6. A typical Tory boom

The Lawson boom was very similar to previous Tory booms in the post-war period. For adventitious reasons, notably the weakness of the dollar, there was no perceived external constraint on monetary policy in 1986 and 1987. With the external constraint in abeyance, the leaders of the Conservative Party did not want to be reminded that expansionary domestic monetary policy would inevitably lead to inflation. As on numerous other occasions since 1951, they were hallucinated by the many signs of prosperity into thinking that they had accomplished an 'economic miracle'. These signs, which were very familiar to anyone who could remember the Barber boom, included get-rich-quick property speculators and young men driving expensive cars on the profits from rising house prices. As in the Barber episode, the Government ignored the domestic symptoms of monetary excess. It changed policy far too late, in mid-1988, and then only because the external constraint had returned. An abrupt and unforecast deterioration in the balance of payments aroused fears that the pound would soon weaken sharply on the foreign exchanges. As in other stop–go cycles in the post-war period, the Lawson boom was brought to an end because of foreign disapproval of the conduct of British macroeconomic policy.

The performance was made all the more pathetic by the contrast with the stated intentions of the Thatcher Government in 1979, when the emphasis had been very much on defeating inflation and preventing stop–go cycles. Although Lawson prided himself on his early advocacy of the Medium-Term Financial Strategy, he had evidently not understood its most essential characteristic – that financial targets were to be stated in terms of domestic variables, not the exchange rate, so that the Conservative Party could never again indulge in silly booms like 'Butler's in 1956, Heathcoat-Amory's in 1960, Maudling's in 1964 and Barber's in 1974'. (The key 'domestic variable' was, of course, the money supply on the broad definition.) As my article 'The return of stop–go?' in *The Times* of 20 October 1987 said, it was not going too far to describe the Thatcher Government's record in the central area of economic policy as 'bewildering to the point of perversity'.

In the late 1970s I had proposed a medium-term financial plan, in the hope that financial targets laid down several years in advance would constrain electoral opportunism and prevent a recurrence of the stop–go cycle. By mid-1987 it was evident that the Medium-Term Financial Strategy was not working in this way. In an article in *The Spectator* of 27 June 1987 I noted that: 'The main message of the latest phase of financial excess, so depressingly similar to many other episodes in the post-war period, is simple: monetary policy is too serious to be left to politicians'. I therefore concluded that monetary policy should be entrusted to an independent Bank of England.

Macroeconomic policy in the late 1980s was full of rich and wonderful ironies. But perhaps the most opulent and fantastic came in a House of Commons speech by Mr Lawson in late 1989, the first after his resignation from the Cabinet. For over six years he had been an opinionated and domineering Chancellor of the Exchequer, consistently disdaining the views of the Bank of England. But from the backbenches he declared himself to be strongly in favour of granting the Bank of England greater independence from government!

Will the House-Buying Boom Save Thatcher?

Reprinted from an article of the same name in The Times *of 17 June 1986.*

As is well known, the mortgage boom of 1986 and 1987 helped Mrs Thatcher's Conservative Party to its third successive general election victory. But it was also inconsistent with the Thatcher Government's commitment to gradual reductions in monetary growth to restore a sound currency. This piece should be read in conjunction with the paper on equity withdrawal on pp. 274–87 and the more alarmist article, 'Even the housing boom can turn to bust', in The Spectator *of 14 May 1988.*

The Conservatives are asking themselves how they can secure re-election. Unless the economy recovers more vigorously, unemployment will remain at over three million and the Government will appear to have failed on the most important social issue of the day. But its self-imposed rules of financial management, with limits on public sector borrowing and money supply growth, prevent an active programme of economic stimulus.

How does it escape? Is there any mechanism still available for strengthening demand and improving business conditions in time to swing enough votes in its direction? For an answer we should look at certain financial antecedents to the last general election. Between 1980 and 1983 lending for house purchase virtually doubled from £7.3 billion to £14.4 billion. The pace of the housing finance boom was fastest in late 1982, as banks joined in on a large scale.

As always, an upturn in housing activity was followed by more spending on consumer durables and then by a general revival in retail demand. In 1983 consumer expenditure rose by 3.9 per cent, sufficient to generate a satisfactory growth rate for the economy as a whole and to check the increase in unemployment. It was not an exciting economic background, but it was enough for the Conservatives to win.

Almost unnoticed in most political commentary, a similar process is at work today. In the first quarter of 1986 net mortgage advances by the building societies, at £3,814 million, were up 26.8 per cent on the same period of 1985. Figures published on Friday show that in April and May combined they were £3,157 million, an increase of 28.9 per cent on the same period of 1985. The surge will undoubtedly gather momentum in the rest of 1986 and in 1987. In April the building societies committed themselves to lend £3,664 million – 64.3 per cent more than in April 1985 – and in May £3,761 million (up 57.1 per cent). This big injection of credit will enliven the housing market in the summer and autumn.

Moreover, the building societies are not the only organizations enjoying the mortgage party. They have been joined not only by the clearing banks and insurance companies, but also by a number of foreign-owned institutions who have no previous experience of lending to the British personal sector. Together they could lend £24 billion for house purchase in 1986, £6 billion more than in 1985. The immediate effect will be a faster increase in house prices (now about 11 per cent). Home-owners will feel better off and, as in 1983, improved consumer confidence will boost spending in the shops, initially on carpets, furniture and other items connected with moving to a new house, but eventually on all consumer goods.

