the fact that it ranks behind bond-holders but ahead of shareholders in the event of a winding up – was made available by the banks with all too predictable consequences.

Whereas it was possible to finance a buy-out in 1989 with six times as much debt as equity, banks now tend to baulk at any multiple higher thatn two. It is a telling example of the way in which the imprudence of bankers can amplify the viciousness of the cycle of credit. However they could not have mismanaged their lending activities so badly if their credulity had not been matched by that of their corporate customers.

The Corporate Sector

The error of optimism in corporate Britain during the 1980s yielded nothing to its counterparts in the personal and financial sectors. Companies were among the most enthusiastic consumers of debt. Outstanding bank borrowings by private industrial and commercial companies increased from £45.1 bn at the end of 1981 to £73.1 bn at the end of 1986, an increase of nearly a quarter in real terms. But it was after the stock market crash of October 1987, which made it more difficult to raise equity finance, that bank borrowings really took off. In the five years to the end of 1991 they increased from £84.8 bn to £164.8 bn, a real increase of nearly one and a half times.[18] In real terms, corporate indebtedness to banks more than doubled over the ten years to 1991. Bank borrowings and other forms of debt increased from two-fifths of the external financing requirements of industrial and commercial companies in 1987 to two-thirds in the peak year of 1989, and new equity finance, the permanent capital which is insensitive to increases in interest rates, fell from a third to just over one-fortieth in the same period [see Table 6].

With indebtedness increasing and share capital scarce in the wake of the crash, there was a commensurate decline in the financial strength of the corporate sector. Financial liabilities rose from a low of 56% of total assets in 1981 to a peak of 91% in 1989 before falling back again. Full data on the value of tangible assets is not yet available but it may be that, with total assets of just over £1,000 bn and liabilities of over £900 bn, industry and commerce had a net worth of less than £100 bn by the end of 1989 [see Table 7]. As a whole, the corporate sector moved from a net financial surplus in 1986 and 1987 to a net deficit of £26.9 bn in 1990.[19] This was an astonishing deterioration for a sector which is traditionally at least in balance, and more often in sizeable surplus. British industry, like the British consumer, entered the recession with an excessive load of debt.

The most obvious explanation for the deterioration in corporate balance sheets is the correct one. Towards the end of a prolonged and vigorous upturn in the economy, companies were simply too optimistic about its continuation. Many misjudged their ability to service debts in the recession which they had assumed at the height of the boom.

Unfortunately, the sharp rise in interest rates from the summer of 1988 failed to choke off the rise in company borrowing. The impact of a rise in base rates was dissipated not only through a complex term structure of interest rates but also by a string of innovations – caps, collars, forward rate agreements, equity-related bonds, and interest rate and currency swaps – which shielded companies from the rise in bank base rates. In any event, profits appeared to be rising fast enough to cope with higher interest rates; most major companies were free to borrow in offshore markets; and even lesser creditors could borrow freely from foreign banks only marginally affected by changes in British monetary policy.

The Takeover Boom

But the increased indebtedness of corporate Britain owed less to its initial insulation from the reality of interest rates than to its absorption in an unprecedented takeover boom, especially in the second half of the 1980s. The amount spent by British companies on takeovers and mergers climbed from £1.1 bn at the bottom of the recession in 1981 to a peak of £27.25 bn at the height of the boom in 1989 [see Table 9]. This was not purely a domestic phenomenon. With the abolition of exchange controls, British companies were free to acquire businesses abroad without paying a premium for the necessary foreign currency. A series of major acquisitions were made abroad, especially in the United States, between 1985 and 1989. The industrial conglomerate Hanson was the most prominent buyer of American businesses but other household names – Beecham, Grand Metropolitan, BP and BAT Industries – also made major acquisitions there.

Until the stock market crash of October 1987 undermined share values, most acquisitions were made using shares as currency. Though companies were obliged to offer a cash alternative to investors who disliked their stock, at a time of rising stock prices most shareholders were happy to be paid in paper rather than money. Much of the increase in share prices was attributable to genuine improvements in productivity and corporate profitability, and to the improved performance of the economy generally, but a rising stock market also reflected the easier availability of credit. Increased corporate indebtedness itself was improving share price performance, at least in the short term. It is an arithmetical truism that companies which enlarge their borrowings to expand can increase earnings per share more rapidly than those which finance their investment needs with equity. After the crash, debt could be used just as easily to pay for takeovers. The proportion of takeover considerations financed with debt necessarily increased after the crash. Cash declined as a percentage of takeover considerations from over two-thirds in 1981 to roughly a quarter in 1986 but quickly climbed back to over four-fifths in 1989 [see Table 9]. Most of the money had to be borrowed.

Industrial Short-Termism

The obsession of British business with takeovers is generally attributed to the short-termism of institutional shareholders, and there is strong *prima facie* evidence to support this argument. Institutional shareholders – insurance companies, pension funds, unit and investment trusts – now control about two-thirds of the shares of listed companies in Britain. Industrial investment may take years to produce a return, but institutional investors are tied to quarterly performance targets set by their trustees or policy holders. The tax-driven collectivisation of share ownership and the introduction of professional fund managers, external performance measurement, computerised investment strategies and derivative financial instruments which obviate the need even to buy the shares of a company has meant that shareholders are no longer owners in any meaningful sense of the term but increasingly little more than speculative investors seeking to attract fee income by outperforming their competitors. The result, runs the argument, is that shareholders are obsessed with the performance of the share price, and management with maintaining the earnings per share ratio on which the share price depends.

It is not unknown for a company facing depressed earnings in a particular year to make an acquisition purely to prop up its profits. If the acquisition is made with borrowed money rather than equity – as with most takeovers after the stock market Crash of October 1987 – there is no dilution of earnings per share. After the deal is completed, acquisition accounting then offers further opportunities to boost earnings per share. The difference between the price a company paid for an acquisition and the actual value of its assets and liabilities, known to accountants as 'goodwill,' is usually written off immediately against reserves, avoiding the risk of reducing earnings per share by depreciating it against future profits. Companies which choose depreciation – usually as a takeover defence, since goodwill is kept in the balance sheet as an intangible asset – can limit the effects on earnings per share by undervaluing the assets acquired, so keeping the depreciation charges low. The under-valued assets can then be sold, at inflated prices over a prolonged period, to boost profits in the years ahead. The liabilities of the acquired company can also be manipulated to increase earnings per share. By overstating the initial costs associated with an acquisition, profits in the following year are inflated effortlessly.

The Drain of Dividends

Even in a recession, when corporate earnings fall, companies are generally managed in the interests of share price performance. Because actuaries value pension fund and life office assets on the basis of their income rather than national capital gains, and tax-exempt funds can claim back most of any income tax withheld, dividend policy can become the key influence over the share price of a company during an economic downturn. This explains the deep reluctance of company managements, at a time when they should be conserving cash and reducing debt as their earnings fall, to pass or reduce a dividend. In theory, passing a dividend should leave overall shareholder returns unchanged because any earnings not paid out will show up as a capital gain in the share price instead.

But studies have shown that lower dividends do hurt share prices, and the shrinkage of internal resources in the corporate sector during the recession [see Table 6] is partly explained by the fact that companies have dipped into their reserves in order to maintain dividend payments.[20] This makes British companies much more reliant on external financing than their foreign competitors. The dividend ratio (dividends as a proportion of earnings) averages 30 to 40% in Britain, against 13% in Germany and less than 1% in Japan. The constant diminution of internal resources further increases the sensitivity of the British economy to interest rates and, by forcing companies periodically to replenish their resources in the marketplace, further exaggerates the credit cycle.

Guilty Managers

Yet the obsession with share price performance and maintaining dividends owes just as much to managerial ambition. Managers seek, through pleasing shareholders to increase their own wealth and security. In other words, even if institutional investors are not short-term in their outlook, managements generally act as if they are. They spend a great deal of time monitoring their share registers and informing key shareholders, formulating defensive strategies in case of an unwanted bid, and setting performance measurements – like sales per employee, or a progressive dividend, as well as earnings per share – which aim to satisfy investors but have little to do with improving the trading performance of the company.

Many managers now assess their personal performance by short term criteria, tying their own remuneration directly to improvements in earnings per share. This has given them a personal as well as professional interest in increasing earnings per share by retiring equity and replacing it with debt and in growth by acquisition rather than capital investment and research and development. The entire pattern of incentives in the corporate sector is perverse in its effects, and accentuates the viciousness of the cycle of credit by giving shareholders and management a vested interest in debt-financed takeovers, creative accounting and unwarranted dividend payments.

These costs would be tolerable if takeovers raised the long term growth rate of the economy. Yet mature economies with higher long term growth rates, like Germany and Japan, generally abjure takeovers. A wide range of academic studies of mergers and acquisitions has demonstrated that few takeovers generate the promised gains in profitability. It is also noticeable that the Anglo-Saxon economies with vibrant takeover cultures and a deregulated financial sector – the United States, Canada and Australia as well as Britain – have experienced a more pronounced credit cycle than other developed economies. In the long run, this may be altering the entire balance of the economy. Over the last 30 years, manufacturing as a proportion of UK output has fallen from a third to a fifth and the share of services in the national income has risen from less than a half to roughly two-thirds.

This 'deindustrialisation' is a much misunderstood issue in Britain – thanks mainly to misconceptions about the primacy of manufacturing in economic growth – but it undoubtedly reflects several indigenous factors as well as a long term secular adjustment to competition from newly industrialised countries which is common to all developed economies.[21] One is a greater proneness to inflation, and so to relatively high rates of interest. This encourages investment in service industries, where the capital requirements are lower, and discriminates against investment in manufacturing by necessitating higher and quicker rates of return. These requirements are mirrored in the ownership and management structure of British industry.

The changing balance within the economy has also increased its susceptibility to a pronounced credit cycle. Services, particularly financial ones, have a much larger appetite for credit than manufacturing, which has radically improved both its stock management and credit control techniques. This is evident, for example, in the differential impact of the recent recession in the north of England, where manufacturing still dominates the regional economy, and the south, which is heavily reliant on financial services.

The preoccupation of British managers and shareholders with short term financial variables may not only be making the economy more vulnerable to the credit cycle, but may actually be embedding it in the economic structure of the country.

PART TWO: PRESCRIPTION

The Authorities

The public tendency to blame economic difficulties on the government, and the Chancellor of the Exchequer in particular, is a recurrent feature of British political life. Stafford Cripps will be forever associated with post-war austerities; Selwyn Lloyd with the infamous Pay Pause; and Anthony Barber and Nigel Lawson with their eponymous, but unsustainable, booms. In elections, triumph or retribution generally depends on the luck and judgment with which the government has ridden the economic cycle.

Yet it would be facile to place blame for the credit boom of the 1980s and its melancholy aftermath on any one individual or any one cause. New financial freedoms, driven only in part by public policy, were superimposed on a business culture, an institutional structure and a pattern of economic and fiscal incentives and subsidies which almost guaranteed their abuse. Disturbingly, all of these problems are still largely unreformed. The second half of this paper prescribes the changes which need to be made if the British economy is to avoid embarking upon another disastrous cycle of boom and bust.

Rules Versus Discretion in Monetary Policy

Perhaps the biggest single institutional obstacle to sustained, non-inflationary growth in Britain is the continuing imbalance between rules and discretion in the conduct of monetary policy. Since 1976 successive chancellors have sought to anchor it in rules, but their chosen lodestars have proved too fickle, perverse or demanding to survive even the quinquennial revolutions of the electoral cycle. In the late 1970s and early 1980s the focus of policy was the broad monetary aggregate, Sterling M3. Hindsight has revealed that it was a reasonably accurate guide to the credit boom in the mid-1980s.[22] Yet it was abandoned as the centerpiece of policy in 1985 precisely because it was such a misleading guide to monetary conditions in the first half of the decade, when high real rates of interest made the holding of bank deposits – which make up the bulk of Sterling M3 – relatively attractive. It also excluded building society deposits, which were becoming an increasingly important part of the money supply. In a speech at Loughborough on 22 October 1986, made notorious by subsequent events, the Governor of the Bank of England concluded that this reshuffling of financial assets meant that broad money targets like Sterling M3 no longer served any useful purpose.[23]

From 1984, the focus of policy switched to the behaviour of the narrow monetary aggregate MO, or cash. It was, in the jargon, a 'coincident' rather than a 'leading' indicator of monetary conditions and therefore of no assistance to policymakers seeking a glimpse at the future. It was the failure of both the broad and the narrow monetary targets to give reliable indications to policymakers which persuaded the government to give increasing emphasis to the exchange rate. Unlike the monetary aggregates, it is real and not subject to the vicissitudes of data collection; it is followed and understood by employers and the general public as well as Whitehall and the City; and it is both a symptom of inflationary pressures and a mechanism by which inflationary forces are transmitted throughout the economy via changes in the domestic value of imports and exports.

The exchange rate can acquire a lasting credibility in the financial markets which is denied to mere monetary targets, if the government demonstrates a formidable commitment to the defence of a particular parity, and if developments in the real economy warrant it. This aspiration lay behind the government's decision, after a period of informal shadowing of the deutsch mark, to enter the Exchange Rate

Mechanism (ERM) in October 1990. The timing – with interest rates at 15%, inflation far from beaten, the pound over-valued and Germany about to embark on the massive borrowings which followed reunification – was inopportune. With the withdrawal of sterling from the ERM less than two years later, exchange targets are now also discredited, having led to inappropriately loose monetary conditions in the late 1980s, and to an excessively tight financial squeeze in the early 1990s.

The Case for an Independent Bank of England

To restore stability in the conduct of monetary policy, an independent role for the Bank of England is now essential. A sophistic debate still rages between the various monetarist sects as to the respective merits of broad and narrow monetary targets, monetary base control, the exchange rate and even the balance of payments as lodestars for steering the economy. But the most comprehensive review of the performance of all of the available monetary indicators in the 1980s concluded that none of them, including the exchange rate, was totally reliable.[24]

The government, having found monetary targets unreliable and the exchange rate perverse in its effects, has decided to monitor every monetary indicator, rather than one or two, and conduct its policy on an entirely discretionary basis. In a world in which the monetary system is constantly evolving, the exercise of discretion is probably inescapable. But, as Nigel Lawson recognised more than a decade ago, it matters greatly who exactly is exercising that discretion.[25] Provided the commitment to financial probity is unwavering, and is buttressed by a tight fiscal policy, the financial markets are willing to entrust an elected government with that responsibility. Unfortunately, it cannot be said that any British government of the post-war era has enjoyed an unsullied reputation for monetary rectitude and fiscal probity.

In the light of this history, a discretionary monetary policy will enjoy greater credibility in the marketplace if it is exercised not by an elected government subject to the inevitable political pressures to spend and borrow but by an independent and powerful central bank.

It is a method of proven effectiveness in the United States, Switzerland, Germany and New Zealand. Even France, where the political control of monetary policy is traditionally absolute, is now considering independence for the Banque de France. The Bank of England should be given a statutory duty to maintain the value of the currency, with full responsibility for the adjustment of short-term interest rates and the use of the reserves in exchange rate management.

However, the Bank should also be obliged – in so far as it is consistent with the defeat of inflation – to conduct its monetary operations within the parameters of government economic policy as a whole. This would place it on the same constitutional footing as the Bundesbank. The Governor would continue to serve five year terms, but on the explicit understanding that failure to contain inflation within a stated target range over his or her entire term of office would result in dismissal. Remuneration might also be linked to performance.

Two principal objections are usually advanced to an independent Bank of England. One is the belief that inflation might be defeated, but at the expense of growth. This is fallacious. The whole of recent economic experience suggests that no bargain can be struck between inflation and growth, except in the short term.