Overall this should result in an appreciably higher growth rate in 1987 than in 1986. If, and at present it seems quite a big if, the world economy moves forward more briskly as well, 1987 could see the fastest rate of economic expansion since the early 1970s. In these circumstances unemployment could well fall by anything up to 300,000. In relation to a total of over three million out of work, that would not represent great progress. But in relation to the media stereotype of where Conservative economic policies are leading, it would seem little short of miraculous. The change in perceptions and expectations would significantly strengthen the Tories' election chances.

It may seem exaggerated to place so much emphasis on housing finance as the key area determining Britain's economic prospects and its political future. But today 63 per cent of adults are owner-occupiers. Not only are they the highest paid 63 per cent of the population (accounting for possibly 85 per cent of all income received), but also their house is for the majority of them the most valuable single asset they own. Indeed, Britain has almost passed the stage of property-owning democracy to become a property-trading democracy. As Mark Boleat noted in his *National Housing Finance Systems: A Comparative Study* in 1980, 'over 50 per cent of households with a head of household aged between 25 and 29 were owner-occupiers, double the proportion of other developed countries.' In consequence, most people buy and sell houses several times during their lives.

Left-wing parties will find it increasingly difficult to sustain the political appeal of rhetoric about wealth redistribution in a society where most people already have some wealth. Denis Healey has quipped that the Conservative Party has been hijacked from the landowners and given to the estate agents. Possibly, but does this not reveal Labour's secret anxiety?

Economists could protest that the housing credit boom is irresponsible. It is an associate – perhaps, one should say, an accomplice – of the excessive growth of sterling M3 in the past year. Nigel Lawson has played down the significance of the above-target money supply expansion by muttering about distortions, institutional changes and the like, but there can be no doubt that the recent behaviour of mortgage credit is contrary to both the spirit of the Government's Medium-Term Financial Strategy and to the letter of its original monetary targets. What now do we hear about price stability as even an 'ultimate' objective? How could the Chancellor plausibly commit himself to that while living in a city where residential property values have soared by 60 per cent in the last two years, and in a country where credit to stoke up similar house price increases has never been more readily available?

The excesses will be forgiven – at least within the Conservative Party – if the mortgage boom proves a successful ingredient in the election campaign. Moreover, it could be argued that the Government is merely responding to those ancient and familiar demands for reflation. But, instead of the reflation being achieved by extra public sector borrowing to finance improvements to the infrastructure, it is being conducted through extra private sector borrowing to finance additions and improvements to the housing stock. Indeed, it may not be too facetious to invent a new concept called the private mortgage borrowing requirement (or PMBR) as a complement to the PSBR. The £6 billion increase in the PMBR in 1986 must have official blessing and could, without caricature, be regarded as old-fashioned pump-priming. Is the British economy entering a new era of Thatcherite Keynesianism?

Why Lawson should have Re-Introduced a Broad Money Target in Late 1986

From an article 'Why Lawson must stick to his target' in The Times *of 31 October 1986.*

A year after the 'suspension' and effective abandonment of broad money targets in the 1985 Mansion House speech, I wrote another article in The Times *about the need to curb monetary growth. It was important to comment on a speech from Mr Leigh-Pemberton, the Governor of the Bank of England, which had argued that financial liberalization had invalidated broad money targeting. In this article I suggested, on the basis of 'a very modest grasp of elementary arithmetic', that 'the message must be that inflation will accelerate in the next few years, perhaps to as much as 10 per cent'. This was right in the end, as inflation went above 10 per cent in 1990. But see the article below, on pp. 143–50, 'The Lawson boom in the light of the Crash', for more discussion of the inflation rate.*

Monetary statistics were first prepared in their present form in 1963. Since then broad money, on the familiar sterling M3 definition (which includes notes and coin, and all sterling bank deposits), has risen by about 12 times, and money national income by about 12½ times.

Targets for the growth of broad money were introduced in July 1976 to restrain inflation. The inflation rate then, as measured by the annual increase in the retail price index, was 13.3 per cent, and rising. Today it is 3 per cent. In more general terms, monetary targets have been instrumental in reducing the trend inflation rate from 15 per cent in the mid-1970s to 5 per cent at present.

The crude facts of the link between broad money and national income, and the apparent success of the system of monetary control established a decade ago, suggest that official targets for broad money should be retained. As the Americans say: 'If it ain't broke, don't fix it'. But the Government has a different view. Broad money targets are now practically defunct and will soon, perhaps in the Chancellor's Autumn Statement, be formally abandoned. The thinking behind this change was explained in a speech by Robin Leigh-Pemberton, Governor of the Bank of England, at Loughborough University last week. His central argument was that technical change in the financial system has disturbed the relationship between broad money and national income so radically in the 1980s that it is 'fair to ask whether a broad money target continues to serve a useful purpose'. Perhaps, to quote his words, 'we would do better to dispense with monetary targetry altogether'.

This argument has considerable force. There is no doubt, for example, that the more attractive interest rates now available on bank deposits should encourage people to hold a higher share of their wealth in this form. But there are at least two reasons for scepticism, perhaps even cynicism, about the Government's decision.