The more serious objection is a constitutional one. An independent central bank, it is argued, would result in a loss of democratic accountability. This is easily rectified. The Governor of the Bank would be appointed by the Prime Minister, subject to the approval of the House of Commons, and he or she would be regularly obliged to appear before the Treasury Select Committee. The other members of the Court of the Bank of England – the deputy governor, executive directors and non-executive directors – might even be appointed directly by Parliament, or at least subject to its veto.

The threat of an unaccountable Bank is any event greatly exaggerated. In an economy where the government spends well over two-fifths of the national income, and the central bank is responsible for funding the public debt in the capital markets, the conduct by the Bank of a monetary policy which is totally at variance with overall economic policy is simply impracticable. The Bank and the Treasury would have to co-ordinate their policies as a matter of practical necessity as well of constitutional propriety. But the constitutional objection is anyway misdirected. An independent Bank would not undermine democracy but actually enhance it, through the limitation and separation of executive powers.

An independent Bank of England would have other advantages too. It would help to restore the fractured moral authority of the Bank of England over the main providers of credit. Paradoxically – given that independence for European central banks is one of the conditions of Economic and Monetary Union (EMU) – greater autonomy for the Bank of England would also alleviate any pressure, especially in the financial markets, for Britain to re-enter the ERM. It would certainly signify that the government can conceive of an alternative future for the Bank and the pound than their absorption into a single European currency managed by a European central bank.

Nor is an independent Bank a particularly bold departure in monetary management. The Bank of England originated as a private institution, and enjoyed a limited freedom from government interference until it was nationalised in 1946.[26]

The Personal Sector

The second fundamental reform which is now necessary is a reduction in the tax privileges of that most cherished of British institutions, home ownership. The individual citizen is entitled to expect that the authorities will ensure financial conditions remain reasonably stable but, if the authorities are not to return consumers to the world of the mortgage queue and hire purchase controls, individuals must be given the incentives to use financial freedom both more responsibly and more imaginatively. At present the excessive proportion of personal wealth invested in housing is diverting savings from productive investment. Through 'equity withdrawal' from housing, savings are also being channelled into consumption. The rising house prices of the 1980s, whose effects are now irreversible, have arbitrarily redistributed resources from productive capital and labour to rentiers without increasing the overall stock of wealth.

The overall effect is inflationary. It has enabled some home owners to increase their spending on consumer goods, school fees or even a second home in France or Spain, whilst leaving others to grapple with mortgage arrears, repossession or 'negative equity' in their home. This has already increased public expenditure on housing and social security, and is exerting upward pressure on prices throughout the economy as the losers attempt to recoup their losses through higher wages and salaries. Houses lack liquidity and are costly to sell even without the additional burden of 'negative equity.'

The wide disparities in house prices between different parts of the country [see Table 5] make it difficult for an owner-occupier to move from a depressed area to a prosperous one without a pay rise. This inhibits labour mobility and exacerbates wage inflation. An inadequate supply of private rented housing, coupled with a fiscal bias in favour of owner-occupation, is also largely responsible for the dilapidated council estates and homelessness which disfigure too many of Britain's inner cities.

Reforming the Taxation of Housing

For all of these reasons, it is vital that the subsidisation of owner-occupation through the tax system is radically curtailed. This is not recommended lightly. The urge to own property is deeply rooted in the British psyche, reaching back at least as far as the freeholder of the Middle Ages, and gratifying it has endowed Britain with an enviable combination of social stability and individual self-reliance. No sensible government would wish to jeopardise these benefits. But with more than two-thirds of the housing market now owner-occupied, the economic consequences of home ownership are becoming increasingly ambiguous.

In the boom of the 1980s owner-occupation underpinned an unprecedented explosion of credit, while in the downturn of the 1990s the problems of repossessions and 'negative equity' in houses bought at the top of the market delayed recovery. The value of owner-occupied housing has now assumed such overwhelming importance in the economic life of the nation that a rise in house prices – to be achieved by such quack remedies as increasing the ceiling on mortgage interest relief, making capital losses on houses tax deductible, abolishing stamp duty, extending subsidies to first time buyers and so on – came to be seen as a necessary condition of recovery.

Ending mortgage interest tax relief would solve part of the problem. Fortunately, it is already much eroded. The value of the ceiling, last raised to £30,000 in the budget of March 1983, is falling steadily in real terms. It is already restricted to the house rather than the individual, and now also to the lowest rate of income tax. However, mortgage interest tax relief is only indirectly responsible for the main problem of 'equity withdrawal.' The imposition of capital gains tax on housing sales (perhaps with rollover relief) or the imposition of a limit on tax-free 'equity withdrawals' would deal with it directly, but would penalise those who have borrowed little in the past and have more equity in their house. It would either discourage them from selling or, paradoxically, encourage them to borrow up to the tax-free limit every year as a way of extracting their equity without taxation. The effect of a tax on land values, which is suggested in some quarters, is too difficult to predict when it is unclear whether land values drive house prices or vice-versa.

Taxing the imputed rental value of owner-occupied housing is the obvious answer to the conundrum, but amounts to electoral suicide. The political realities dictate that the 'wealth effect' of housing – and its most pernicious side-effect, 'equity withdrawal' – can only be tackled indirectly, by time-limiting mortgage interest tax relief and confining it to first-time buyers. This should be done by raising the ceiling to £40,000 and then withdrawing it in equal slices over the first four years of home ownership. This would erode substantially the subsidisation of house prices through the tax system, and eliminate the tax advantages of borrowing against the security of a house to finance consumption. It would also place the taxation of housing on the same basis as most financial assets, thus enhancing the attractions of other forms of investment. All investment in bricks and mortar would be made out of taxed income and would accumulate free of all income and capital taxes until death, when it would be subject to inheritance tax.

Reviving the Private Rented Sector

Any reform along these lines would raise the age at which people bought their first house. To prevent an acute shortage of affordable housing for young people, the change needs to be accompanied by a vigorous revival of the private rented sector. There are encouraging signs at last of a positive response by private landlords to the deregulatory measures introduced in the 1980 and 1988 Housing Acts, which restricted tenants' rights and freed up rents. The members of the Association of Residential Letting Agents have reported an average increase of 13% in private lettings last year.[27]

But there are justifiable fears that a large part of the apparent growth of the private rented sector is superficial, and reflects only a temporary willingness to let among owner-occupiers unable to sell. Until the fiscal advantages of buying over renting are curtailed, this will remain a problem. However, it is better to restrict the tax privileges of the owner-occupier than it is to extend similar favours to the private landlord, by allowing landlords to receive rents free of income tax and to charge depreciation against their assets.

The Financial Sector

The third important reform is the breaking up of the clearing banks. This is the essential prelude to a sounder appreciation of credit risk by bankers and a clearer recognition by the banking industry of where its future lies. In their present form, the clearing banks are a menace to their staff, their customers, their shareholders and the national economy. They were not only the main authors and agents of the disastrous amplification of the credit cycle in the second half of the 1980s, but also its most prominent victims as well. Yet it is an experience from which they appear to have learned nothing.

The lessons of the 1980s were that the banks failed to control, or even to measure, their costs. They were unable to price their products correctly. Large but wasteful branch networks, and foolish forays into estate agency, bear palpable witness to their inability to adapt to new circumstances and suggest an obsession with market share rather than profitability. Their bureaucratic and hierarchical management structures almost guaranteed poor decision-making. Major loans were approved at so many different levels that they become unstoppable. They usually hinged not on the viability of a project or the character and record of the borrower but upon the security which was offered, usually in the form of property.

According to some estimates, three-quarters of all outstanding bank loans today are underpinned by property. It was the apparent value of this collateral, not the financial and managerial skills of the borrowers, which drew the banks into the commercial property industry. The same myopic approach persuaded all four of the main English clearing banks, and a host of foreign institutions as well, to lend to Robert Maxwell. This is not the case in the United States, for example, where banks are far readier to base lending decisions on the business prospects of their customers rather than the value of a floating charge over assets.

This is the main weakness of the British clearing banks: their inability to discriminate between sound and unsound banking propositions. They are simply too big and too diversified to do so. Financial deregulation undoubtedly played upon this weakness – it encouraged 'transactional' rather than 'relationship' banking, in which lenders competed for business on price alone – but the indiscriminate expansion of credit is a longstanding characteristic of the British banking industry, which stems from its belief that collateral is more important than character.

In a boom, when asset values are rising, banks expand their loan books recklessly. In a recession, extra collateral is demanded and lending margins are widened to cover the expense of the loans which went sour and reduce the risk on the remainder.[28] This raises the cost of finance for all borrowers. A similar lack of discrimination raises the cost of personal loans. The high cost of consumer credit – where the interest rates offered by most banks are currently between 25% and 30%, against a base rate of 6% – reflects the need to build the inevitable losses into lending margins. All borrowers are punished for the fecklessness of the few, and the economy is condemned to a vicious cycle in which credit explodes and implodes without reference to the standing of particular borrowers.

Too Big To Succeed

The banks will continue to churn out credit to unviable projects and spendthrift individuals until they are reduced to a more manageable size, and forced to assume more of the risk of imprudent lending. Before the first world war the country was covered with independent banking partnerships, several with headquarters not in the City of London but in the provinces where the new industries were starting up. They were close to their clients, often encountering them socially as well in business, and knew those whom they could trust and those whom they could not.

Unlike a modern high street bank, which is allowed neither to fail nor to be taken over, the banking partners also paid a high price for their own misjudgments. If the modern clearing banks were broken up into regional, or even local, suppliers of credit akin to the small partnership banks from which most of them were formed, they would gain a better understanding of their borrowers and adopt a more cautious approach in their lending. The Scottish banks – which are smaller, easier to manage and more selective in their choice of client – already emerge better from surveys of business than their English counterparts.[29]

It is conceivable, but far from certain, that the banks could be forced to break themselves up as an act of public policy. There is already a reasonable case for an investigation of the clearing banks by the Office of Fair Trading on competitive grounds alone. Their ability to raise charges and widen their lending margins in a recession is strong *prima facie* evidence of an informal cartel. In lending to small and medium-sized companies only about ten institutions are competing for business, and just two banks – National Westminster and Barclays – control half of the market. The money transmission, personal loan and credit card businesses of the clearing banks have oligopolistic characteristics.

But it would be infinitely preferable if the clearing banks and their shareholders recognised that the entire raison d'etre of the old-style clearing bank has disappeared. They were formed in the late nineteenth and early twentieth centuries because it was believed that banks needed to be big enough to service the huge industrial corporations which were then being formed through a series of mergers.

Today, those companies borrow not from the banks but in the international capital markets. It was for that reason that the modern clearers were diverted into lending to commercial property developers and into various types of dubious financing used to mount leveraged takeover bids for their former clients. This suggests that their natural franchise is the small and medium-sized companies on which a strong, vibrant and innovative economy depends. Rather than restrict credit in the same indiscriminate fashion that they dispensed it, the clearing banks should become major providers of equity finance and long term, fixed rate debt to the small business sector.

Finance for Small Business

Far from recognizing this fact, the clearing banks are busily alienating small businesses with increased lending spreads, reduced overdraft facilities, higher transaction charges and demands for additional security as asset values decline. One bank chairman has declared that he will be reducing his exposure to the small business sector, and another has demanded subsidies from the taxpayer for maintaining even his present level of lending to it. Many small businesses which have survived the recession are still burdened with debt which they cannot raise the equity or fixed rate finance to repay. Banks, rather than foreclosing or pressing for additional security, should supply it. Small businesses have long used bank credit as a form of permanent capital anyway, for the simple reason that no equity finance could be had.

Banks are often assuming an equity risk, but failing to recognize it in the structure and pricing of small business loans. In several major financial restructurings – Brent Walker, Imry, Randsworth Trust and Speyhawk – banks have ended up with an equity stake in the rump of the business. A willingness on their part to assume an equity risk at the outset would not only offer them the prospect of an equity reward, but would help to put many of the businesses to which they lend on a sounder financial footing. It would also reduce the propensity of the banks to increase fees and charges, since doing so would damage the value of their own investment. Although many small businesses are undoubtedly hostile to external shareholders, it would be simple for the banks to conclude mutually satisfactory buy-back arrangements with owner-managers. The present spate of financial restructuring offers the banks a major opportunity to become serious stakeholders in an important part of British business.

There is also a desperate need for equity finance to fund business start-ups. Recognition of a gap in equity funding for small businesses can be traced back at least as far as the Macmillan Committee of 1931, which reported that 'great difficulty is experienced by the smaller and medium-sized businesses in raising the capital which they may from time to time require, even when the security offered is perfectly sound.'[30] Though the Macmillan report was the inspiration behind the formation of the Industrial and Commercial Finance Corporation (now 3i) by the Bank of England and the clearers in 1945, the Bolton Committee of 1971 found the funding gap still existed.

The Conservative government elected in 1979 – which was heavily influenced by the Bolton report – introduced a series of tax incentives, subsidies and advice services to help small businesses, but a survey of the sector by the Cambridge University Small Business Research Centre in June last year found the lack and high cost of finance was still the biggest single constraint on growth. Yet a sustainable economic recovery, and particularly a revival of employment, depends to a large extent upon the emergence and growth of small and medium-sized businesses.

This shortage of capital for new and growing businesses is essentially a modern phenomenon. In the early industrial era, businesses relied on family or clan resources to start up and on the reinvestment of profits to expand. Unfortunately, the heavy corporate and personal taxation (especially death duties) of the twentieth century has erased that source of finance, and also prevented smaller companies from accumulating capital out of revenues. The Bolton Committee of 1971 argued specifically that high taxation, by denying companies the resources to expand, was one of the main causes of the small business sector's decline.

Taxation has also obliterated that large class of private investors who had made their fortune, and were able to redeploy it in new business ventures. Various attempts to reinvent the wealthy private investor, initially through the Venture Capital Scheme and latterly through the Business Expansion Scheme, quickly degenerated into tax shelters which the government has rightly chosen to demolish. The British equivalent of the American 'business angel' – rich individuals, sometimes organized in syndicates, who offer finance and advice to small businesses without charging exorbitant fees – has yet to emerge, and no other group of investors is taking their place. There is a clear gap in the market, devoid of serious competition, for the clearing banks to seize.

Unadventurous Venture Capitalists

It is sometimes mistakenly assumed that the venture capital industry which has emerged over the last decade is a competitor in the field of business start-ups. This was one reason for restricting the scope of the Business Expansion Scheme, and eventually winding it up this year. But it is far too sanguine a view. The venture capital industry is actually rather small, with less than £2 bn available for investment. It is also, despite its nomenclature, decidedly unadventurous. After some discouraging experiences with business start-ups in the early 1980s, venture capitalists now spend most of their time and resources on management buy-outs (MBOs), where the business is already well-established and in need of capital, not to start up or to expand, but to change hands at a discounted price.

Such transactions are thriving in the recessionary climate, as major companies sell subsidiaries to reduce debt, and in 1991 MBOs accounted for 55% by value of all venture capital investments in Britain. Most business start-ups require far smaller amounts of capital than an MBO, but the venture capitalists say it is too costly to consider any proposition which requires less than £250–500,000. The only genuine business start-up organization, it seems, is the Prince of Wales' Youth Business Trust. It has a remarkable record of success. At the moment Britain has not so much a venture capital industry as a buy-out or development capital industry and, with the closure by the London stock exchange of the Third Market in 1990 and the possible closure of the Unlisted Securities Market this year, share capital for smaller businesses is likely to be in still shorter supply.

The 'Macmillan gap' is still there. The banks, even in their present form, should have the imagination to fill it.

Unbundling the Banks

Unfortunately, there is every reason to suppose that they will pass up the opportunity. The clearers argue that channelling equity and fixed rate finance to smaller businesses cannot be made profitable. Without a radical change in their own structure, this is undoubtedly true. Highly centralized and bureaucratic banks are quite unable to assess lending risks properly, lumber the smallest loans with the same overhead costs as the largest and prevent bankers from taking a close day-to-day interest in the performance of a company by joining its board of directors. All of these difficulties can be surmounted by breaking the clearing banks up into smaller regional and metropolitan entities, which would reduce overheads and disseminate risk assessment and financial management expertise from the centre to the periphery.