The first is that technological advance in banking and other financial services has been continuous since the early 1960s. Some of the innovations have reduced the amount of money people need to keep (as a proportion of income) in their banks, while others have increased it. But over the whole period their effects have broadly cancelled out. Although the rate of change may have accelerated in recent years, and there does appear to have been some rise in the desired ratio of money to national income, the 1980s are not obviously special or unusual. An unhappy memory is that the Bank of England made excuses for very high growth rates of broad money in the early 1970s by attributing them to technical and institutional developments it could not easily interpret. But confusion about the meaning of the statistics should not have been a pretext for nihilism about the right way to conduct policy. In 1975 the inflation rate exceeded 25 per cent, the highest in Britain's peacetime history. Technical and institutional developments today should not be used to justify any rate, no matter how rapid, of broad money growth. It is one thing to say that the liberalization of mortgage finance, the internationalization of company finance, the Big Bang and various other upheavals have altered the relationship between money, income and expenditure. It is something quite different to claim that, in the new circumstances, there is no such thing as an excessive rate of broad money growth which will cause inflation.

The second worry is related to the first. If broad money was being demoted at a time when the Bank of England was meeting its targets with reasonable precision, there would not be much suspicion in the City about the Government's motives. But, in fact, broad money growth is not only far ahead of the official target range, but also – at almost 20 per cent in the last year – higher than at any time since the Barber boom. There may be grounds for expecting broad money to increase by 3 or 4 per cent a year more than national income for quite a long period. That would, indeed, explain why the 11 or 12 per cent increases in broad money recorded between 1981 and 1985 were typically accompanied by real growth of 3 per cent and inflation of 5 per cent. But how can 20 per cent rises in sterling M3 be reconciled with the Government's objectives?

A very modest grasp of elementary arithmetic is sufficient to suggest that, if the pattern of the early 1980s persists, 20 per cent increases in broad money imply that money gross national product will eventually rise by about 15 per cent. Since it is fantasy to imagine that real growth can be much above 5 per cent, the message must be that inflation will accelerate in the next few years, perhaps to as much as 10 per cent.

In short, the fact of financial change does not in itself rule out the possibility of excessive monetary growth, while the latest numbers suggest disturbingly that monetary growth has indeed become excessive. It may be convenient for Nigel Lawson that he can discard a major barrier to stimulatory policies so close to a general election. But, after the experience of the Barber boom and its sequel, no one should be surprised if seemingly good political tactics in the short run prove to be electorally unrewarding and bad economic strategy in the medium term.

The Credit Boom and the Case for a More Independent Bank of England

From an article 'Mr Lawson's secret inflation' in The Spectator *of 27 June 1987.*

Credit growth, by both banks and building societies, was higher in real terms in 1986 and 1987 than in the notorious Barber boom years of 1972 and 1973. The argument of this article was therefore that politicians could not be trusted to control inflation. The job had to be given to an independent Bank of England.

Much has gone wrong with the management of the British economy in the last two years. The growth of credit amd money is too high, the economy is expanding too quickly and interest rates are too low to prevent the return of inflationary pressures. Indeed, the scale of the present credit boom is without precedent. In terms of the amount of money being lent by both banks and building societies, it is larger than the notorious Heath/Barber boom of the early 1970s. The main message of the latest phase of financial excess, so depressingly similar to many other episodes in the post-war period, is simple: monetary policy is too serious to be left to politicians. Britain should follow West Germany's example by giving the Bank of England as much independence from government as is currently enjoyed by the Bundesbank.

That, in brief, is the argument of this article. It is an expression of deep scepticism about the ability and willingness of British governments to conduct financial policy in a consistent, stable and non-inflationary way. Their monetary performance over the last 40 years has been too unreliable for them to be trusted in future. Alternative arrangements, which as far as possible take macroeconomic policy outside the political domain, are needed.

True enough, three or four years ago such scepticism seemed unjustified. Mrs Thatcher's first term had succeeded in bringing inflation down from over 20 per cent in early 1980 to under 5 per cent by mid-1983, while confidence in the permanence of responsible financial policies was buttressed by targets for monetary growth and public sector borrowing in the Medium-Term Financial Strategy. There appeared to be a consensus that monetary policy had been anti-inflationary and would remain so, at least as long as the Conservatives stayed in power. The breakdown of that consensus has a complicated story, in which many of the details are technical. But the main points are not particularly abstruse. They should not be allowed to frighten away readers who have a hunch that the subject is important and deserves to be understood, but are sometimes deterred by commentators who make it seem more confusing than it actually is.

One of the most important debates in British monetary policy in recent years has related to the significance of narrow money as compared to broad money. Narrow money consists of notes and coin held by people and companies, plus (on some definitions) bank deposits which can be drawn on without notice; broad money consists of notes and coin, and all bank deposits. Holdings of bank deposits are many times larger than holdings of notes and coin. When the first monetary targets were announced by Mr Healey in 1976 and again after 1980 in the early versions of the Medium-Term Financial Strategy, monetary policy was stated in terms of broad money. Indeed, for a few years the phrase, 'the money supply', was virtually synonymous with broad money. The reliance on broad money could be explained partly by the reasonably close connection it had had with total spending in the economy in the 1960s and 1970s.

This approach had a very important practical result. Bank deposits make up 90 per cent of the broad money total, but banks can expand their deposits on one side of the balance sheet only if they can expand their loans on the other. A target for broad money therefore contains, at least by implication, a limit on the growth of bank credit. In consequence, the period of broad money targets involved careful monitoring of credit to both the public and private sectors. Credit to the public sector was curbed by reducing the Government's budget deficit and credit to the private sector by maintaining an appropriately high level of interest rates. This system of monetary control was a success. Contrary to all the sneers in the media, and despite many awkward teething troubles in its implementation, it worked on the only test that really mattered: it brought a sharp fall in inflation to a country which had seen rising inflation, comparing one cyclical peak with another, for over 20 years. In 1984 and 1985 there was no need to change it. It could – and should – have been left alone.