This 'unbundling' of the clearing banks could be achieved without jeopardising either their international investment banking activities – mergers and acquisitions, underwriting, fund management and securities and money market dealing, which are already conducted by separately capitalized subsidiaries – or their ability to provide nationwide money transmission services. The German banking system, in which a number of regional banks have high international reputations despite limited branch networks and even partnership structures, proves that size is not essential to international success. And nationwide money transmission services are increasingly a matter of technology, and of understandings between institutions with exposure to different parts of the country, rather than branch networks.

The main potential disadvantage of breaking up the clearing banks is that their ability to borrow directly in the capital markets would be much reduced, diminishing in turn their ability to on-lend at competitive rates to small businesses. This problem could be circumvented through the creation of a jointly owned borrowing vehicle akin to 3i, which is owned by the clearing banks, or the public sector institutions in continental Europe like the Kreditanstalt fur Wiederaufbau (KfW) in Germany and Credit d'Equipement Pour Les Petites et Moyennes Entreprises (CEPME) in France.

The KfW, or Reconstruction Loan Company, which is owned jointly by the central government and the federal states, was set up in 1948 mainly to supply long term loan capital and export finance to smaller companies. It borrows fixed rate finance at fine margins in the capital markets, and passes the proceeds to the banks for onward lending to businesses. CEPME lends directly to small companies, but borrows cheaply in the capital markets with the benefit of a government guarantee.

The extension of a similar guarantee to a British borrowing vehicle would certainly cheapen the cost of borrowing, but under present Treasury rules would inflate the Public Sector Borrowing Requirement (PSBR). It would be better to change the Treasury rules rather than substitute the formal subsidy that some clearing bankers are calling for, provided risk assessment was improved through the disaggregation of the banks. It would be a valuable first step in this direction if the Treasury were to instruct the Bank of England to undertake a fundamental review of the commercial banking industry: to make recommendations as to how it might be restructured in order to satisfy the expectations of its customers and shareholders, and of the nation as a whole.

The Corporate Sector

A fourth essential reform is the reorientation of the incentives which encourage British business to prefer financial engineering to adding value. The number of takeovers, which reached unprecedented levels in the closing years of the 1980s [see Table 9] shrank considerably during the recession. But it caused the financial enfeeblement of British industry, leading to the deferral of capital investment and the curtailment of expenditure on research and development. This in turn may have left business short of the capacity to take advantage of the upturn. It also contributed to the length of the recession.

By reducing the net stock of equity, takeovers and the fear of takeovers increased the vulnerability of companies to the subsequent rise in interest rates. At the height of the boom it directly increased the cost of borrowing throughout the corporate sector, as the value of unsecured bonds issued by companies perceived to be at risk fell to take account of the possibility that the company would be acquired by a group of fly-by-night financiers. Although this effect evaporated during the recession, it contributed to the financial weakness of the corporate sector.[31] And until the institutional, managerial, fiscal and accounting incentives which drive it are rectified, there is a risk that takeover activity will resume once the economic recovery is more firmly established.

Institutional weaknesses in the ownership and management of public companies in Britain are too changeable and varied to be susceptible to a single, elegant solution. There are some obvious answers, such as enlarging competition policy to encompass wider social criteria, or even state direction of savings into long term equity investments. But these raise difficult questions of natural justice, and may in any event be ineffective without a wider reordering of the fiscal and financial incentives which encourage institutional forms of saving, the over-use of debt and the penchant for growth through acquisitions which cause short-termism.

The current pattern of incentives can be tackled only from a variety of directions, not all of them statutory. This is to some extent happening already. A voluntary committee chaired by Sir Adrian Cadbury has made a number of recommendations which its members believe will improve corporate governance if they are implemented. The opportunities for creative accounting in mergers and acquisitions are being eroded by another voluntary body, the Accounting Standards Committee. The adoption of the recommendations of both of these committees, at present frustrated by the operation of vested interests in the business and accounting communities, might be accelerated by an explicit threat of statutory action unless the changes are made before a published deadline.

The Reorientation of Tax Incentives

The reform in the March 1993 Budget of the Advance Corporation Tax regime, which reduced the attractions of high pay-outs to tax-exempt funds, was a model of uncontroversial readjustment of fiscal incentives in this area. The reduction in the fiscal privileges of the investment institutions begun in the 1980s should be resumed as the economy recovers in the 1990s, with a view to increasing individual rather than institutional share ownership.[32] It is an area fraught with political difficulties, and any wholesale diminution in the tax advantages of saving through pension funds would have to be accompanied by a substantial cut in the basic rate of income tax, probably to as little as 15%.

Company directors, many of whom have in recent years made excessive use of the tax privileges of pension funds, must also be prepared to demonstrate leadership in this sphere. When Nigel Lawson attempted a modest reform of lump sum pension contributions in 1985 he records that 'the CBI ran a slogan 'Hands Off Peoples' Pensions,' while at the boardroom lunches I attended at this time all talk of the state of the economy, or of their own business, was suspended, as the directors turned the conversation to the all-important issue of their pensions.'[33] British business cannot have it both ways, complaining about institutional short-termism but unwilling even to contemplate reforming the taxation of occupational pensions which is at the root of the problem.

New Forms of Corporate Ownership

British business must also be encouraged, perhaps through the tax system, to explore alternative ownership structures. Many of Britain's most successful and inventive companies – John Lewis, Virgin, Pilkington, Reuters, NCP, Sainsbury's – have or have had private status, shares with restricted voting powers, sizeable family shareholdings, or employee ownership structures.

The joint stock company which divorces ownership from control is the main reason for the obsession of the British corporate sector and its institutional shareholders with the appropriation rather than the creation of wealth. It was devised in an era before stock market listings and institutional shareholders, when most industrial companies were mainly owned as well as run by their managers and their families, friends and associates.

In mid-Victorian Britain, the joint stock company was an appropriate means of attracting capital and limiting personal risk, but it is now an increasingly pernicious influence in the economic life of the country. Owned by short term institutional investors, and controlled by managers who often fail to distinguish between their personal and public responsibilities, it is at the heart of our present economic difficulties.

Ownership structures which give greater emphasis to long term investment – in relationships with staff, customers, suppliers and local communities, as well as physical and intellectual assets – will have a reduced appetite for consumption and credit and a greater propensity to add value.

Afterword

A maladroit monetary policy, financial deregulation, the maladjustment of fiscal incentives and the institutional shortcomings of the corporate sector, the housing market and the banking industry all contributed to the explosion of credit in the 1980s.

Yet there was also, of course, a moral dimension. In economic affairs there is a persistent tendency for appetites to outrun capacities. Inflation – so aptly described as 'too much money chasing too few goods' – is merely the measure of the gap between the two. All of the great inflations of our history were associated with periods of rising output and affluence and of increased government spending. It is at such times that the temptation to bridge the gap between means and desires with borrowed money is at its most intense, and it has achieved a new pitch in the age of mass consumption in which we live.

Thorstein Veblen, who chronicled the foibles of the American plutocracy, coined the phrase 'conspicuous consumption.' When he published *The Theory of the Leisure Class* at the turn of the century, consumption was the privilege of a small elite. Today, all citizens are consumers. This does not mean that the credit explosion of the 1980s was purely the result of the revivified economic individualism of those years. Indeed, it is far more likely to have stemmed from the long hegemony of a bastard Keynesianism, which seemed to turn borrowing into a virtue and thrift into vice. Its progenitor always favoured expediency over principle and gratification over self-denial. Temperence and restraint are virtues which Keynes associated with the Micawbers of his Victorian boyhood.

In its final forms, the success of Keynesian demand management became wholly dependent on the restraint of private appetites through a panoply of income, price and credit controls. It is not surprising to find modern critics of the affluent society advocating the re-imposition of direct controls over the growth of credit. Yet even if such methods were workable, which is unlikely in an economy without exchange controls, they would be out of step with an enterprise culture.