However, officials at the Treasury and, to a lesser degree, at the Bank of England, were concerned about certain changes in the relationship between broad money and money national income. Control over broad money may have achieved lower inflation, but they were mystified that a particular growth rate of broad money seemed to be associated with less inflation in the 1980s than it would have been in the 1970s. There was enough of a puzzle for them to recommend to Mr Lawson that the Government shift its attention towards narrow money. Mr Lawson accepted their view and abandoned broad money at some stage in the middle of 1985.

This may have seemed, to those uninitiated in the subtleties of monetary management, a petty detail in the political life of the nation, a point of some interest to the financial artisans who work the parish pumps of Lombard Street and Threadneedle Street, but of none to the more dignified citizens of Westminster and Whitehall. In fact, the move away from broad money is fundamental to explaining both subsequent developments in the economy and the Conservatives' success in the general election. With broad money targets no longer the focus of policy, the Government was excused from the need to limit the growth of bank credit. Whether by accident or by design, Mr Lawson had set the scene for the largest boom in private credit this country has ever seen. It is this boom which, more than anything else, has been responsible for the recent upturn in the economy, for the sense of well-being undoubtedly felt by the majority of voters (particularly those owning homes) and for the Government's re-election.

The Government may not have realized, as preparations were made for the credit boom, just how spectacular it would prove to be. The growth of private credit had been high throughout the early 1980s, largely because of the removal of a variety of restrictions on the banks and other financial institutions, but it was not out of control. Sterling bank lending to the private sector was steady at about £13 billion in 1982, 1983 and 1984, with the growth rate under 20 per cent a year and falling. After adjustment for inflation, the amount of bank lending was appreciably less than in the Heath/Barber boom of 1972 and 1973. But in 1985 and 1986 the position changed radically. Bank lending doubled in just two years to reach £30 billion, a level far higher than ever before in nominal terms and about 25 per cent more in real terms than at the previous peak in 1972.

The extra credit was not sprinkled evenly over all parts of the economy, but channelled particularly into the housing market. A substantial portion of the record bank lending total was accounted for by mortgage credit, as the banks tried to gain market share from the building societies. Nevertheless, building society lending was also exceptionally strong. As Table 6.1 shows, the expansion of the building societies' business has been more than that of the banks' since the Thatcher Government came to power. In real terms building societies' net mortgage advances were not just greater in 1985 and 1986 than in 1972 and 1973, but virtually twice as high.

These figures are both an eloquent tribute to the Thatcher Government's determination to promote home-ownership and a disturbing commentary on the consequent problems of financial management. It was almost as if, once Treasury ministers had liberalized the market in mortgage finance and so enabled more people to buy a house, they felt obliged to make people happy with their investment. Since the start of the credit boom in mid-1985 the national rate of house price increase has gone up from under 10 per cent a

Table 6.1 The growth of credit over the last 20 years

	Bank lending in sterling to UK private sector (£million, current prices)	Net mortgage advances by building societies (£million, current prices)	GDP deflator (factor cost, expenditure data) 1980 = 100	Bank lending in sterling to UK private sector (£million, 1986 prices)	Net mortgage advances by building societies (£million, 1986 prices)
1967	511	823	22.9	3182	5125
1968	538	860	23.7	3237	5175
1969	429	782	24.5	2497	4552
1970	678	1088	26.4	3662	5877
1971	1776	1576	29.3	8644	7670
1972	5511	2215	32.3	24330	9779
1973	5671	1999	34.8	23238	8191
1974	3734	1490	40.7	13083	5220
1975	–367	2768	51.8	–1010	7620
1976	3081	3618	59.3	7409	8700
1977	3492	4100	66.6	7477	8779
1978	4710	5115	74.7	8991	9764
1979	8573	5271	84.2	14519	9078
1980	9622	5722	100.0	13721	8160
1981	8633	6207	110.3	11161	8025
1982	13055	8147	118.0	15777	9845
1983	13628	10928	124.6	15597	12507
1984	13479	14572	130.4	14740	15935
1985	19839	14711	138.5	20426	15146
1986	30005	19072	142.6	30005	19072

Source: Financial Statistics, Economic Trends

year to almost 15 per cent, while in some parts of London property prices have doubled. It is not coincidence that those areas of the country with the highest proportion of owner-occupied housing were the same areas which saw a swing towards the Conservatives in the election.

As in the Heath/Barber boom of the early 1970s, the explosion in credit has led to accelerated growth of broad money. For some time now the money supply has been expanding at an annual rate of about 20 per cent. There may be some doubts about the precise nature of the link between broad money and money national income, but that does not mean there is no link at all. It is almost incredible that the Mr Lawson who now as Chancellor of the Exchequer is so insouciant about the fastest monetary growth for 15 years is the same Mr Lawson who as Financial Secretary to the Treasury in June 1980 declared that 'in order to reduce the inflation rate on anything more than an ephemeral basis it is necessary to reduce the rate of monetary growth'. As Professor Charles Goodhart has remarked in the latest *Gerrard & National Economic Viewpoint*:

> The capacity of the present Conservative Government, and of the Treasury, to move from the (invalid) viewpoint that the growth of broad money is an exact determinant of the growth of nominal incomes to the (invalid) viewpoint that the growth of broad money has no relationship at all with the growth of nominal incomes is staggering with respect both to its speed and to the comprehensive nature of the intellectual somersault involved.

Those who are perplexed by broad money might like to reflect on the more accessible idea that house prices and the general price level tend to move together over periods of several years. (As with the money/incomes relationship, there are many short-term disturbances to the long-term link.) It follows that, if the present disparity between the behaviour of house prices and prices in the shops is to end, either the rate of house price inflation has to be reduced to 5 per cent or the rate of retail price inflation has to move up.

What is to be done now? How can an authentic anti-inflation policy be restored? There is not much to be expected from the Opposition parties. Since their leaders have variously derided monetary control as mumbo-jumbo, punk economics, a 'fashion' and the like, and since they have shown in their election manifestoes that they would be happy to trade more inflation for less unemployment, they are unlikely to become credible guardians of sound money. The Government bamboozled them into thinking that it was rigidly anti-inflationary, when in fact it was manipulating the financial environment for its own electoral benefit. But they have only themselves to blame for their inability to criticize the Government. Having said that irresponsible monetary policies do not matter, they of course have no right to challenge the Government for the irresponsibility of its monetary policies.

The best hope in the short run is that the Thatcher Government, which had such an excellent record on inflation in its first term, restores the system of monetary control which was working well in 1983 and 1984. That means bringing back broad money targets and demonstrating a preparedness to deter private sector credit by an appropriately high level of interest rates. In the long run, however, the answer is to give the Bank of England greater independence from government. In a well-ordered country, decisions on monetary policy should not be subject to the vagaries of the electoral cycle, and fluctuations in credit growth should not reflect politically-motivated calculations about house price increases and the voting propensities of home-owners. The Bank of England should be privatized, its autonomy from government should be protected by statute, and both the tactics and strategy of monetary policy should be determined by the Governor of the Bank of England in consultation with its Court of Directors. The Chancellor of the

Exchequer would be left with the humdrum but necessary task of keeping the Government's finances in good shape.

The most widely canvassed alternative to domestic monetary control on traditional lines is that Britain become a full member of the European Monetary System. Has none of its many advocates noticed that the pivotal institution of the EMS is the Bundesbank, the only truly independent central bank in the EEC? Has none of them wondered why the Bundesbank, so unlike its counterpart in Britain in the last two months, was able to ignore the course of the West German election during December and January? And has none of them realized that the superiority of West Germany's inflation record is not due to some innate national characteristic, but to a constitutional arrangement which Britain could readily imitate? Indeed, has none of them remembered that before 1946 Britain had its own independent central bank, that Britain's currency – not Germany's – was the hub of a major international trading area, and that Britain's inflation record had long been better than that of any other European nation?

Stop-Go Returns

From an article 'The return of stop-go?' in The Times *of 20 October 1987.*

This article said that the boom of late 1987 resembled the 'go' phases of previous stop-go cycles. The likely antidote was a sharp rise in interest rates after 'shock trade figures' in accordance with 'the classic pattern'. (This did indeed happen in late 1988.) Some people have tried to excuse Lawson for his misjudgements in this period by saying that he believed, genuinely, that Britain's underlying rate of output growth had increased to 4 or 5 per cent a year. But similar illusions had been held by other unsuccessful Conservative Chancellors at the same stage of their booms.

It is becoming increasingly clear, as they recede into the past, that the five years from mid-1981 to mid-1986 were a golden age of macroeconomic management. National output grew steadily at a sustainable rate of about $2^3/_4$ per cent a year, while inflation was moderate and declining gradually, and the balance of payments usually in small surplus. Few periods in our history have been characterized by greater economic stability. It is also becoming increasingly clear, as the months go by, that the stability of the 1981–86 period has been ruptured. The growth of national output in 1987 is projected at an above-trend and unsustainable 4 per cent, while manufacturing production is increasing even faster. There is a general mood of excitement.

Unemployment is going down, profits are going up and property speculators are making lots of money.

Why is the economy booming more vigorously now than at any time since the early 1970s? It cannot be because the UK is reflecting international trends, since the world economy has made indifferent progress in the last couple of years. Nor can it be due to fiscal reflation, as public expenditure has been kept under such a tight rein that there is a chance of a budget surplus in both 1987/88 and 1988/89. The answer is instead to be sought in the behaviour of credit and money.

In the golden period of economic stability in the early 1980s the Treasury and the Bank of England watched trends in bank lending with great care, mainly because each new bank loan creates a new bank deposit and so adds to the money supply. It is true that both bank lending and the money supply increased faster than originally expected, and that monetary control often gave the appearance of incoherence and muddle. But it is also true that the growth rate of the money supply (on its broad M3 definition) was kept down to a level consistent with a stable economy and moderate inflation. The system of monetary control operating in the early 1980s, widely labelled 'monetarist', was a success in its own terms. Despite much pragmatic compromising and frequent technical embarrassments, it was the key to the Government's principal economic achievement, the reduction in inflation to under 5 per cent. But – for reasons that are not altogether clear – the system was abandoned about two years ago.

Since then Britain has had the strongest surge in private sector credit in its history and the annual rate of money supply growth has increased from about 12 per cent to over 20 per cent. Today sees the publication of the September money supply figures. Analysts are expecting another massive lending total of about £3 billion and money supply growth in the month of about $1\frac{1}{2}$ per cent. It is interesting and legitimate to make comparisons with the Heath–Barber boom of the early 1970s, when the growth rate of the money supply peaked at over 25 per cent. Without doubt, it is the flood of credit and money into the economy which explains the current boom in output. This boom has an all too obvious resemblance to the 'go' phases of the many previous stop–go cycles in the post-war period. Like its predecessors in 1955, 1959, 1964 and 1973, it will eventually have to be restrained.