For although some people and institutions will always abuse an unaccustomed liberty, the free man or woman who learns from their mistakes is always prefereable to a slave who cannot make them. As Dr. Johnson wrote,

> Do not accustom yourself to consider debt only as an inconvenience; you will find it a calamity. Poverty takes away so many means of doing good, and produces so much inability to resist evil, both natural and moral, that it is by all virtuous means to be avoided … Let it be your first care, then, not to be in any man's debt. Resolve not to be poor; whatever you have spend less. Poverty is a great enemy to human happiness; it certainly destroys liberty, and it makes some virtues impracticable and others extremely difficult. Frugality is not only the basis of quiet, but of beneficence. No man can help others that wants help himself; we must have enough before we have to spare.

The bursting of the credit-induced illusions of the 1980s may be the beginning of the re-discovery of that practical economic wisdom

SUMMARY

In the 1980s, an unprecedented explosion of credit propelled the economy into a euphoric boom which unravelled in the prolonged slump of the early 1990s. According to the conventional wisdom, the surge in borrowing was triggered by an irresponsible deregulation of financial services. In fact, it was not caused solely by financial deregulation, but by its superimposition on a society and an economy whose structural imbalances, habits, institutions and economic incentives guaranteed the abuse of this unaccustomed freedom. These include:

- An ineffective central bank
- An excessive level of owner-occupation
- A hidebound banking industry
- A short-sighted business culture
- A damaging pattern of tax incentives
- A fixed price culture

All of these remain in place. As long as they do, fears of a renewed bout of unsustainable inflationary growth are amply justified. The priority now is to eliminate the structural obstacles to the responsible use of financial freedom. This will enhance the prospects of sustained long term, non-inflationary growth in the British economy. The necessary reforms include:

- An independent Bank of England
- The break-up of the clearing banks into regional entities

- Truncation of the tax subsidies given to owner-occupiers
- Curtailment of pension fund tax privileges
- New forms of corporate ownership

TABLES

Table 1. Bank and building society lending

Year	Increase
1979	20.3
1980	17.7
1981	20.3
1982	18.9
1983	17.1
1984	18.3
1985	16.6
1986	19.4
1987	21.2
1988	24.5
1989	20.7
1990	11.5
1991	5.0
1992	2.3
*1993	4.5

* January and February only.
Source: H. M. Treasury.

Table 2. Net advances for house purchase (£ billions)

Year	Annual increase: banks	Building societies	Other*	Total	Annual increase (%)	Total amount o'stding	Annual increase (%)
1980	0.5	5.7	1.1	7.3	–	52.4	–
1981	2.3	6.3	0.7	9.3	27.4	62.3	18.9
1982	5.1	8.1	0.9	14.1	51.6	76.4	22.6
1983	3.5	10.9	−0.1	14.3	1.4	91.3	19.5
1984	2.4	14.6	0.1	17.1	19.6	108.3	18.6
1985	4.2	14.7	0.3	19.2	12.3	127.4	17.6
1986	5.2	19.5	2.7	27.4	42.7	154.3	21.1
1987	10.1	15.0	4.5	29.6	8.0	183.6	18.9
1988	10.9	23.7	5.5	40.1	35.5	223.7	21.8
1989	7.2	24.0	2.9	34.1	−14.9	257.9	15.3
1990	6.4	24.1	2.1	32.6	−4.4	294.4	14.2
1991	4.8	20.9	1.0	26.7	−18.1	320.9	9.0
1992	5.0	11.6	−1.5	15.1	−29.1+	336.2	4.8

* Local authorities and other public sector bodies, pension funds, insurance companies, miscellaneous financial institutions. From 1983 mortgagors of local authorities were net repayers of debt. 1992 figures to third quarter only.

+ Percentage change on first three quarters of 1991.

Source: Council of Mortgage Lenders.

Table 3. Consumer credit (£ billions)

Year	Banks	Building Societies	Other	Total	Annual Increase (%)	Total 1991 Prices	Annual Increase (%)
1979	5.6	–	4.2	9.8	–	23.1	–
1980	6.7	–	4.8	11.5	17.3	23.0	−0.4
1981	10.2	–	5.2	15.4	34.9	27.6	20
1982	12.6	–	3.3	15.9	3.2	26.1	−5.4
1983	14.8	–	4.0	18.8	18.2	29.5	13.0
1984	17.4	–	4.8	22.2	18.1	33.3	12.9
1985	20.3	–	5.7	26.0	17.1	36.7	10.2
1986	23.8	–	6.3	30.1	4.1	40.9	11.4
1987	28.6	0.07	7.4	36.1	19.9	47.3	15.6
1988	34.3	0.28	7.9	42.5	17.7	53.1	12.3
1989	39.1	0.58	8.8	48.5	14.1	56.3	6.0
1990	42.7	0.78	9.3	52.8	8.9	55.9	−0.7
1991	43.5	0.73	9.4	53.6	1.5	53.6	−4.1
1992	43.0	0.74	8.8	52.5	−2.1	50.7	−5.4

Source: Central Statistical Office.

Table 4. Mastercard and visa credit cards issued by banks

Year	Number of Cards Issued (Millions)	Annual Percentage Increase	Total Credit Outstanding (£ millions)	Annual Percentage Increase
1979	9.8	–	934	–
1980	11.7	19.4	1,186	26.9
1981	13.1	11.9	1,571	32.5
1982	14.6	11.5	2,021	28.6
1983	15.8	8.2	2,593	28.3
1984	17.5	10.8	3,198	23.3
1985	19.6	12.0	4,047	26.5
1986	21.9	11.7	4,885	20.7
1987	24.5	11.9	5,776	18.2
1988	25.8	5.3	6,345	9.9
1989	28.6	10.9	6,924	9.1
1990	29.8	4.2	8,216	18.7
1991	26.8	−10.0	8,663	5.4

Source: British Bankers Association.

Table 5. Average house prices in the United Kingdom 1979, selected regions

Year	Greater London	Change (%)	North	Change (%)	Scotland	Change (%)	United Kingdom	Change (%)
1979	25,540	36.6	15,655	21.7	19,448	21.1	20,903	29.9
1980	29,203	14.3	18,273	16.7	22,015	13.2	24,547	17.4
1981	29,688	1.7	18,635	1.9	23,528	6.9	25,249	2.9
1982	30,955	4.3	20,175	8.3	24,860	5.7	26,696	5.7
1983	35,481	14.4	22,244	10.3	27,509	10.7	29,117	9.1
1984	41,870	18.2	24,725	11.2	30,499	10.9	32,758	12.5
1985	49,328	17.8	26,900	8.8	33,123	8.6	36,283	10.8
1986	59,385	20.4	28,019	4.2	34,313	3.6	39,663	9.3
1987	75,314	26.8	29,222	4.3	35,375	3.1	45,500	14.7
1988	85,966	14.1	30,659	4.9	36,045	1.9	54,187	19.1
1989	91,759	6.7	42,496	38.6	44,649	23.9	64,843	19.7
1990	81,071	−11.6	45,936	8.1	46,259	3.6	60,805	−6.2
1991	73,032	−9.9	49,416	7.6	48,438	4.7	57,908	−4.8
1992	66,355	−9.1	49,005	−0.8	50,279	3.8	54,811	−5.3

Source: Nationwide Anglia Building Society

Table 6. UK Industrial and commercial companies: sources of capital (£ millions)

Year	Total Internal Funds	Bank Loans	Other Loans & Mort-gages	Ordin-ary Shares	Other Exter-nal Funds*	Total External Funds	Shares Total Exter-nal Funds (%)
1979	26,073	3,981	1,402	879	402	6,664	13.2
1980	19,958	6,340	831	896	2,080	10,147	8.8
1981	22,200	5,849	1,315	1,660	1,886	10,710	15.5
1982	19,628	6,562	1,498	1,033	1,646	10,739	9.6
1983	27,237	1,619	1,196	1,872	2,481	7,168	26.1
1984	29,178	7,082	1,448	1,127	−2,244	7,413	15.2
1985	31,816	7,454	2,520	3,407	4,417	17,798	19.1
1986	30,937	9,323	1,673	5,483	10,077	26,556	20.6
1987	39,395	12,475	3,696	13,409	9,901	39,481	33.9
1988	39,863	31,452	5,761	4,349	14,871	56,433	7.7
1989	34,559	33,950	9,120	1,880	25,085	70,035	2.7
1990	33,838	19,911	8,045	2,851	22,858	53,665	5.3
1991	33,013	−878	3,585	9,746	21,288	33,741	28.9
1992	N/A	−1881	2,519	5,117	14,367	20,122	25.4

* Includes debentures, preference shares and other capital market issues and overseas investment in UK companies.
Source: Central Statistical Office, *Financial Statistics*, Table 8.2.