It is not going too far to describe the Government's performance – in this central area of economic policy – as bewildering to the point of perversity. In 1979 and 1980 it instituted rules of economic management that were intended to combat inflation and eliminate the stop–go cycle. These rules achieved most of what the Government asked of them. In 1984 and early 1985 Nigel Lawson could claim, without being frivolous, that the cycle had been relegated to the history books. Moreover, in business circles there was a general expectation that the next few years would be as stable as the previous three. But then, just at the moment of apparent triumph, the Government scrapped its own rules. Instead of adhering to the broad money targets that had existed for almost a decade, it embarked on a credit binge certain to lead to unsustainably rapid economic growth. Whether by accident, design or mere inadvertence, it had restored the stop–go cycle.

At this stage of the earlier cycles there have always been a few economists prepared to advocate permanent boom and there have sometimes been Chancellors of the Exchequer foolish enough to believe them, at any rate for a few months. But, sooner or later, common sense has prevailed. The classic pattern is that shock trade figures and/or a car strike initiate a sterling crisis and oblige the government to slow the economy, with an interest rate hike the most familiar weapon.

The sudden collapse in share prices yesterday suggests that investors are beginning to fear deflationary measures of the traditional kind. As the stock market normally anticipates developments in the economy, the largest-ever one-day fall in share prices is worrying. Comparisons with 1974 – when share prices dropped by 60 per cent – are unjustified, since the economic and political background is much more favourable than it was then. But a milder 15 to 25 per cent downward adjustment to share prices would be similar to that seen in the concluding stages of most post-war stop–go cycles.

Lawson has recently shown disturbing signs of believing, if not in permanent boom, that nothing much is wrong. In particular, he has implied that growth will moderate to a lower and more sustainable pace in 1988, without corrective action by the Government and without any inflationary repercussions from the 1987 boom. In the Autumn Statement early next month he is expected to be more complacent than ever, with several newspapers suggesting that he will promise more tax cuts in the 1988 Budget.

In fact, no part of the economy (except, ominously, exports) is weakening and several pointers to faster growth have emerged. In particular, it should be noted that a number of large construction projects (the Channel Tunnel, Canary Wharf, the Stansted Airport expansion) will add $^1/_2$ to $^3/_4$ per cent to gross domestic product next year. The question is not *if* the boom will have to be checked by the Government, but *when*.

On Friday the September trade figures will be announced, while the car strike at Vauxhall may be joined in the next few weeks by one at Ford. If these events are followed by a sterling crisis, they would fit an old and familiar pattern; and, if sterling depreciation and excessive pay awards in the car industry lead to higher inflation, the recent mistakes in monetary policy would meet with the usual retribution. Lawson, who has had more than his fair share of good fortune in his years as Chancellor, will be lucky if his boom does not end in the same manner as Butler's in 1956, Heathcoat-Amory's in 1960, Maudling's in 1964 and Barber's in 1974.

The Lawson Boom in the Light of the Crash

From an article of the same name in Economic Affairs, *February/March 1988.*

This piece was critical of the easing of monetary policy which followed the stock market crash of October 1987. As I pointed out, most indicators of domestic demand were rising strongly at the beginning of 1988. The post-Crash loosening of monetary policy would therefore aggravate the rise in inflation that was already inevitable. The inflation forecast in this article, 'that inflation will increase significantly, but should not move above the 8 to 10 per cent area', was largely correct. Nevertheless, the peak in headline retail inflation in late 1990 was over 10 per cent because of higher oil prices and the effect of increased interest rates on mortgage costs. (Incredible though it may seem now, most of the so-called 'leading forecasting bodies' expected in early 1988 that inflation would fall in 1989 and 1990!)

In its section on the UK, the Group of Seven (G7) statement of 23 December 1987 remarks that 'The Government, in the context of the British economy's vigorous growth of output and domestic demand, coupled with sound public finances, will continue to strive to reduce inflation by pursuing a prudent monetary policy.' The bland and colourless phrasing, presumably the work of senior Treasury officials, may seem appropriate coming from an august international gathering. In fact, it is a tribute to its authors' sense of humour. The remarks on vigorous output growth and sound public finances are fair enough, but the reference to 'prudent' monetary policy must have been written with mandarin tongues firmly in embarrassed official cheeks. The truth is that monetary growth in the UK is grossly excessive, that excessive monetary growth is fuelling an unsustainable boom in the economy and that the boom will be followed by a significant increase in inflation. There are ample grounds for calling the current period of economic excitement the 'Lawson boom', just as its forerunners in 1964 and 1973 are associated with the names of Maudling and Barber.

However, the G7 verdict on the UK is not altogether facetious. There was a period, in the very recent past, when it was legitimate to talk of the prudence of British monetary policy. In early 1985 the Government could fairly claim to have reduced the rate of inflation by the determined and consistent pursuit of a responsible monetary policy. At that time, as for nearly all of the previous decade, the centrepiece of monetary policy was a target for the growth of broad money which was intended to constrain, in a rough-and-ready way, the rate of increase in nominal gross domestic product. With the underlying growth rate of output set by the economy's supply-side characteristics, the limit on nominal GDP secured control over inflation. It was essential to the whole approach that the budget deficit, as measured by the public sector borrowing requirement, was not used to manage the amount of demand in the economy, but was restricted to a level compatible with the monetary targets. But in mid-1985 broad money targets, and most of the so-called 'monetarist' framework of financial control, were abandoned.

At the end of 1984 broad money was under reasonably good control, with sterling M3 showing an annual growth rate of about 10 per cent. The figure of 10 per cent was at the top end of the official target range of 6 to 10 per cent, but was broadly comparable to a figure of 11 per cent recorded at the end of 1983 and 9 per cent at the end of 1982. As high real interest rates and certain institutional changes in the banking system were tending to increase the economy's propensity to hold money, money supply growth of about or slightly above 10 per cent was consistent with inflation of 5 per cent and real growth of 3 per cent. Indeed, the economic stability of these years was an impressive endorsement of the monetarist system of financial control which by then seemed well established.

Despite the sound financial environment, officials in Whitehall and the Bank of England became dissatisfied with monetary policy. Exactly why they became dissatisfied is far from obvious, but Mr Lawson, as Chancellor of the Exchequer, was readily persuaded that change of some kind was needed. In May 1985 he gave a foretaste of what was to come by stating that the significance of sterling M3 had 'somewhat diminished'. Shortly afterwards the authorities decided to end a method of determining official gilt sales, known as 'overfunding', which had been essential to monetary control over the previous four years. The demise of overfunding – which was confirmed in the September 1985 *Bank of England Quarterly Bulletin* – was made to appear purely technical in import and not given much attention in the financial press. But it had a crucial consequence. The Government could no longer adjust gilt sales flexibly to meet broad money targets. In the Mansion House speech on 17 October Mr Lawson announced that the sterling M3 target for 1985/86 had been suspended.

The scrapping of the monetarist policy framework was soon followed by an acceleration in broad money growth. In the six months to January 1986 sterling M3 grew at an annualized rate of 15 per cent. This was followed by 18 per cent in the year to January 1987 and over 20 per cent in the year to November 1987. By the beginning of 1988 the economy had had two-and-a-half years of broad monetary growth in the region of 15 to 20 per cent. The contrast with the preceding four years of 10 to 12 per cent growth is clear and definite. Moreover, this contrast is not an accident, but the logical result of a deliberate shift in Government policy. Mr Lawson was very articulate in his justification of this policy shift when it was made.

No one – and certainly none of the small and dwindling band of 'monetarist' commentators in the City – expected the acceleration in monetary growth to be followed in short order by an exactly commensurate acceleration in inflation. On the contrary, past experience suggested that the initial impact of excess monetary growth would be felt on asset prices (houses, commercial property and shares) and on economic activity. The usual pattern was that output growth picked up nine to 18 months after the increase in monetary growth, while inflation responded after a long lag of three or more years.

The behaviour of the economy in 1986 and 1987 fitted in neatly with the standard monetarist timetable. Output started to move ahead strongly about three quarters after the acceleration in monetary growth. Gross domestic product (as measured by the output estimate) increased by 1.3 per cent in the second quarter of 1986, by 1.2 per cent in the third quarter and 1.0 per cent in the fourth, implying an annualized rate of advance in every quarter of over 4 per cent. The most buoyant component of expenditure was consumption, which soared by 6 per cent in the year. The consumption boom was widely attributed to the ready availability of personal loans and was associated in the public mind with the proliferation of credit cards. While these were notable aspects of the consumer scene, they were completely overshadowed in scale by an upturn in mortgage lending. Net mortgage advances totalled £19.1 billion in 1985 and £25.8 billion in 1986, a multiple of borrowing on credit cards which was under £1 billion in both years. Through a process known as 'equity withdrawal' a high proportion of mortgage finance escaped from the housing market and was used to finance increased purchases of consumer durables. In this way the high level of mortgage lending was a major reason for an extraordinary leap of 17 per cent in sales of consumer durables between the second quarter of 1985 and the third quarter of 1986. Nevertheless, there was still enough money remaining in the housing market to initiate a surge of house price increases. According to the Building Societies' Association index, house prices were 13.9 per cent higher in December 1986 than a year earlier.

Houses were not the only assets to increase sharply in price. As rapid monetary growth meant that people had a far higher level of bank deposits than they needed to carry out their usual transactions, they were keen to transfer the excess deposits into more attractive investments. Inflows into unit trusts soared, while insurance companies found it easy to sell policies and put on record amounts of new business. Because of all this extra money, the long-term savings institutions (insurance companies, pension funds, unit trusts) had £24 billion to invest in 1986, significantly higher than the £20.9 billion in 1985. Here was the financial raw material to support a substantial rise in share prices. The stock market advanced particularly briskly in the months leading up to March 1986, when the *Financial Times* industrial ordinary index stood almost 50 per cent higher than nine months earlier.

Faster output growth in 1986 cannot be attributed to an easing of fiscal policy, since public sector borrowing was kept under tight control, or to more buoyant international economic conditions, since the growth of the world economy was roughly the same in 1986 as in 1985. Instead the upturn in Britain bore the strong imprint, in both its timing and character, of the increase in broad money growth. There were obvious parallels with the Barber boom of the early 1970s, which saw a jump in sales of consumer durables of 28 per cent in the year to the second quarter of 1972, a rise of almost 40 per cent in house prices in the year to December 1972, and a spectacular bull market in equities with the *Financial Times* industrial ordinary index up by 65 per cent between March 1971 and May 1972.