Table 7. Industrial and commercial companies: balance sheet (£ billions)

Year	Tang Assets	Ann Inc (%)	F'cial Assets	Ann Inc (%)	F'cial L'ties	Ann Inc (%)	Liab/ Total Asset Ratio	Fin Liab/ Asset Ratio
1980	268.1	14.4	123.7	13.6	218.4	16.9	0.56	1.76
1981	294.9	9.9	148.2	19.8	247.0	13.1	0.56	1.66
1982	316.0	7.2	168.2	13.5	292.5	18.4	0.60	1.74
1983	338.8	7.2	193.2	14.9	341.9	16.9	0.64	1.77
1984	388.6	14.7	230.7	19.4	405.1	18.5	0.65	1.76
1985	414.4	6.6	239.8	3.9	458.2	13.1	0.70	1.91
1986	446.5	7.7	274.7	14.6	571.6	24.7	0.79	2.08
1987	500.9	12.2	302.4	10.1	649.4	13.6	0.81	2.15
1988	576.0	15.0	342.6	13.3	742.2	14.3	0.81	2.17
1989	633.6	10.0	398.4	16.3	938.6	26.5	0.91	2.36
1990	697.0	10.0	402.6	1.0	930.2	−0.9	0.85	2.31
1991	766.7	10.0	436.7	8.5	1047.3	12.6	0.87	2.40

Valuations are not available from the CSO for 1988–1991, so tangible assets are estimated for these years.
Source: Central Statistical Office, *UK National Accounts*, Table 12.3.

Table 8. The clearing banks: lending to the property sector

Year	Nat West (£m)	Change (%)	B'clays (£m)	Change (%)	M'land (£m)	Change (%)	Lloyds (£m)	Change (%)
1986	997	–	1,197	–	632	–	N/A	–
1987	1,394	39.8	2,140	78.8	733	15.9	N/A	–
1988	1,931	38.5	3,195	49.3	1,301	77.5	N/A	–
1989	2,633	36.4	4,493	40.6	1,859	42.9	3,900	–
1990	2,813	6.8	5,265	17.2	2,100	12.9	4,300	10.3
1991	2,478	−11.9	5,397	2.5	1,800	−14.3	4,100	−4.7
1992	2,138	−13.7	4,981	−7.7	1,800	0.0	3,900	−4.9

Source: IBCA: Bank Annual Reports.

Table 9. UK industrial and commercial companies: Takeovers and mergers, and domestic and overseas investment

	Takeovers and Mergers				Investment					Proportion of Total Investment				
Year	No. of Acqs	Cost (um)	Change (%)	P'tage of Cost in Cash	Dom. I'ment	Change (%)	O'seas I'ment	Change (%)	Total I'ment	Change (%)	M & A	Dom. I'ment	O'seas I'ment
1982	463	2,206	92.8	58.2	17,329	5.4	2,661	−30.6	22,196	3.6	9.9	78.1	11.9
1983	447	2,343	6.2	43.8	17,704	2.2	3,388	27.3	23,435	5.6	10.0	75.5	14.4
1984	568	5,474	133.6	53.8	22,304	25.9	1,268	−62.6	29,046	23.9	18.8	76.8	4.4
1985	474	7,090	29.5	40.3	28,558	28.0	2,236	76.3	37,884	30.4	18.7	75.4	5.9
1986	842	15,370	116.7	26.4	29,492	3.3	5,625	151.5	50,487	33.3	10.6	58.4	11.1
1987	1,528	16,539	7.6	34.5	36,006	22.1	11,671	107.5	64,216	27.2	10.2	56.1	18.1
1988	1,199	22,839	38.1	70.0	43,499	20.8	12,703	8.8	79,041	23.1	3.6	55.0	16.1
1989	1,337	27,250	19.3	82.0	52,347	20.3	10,361	−18.4	89,958	13.8	8.1	58.2	11.5
1990	779	8,329	−69.4	76.9	54,863	4.8	507	95.1	63,699	−29.2	13.1	86.1	0.79
1991	506	10,434	25.3	69.8	49,855	−9.1	4,259	740	64,548	1.3	16.2	77.2	6.6
1992	426	5,850	−43.9	62.9	48,433	−2.9	2,528	−40.6	56,811	−11.9	10.3	85.3	4.4

Source: Central Statistical Office, *Financial Statistics*, Tables 8.2 and 8.8.

Table 10. UK management buy-outs and buy-ins

Year	Number	Change (%)	Value (£m)	Change (%)	Average Value	Change (%) (£m)
1979	19	–	14	–	0.7	–
1980	36	89.5	28	100	0.8	14.3
1981	149	313.8	204	628.5	1.4	75.0
1982	246	65.1	664	225.5	2.7	92.9
1983	244	−0.8	375	−43.5	1.5	−44.4
1984	243	−0.4	408	8.8	1.7	13.3
1985	293	20.6	1,183	189.9	4.0	135.3
1986	366	24.9	1.491	126.0	4.1	2.5
1987	434	18.6	3,521	136.2	8.1	97.6
1988	4898	12.4	4,928	39.9	10.1	24.7
1989	521	6.8	7,501	52.2	14.4	42.6
1990	594	14.0	3.110	−58.5	5.2	−63.9
1991	565	−4.9	2,829	−9.0	5.0	−3.8
1992*	301	–	1,648	–	5.5	–

*January to June only.
Source: Centre for Management Buy-Out Research.

NOTES

1 Nigel Lawson, speech to the Edinburgh Chamber of Commerce, 23 June 1987.
2 Robert Skidelsky, *John Maynard Keynes: The Economist as Saviour 1920–1937*, Macmillan, 1992, page 619–20.
3 Samuel Smiles (1812–1904) was the author of celebrations of entrepreneurial capitalism like *Lives of the Engineers*, and of improving works such as *Self-Help, Thrift, Character* and *Duty*. Much mocked in the twentieth century, his thinking is in my judgment long overdue for rehabilitation. His best-known work, *Self-Help*, contains a chapter entitled 'Money – Its Use and Abuse,' which opens with the following passage:

> How a man uses money – makes it, saves it, and spends it – is perhaps one of the best tests of practical wisdom. Although money ought by no means to be regarded as a chief end of man's life, neither is it a trifling matter, to be held in philosophic contempt, representing as it does to so large an extent, the means of physical comfort and social well-being. Indeed, some of the finest qualities of human nature are intimately related to the right use of money; such as generosity, honesty, justice, and self-sacrifice; as well as the practical virtues of economy and providence. On the other hand, there are their counterparts of avarice, fraud, injustice, and selfishness, as displayed by the inordinate lovers of gain; and the vices of thriftlessness, extravagance, and improvidence, on the part of those who misuse and abuse the means entrusted to them.

From Samuel Smiles, *Self-Help*, Popular Edition, John Murray, 1897, page 290.

4 Robert Skidelsky, *John Maynard Keynes: The Economist as Saviour 1920–1937*, Macmillan, 1992, page 156.

5 Long gilt yields are over 8%, against 6% base rates.

6 Nigel Lawson, *The View From No. 11: Memoirs of a Tory Radical*, Bantam, 1992, page 626.

7 It is often thought that exchange controls were abolished in one step on 23 October 1979, but in fact they were relaxed twice – in the Budget of 12 June and on 18 July that year – before complete abolition.

8 Even before the abolition of exchange controls, the Corset was diverting lending from the banking system to the money markets. This complicated official assessment of Sterling M3, the bank deposit counterpart to bank lending which then served as the lodestar of monetary policy.

9 The 'queue' meant that, unlike today, potential borrowers were obliged to save with a building society for several years in order to accumulate the initial deposit to purchase a house. The size of an advance was also limited to a low multiple of gross earnings, typically two and a half to three times.

10 In 1986 Stephen Fay asked the Governor of the Bank of England whether he still thought greed and fear the principal motives in the financial markets. Robin Leigh-Pemberton replied:

> I think they are more motivated now by the intensity of competition, and that is a simple function of internationalism. For greed, I would substitute pressure to perform. For fear I would substitute anxiety about the new situation. This results from a change in emphasis. It is no longer so easy for a merchant banker to be the guide, philosopher and friend. I do hope that old sentiments will survive and that markets will live by the spirit rather than the letter of the law, enabling us to maintain a flexible approach to regulation. That's been the strength of the London market. It's what visitors from overseas find so attractive about business here. It would be a pity if we were to lose sight of that.

See Stephen Fay, *Portrait of an Old Lady*, Penguin, 1988, pages 177–8.

11 Nigel Lawson, *The View From No. 11: Memoirs of a Tory Radical*, Bantam, 1992, page 367.

12 Real Rates of Interest 1979–89.

	Nominal Rates				Real Rates		
Year	RPI♠	PPI♥	3mR♣	M. Rte♦	3m/RPI	3m/PPI	MR/RPI
1979	12.5	10.8	13.7	11.9	1.2	2.9	−0.6
1980	16.9	14.0	16.6	14.9	−0.3	2.6	−2.0
1981	12.7	9.5	14.0	14.0	1.3	4.5	1.3
1982	8.5	7.7	12.2	13.3	3.7	4.5	4.8
1983	5.2	5.4	10.1	11.0	4.9	4.7	5.8
1984	4.4	5.7	9.9	11.8	5.5	4.2	7.4
1985	5.2	5.3	12.2	13.5	7.0	6.9	8.3
1986	3.6	4.3	10.9	12.1	7.3	6.6	8.5
1987	3.7	3.9	9.7	11.6	6.0	5.8	7.9
1988	4.6	4.5	10.3	11.1	5.7	5.8	6.5
1989	5.9	5.1	13.9	13.7	8.0	8.8	7.8

♠ Retail Price Index excluding mortgage interest payments.
♥ Producer Prices Index.
♣ Three month inter-bank interest rate.
♦ Building Society mortgage rate.
Source: H. M. Treasury.

13 Central Statistical Office, *Social Trends*, Table 2.4.

14 It was partly the machinations of the same process, but in reverse, which suppressed consumer spending during the recession. This exacerbated the cyclical need to re-pay excessive debt accumulated during the boom.

15 *Bank of England Quarterly Bulletin*, September 1982, page 390.

16 It was argued at the time that the mounting private sector deficit did not matter, provided the public sector was in surplus. But £114 bn was equivalent to four times the amount of debt the government managed to repay between 1987 and 1990, before it slipped back into deficit again in 1991.

17 Central Statistical Office, *Economic Trends*, Table B5, Banks Balance Sheet.

18 Central Statistical Office, *UK National Accounts*, Table 12.3.

19 Central Statistical Office, *Financial Statistics*, Table 8.3.

20 Many household names – BP, British Aerospace, Barclays Bank, Commercial Union, Rolls Royce, Wimpey, T & N, GKN, BICC and Pilkington – have in the last two years chosen to maintain their dividend despite financial difficulties.

21 The misconception that manufacturing is the source of all other economic activity, and that services can neither be exported nor increase their productivity, is often used to support calls for interventionism to promote

manufacturing industry. In fact the distinction between manufacturing and services is largely illusory. The respective roles of hardware and software in the computer industry, or of engineers and steelworkers in the construction industry, suggests that the relationship between manufacturing and services is symbiotic rather than parasitic. Services are exported – obvious examples are the film and popular music industries – and would be traded more widely if markets were opened, as envisaged in the current Uruguay Round of trade negotiations within the General Agreement on Tariffs and Trade (GATT). They can also increase their productivity, though output per head is hard to measure in service industries.
A recent study of 'deindustrialisation' in Britain by the economic historian, Professor N. C. R. Crafts (*Can Deindustrialisation Seriously Damage Your Wealth?*, Institute of Economic Affairs, January 1993, pages 76–7) concluded that:

> The present grief stems largely from macro-economic mistakes in exchange rate/interest policies which first require to be corrected rather than being compounded by distortions introduced into micro-economic policy … Policy efforts should increasingly be directed towards reforming institutional structures to reduce short-termism and to strengthen human capital formation whilst retaining the disciplines of competition.

The analysis and prescriptions set out in this paper are in accordance with that conclusion, but a full discussion of the issue is outside its scope.

22 Professor Tim Congdon, who diagnosed the inflationary over-heating of the mid-1980s in terms of Sterling M3, is the only economist who can be credited with foresight.

23 The speech is reproduced in full in *The Bank of England Quarterly Bulletin*, December 1986.

24 See Gordon Pepper, *Money, Credit and Inflation: An Historical Indictment of UK Monetary Policy and a Proposal for Change*, Institute of Economic Affairs, April 1990. Pepper's recommendation is that the Bank of England control the growth of credit directly. The Bank has traditionally controlled the growth of credit by raising interest rates but, if the demand for credit continues unabated, the Bank is obliged in its capacity as lender-of-last-resort to supply the banking system with all the liquidity it demands. Pepper argues that, if the Bank of England restrained the growth of its own balance sheet it would be able to restrict the supply of money to the banking system directly.

25 Nigel Lawson, *Financial Discipline Restored*, text of a speech to the Association of Economic Representatives in London, 17 January 1982, published as a pamphlet by the Conservative Political Centre, May 1982.

26 Contrary to popular wisdom, independence for the Bank of England is also a Conservative policy of longstanding. The main economic policy document published by the party when it was in opposition in the mid-1970s stated explicitly that 'we favour a more independent role for the Bank of England.' The document also recognised that a more open and informed dialogue between Parliament and the Bank of England, with the Governor appearing regularly before a powerful committee of parliamentarians, was likely to lead to a more effective monetary policy. (See Geoffrey Howe, James Prior, Keith Joseph and David Howell, *The Right Approach to the Economy: Outline of an Economic Strategy for the Next Conservative Government*, Conservative Central Office, October 1977, page 9). That insight remains valid today.

27 *The State of the Private Rented Sector*, Joseph Rowntree Foundation, May 1993.

28 A recent survey by St Quintin, a firm of chartered surveyors, estimated that £37.9 bn of banks loans are now secured against property assets which have fallen in value from £50.5 bn in 1987 to £31 bn today.

29 *Small Businesses and Their Banks*, Forum of Private Business, January 1993.

30 Quoted in W. A. Thomas, *The Finance of British Industry 1918–76*, Methuen, 1978, page 114.

31 The impact is concentrated mainly on unsecured loan stocks. An analysis by BZW Securities shows that the risk premium demanded by investors in unsecured corporate bonds over their secured counterparts has shrunk from 0.8% at the height of the leveraged buy-out boom in 1988–90 to about 0.2% in the more settled conditions of today.

32 Life assurance premium relief was abolished in 1984, and relief on existing policies restricted to the basic rate; new rules were introduced in 1986 to limit the surpluses which can accumulate, tax-free, in pension funds; tax-free lump sum contributions to pension schemes, and fast accrual pension schems, were capped in 1987; and tax relief for pensions was capped in 1989.

33 Nigel Lawson, *The View From No. 11: Memoirs of a Tory Radical*, Bantam, 1992, page 369.