In 1987 the expansion broadened and gathered pace. Investment overtook consumption as the most dynamic category of demand, with construction activity showing particular vigour. The buoyancy of sales and orders came as a surprise to most businessmen, who initially met higher demand partly by running down their stocks. By the end of the second quarter the stock/output ratio to manufacturing was at its lowest level in the post-war period. It was necessary and inevitable that companies rebuild their stocks. The process began in the third quarter and caused output growth to move into a yet higher gear. The average measure of GDP went up by 2.2 per cent, implying an annualized growth rate of 9 per cent.

As the economy gathered momentum, the private sector's demand for bank credit strengthened and the pace of monetary growth increased. In these circumstances institutional cash again grew very rapidly, propelling a further surge in share prices. In July the *Financial Times* industrial ordinary index was 45 per cent higher than at the end of 1986 and almost double its level of two years earlier. House price inflation also accelerated, suggesting a generalized condition of 'too much money chasing too few assets'. The speed of economic growth in the third quarter was not known in full until the release of the relevant GDP data in December. But there were many symptoms of excessive demand. Fears about future inflationary trouble gained new cogency when information became available about a £4.5 billion leap in bank lending in July. At the behest of the Bank of England, clearing bank base rates were raised from 9 to 10 per cent on 9 August, with domestic monetary conditions cited as the principal justification. Bad August trade figures, released in September, were another warning that the boom was running out of control. Despite these jolts to confidence share prices remained at such high levels that companies felt they had to raise money by rights issues. At the same time the Government was eager to press ahead with its privatization programme. In the three months from August to October about £7 billion was taken out of institutional cash holdings by rights issues, new privatizations, calls on old privatizations, offers for sale and other kinds of corporate money-raising. By mid-October, for the first time in several years, the institutions were short of cash. The scale of the cash drain left the stock market vulnerable to disappointments. On 19 October – ahead of a week which included potentially troublesome statistics on the money supply, bank lending and the trade balance – share prices collapsed. Although foreign stock markets also fell heavily, worries about domestic inflationary trends within the UK were undoubtedly a bearish influence on London equity prices.

But Mr Lawson and his advisers did not see it that way. In their view the economy was growing at about the right rate and the prospect, even before the Crash, was for a slowdown in 1988. Their new anxiety was that the drop in share prices would seriously undermine economic activity, turning the slowdown into a recession. Instead of interpreting the Crash as a warning about excessive growth, they saw it as liable to precipitate unnecessary contraction. They reacted by reducing interest rates. Base rates were lowered to 9½ per cent on 23 October and to 8½ per cent in two further falls in the next few weeks.

It soon became obvious that these interest rate cuts were inappropriate. At the time of writing (early January 1988) there are few indications of weakening demand and many signs that demand is growing faster than ever. Retail sales and car registrations in November showed increases from October and very large increases compared to a year earlier; the trade figures for November were disturbingly bad, with a current account deficit of almost £600 million in the month and of £1,800 million (the equivalent of 1 per cent of gross domestic product) in the most recent four months; labour shortages are being widely reported, with concern over a shortage of nursing staff being given considerable media coverage; and retail spending over Christmas and at New Year sales appears to have been unusually buoyant. Moreover, the portents are for an intensification of excess demand pressures in the early months of 1988. The December CBI survey had the highest proportion of companies reporting above-normal order books since the mid-1970s; the rise in mortgage credit, arguably the financial dynamo behind the Lawson boom, is due to gain momentum in the next few months because of promises to lend already made by building societies and banks. Manpower, the staff consultancy, has said that more companies plan to recruit people in early 1988 than at any time in 1987, while the number of vacancies notified to

Jobcentres is rising every month, and is now higher than for most of the late 1960s.

At this point in a standard UK stop–go business cycle the pound usually suffers a speculative attack on the foreign exchanges. A sterling crisis is the financial markets' characteristic reaction to loose monetary policy and the Government responds by raising interest rates. Higher interest rates then serve the dual function of bolstering the international value of the pound and moderating the growth of domestic credit. However, at present the pound is very firm on the foreign exchanges, largely as a by-product of dollar weakness. The dollar's problems are therefore disguising the irresponsibility of UK policy and allowing the Government to postpone the necessary restrictive action.

A strong pound contains the domestic price level because it reinforces foreign competition. For the time being the excessive growth of credit and money will tend to damage the balance of payments rather than inflation. But the foreign exchanges will not forever remain indifferent to the UK's worsening payments position. As long as the growth of the money supply continues to be three or four times faster in the UK than in West Germany and the USA, and the trend in the balance of payments is remorselessly into more substantial deficit, a sterling crisis is inevitable. After sterling has fallen in value, inflation will increase. Precise medium-term inflation forecasts are difficult to make because the price level is subject to random influences such as world commodity prices and Government policy towards public sector pricing. All one can say on past form is that an acceleration in monetary growth normally hits the inflation rate about three years after it began. A reasonable expectation is that sterling will weaken in early 1988, perhaps in conjunction with falling oil prices, and that the inflation rate will rise for much of late 1988 and 1989. Alternatively, the weakness in sterling may be combined with a transitory phase of renewed confidence in the dollar.

Since monetary growth has been 5 to 10 per cent more than in the stable period before the middle of 1985, it would be logical to envisage the rate of increase in nominal GDP also rising 5 to 10 per cent above the 8 per cent figure associated with that period. But this may overstate the inflationary threat. The last three years may have seen a continuing and more pronounced increase in the economy's propensity to hold money, because of institutional changes. Moreover, because unemployment was so high before the Lawson monetary stimulus, much of its impact will be felt in higher output rather than a rise in the price level. A cautious view is that inflation will increase significantly but should not move above the 8 to 10 per cent area. Although that would be modest by the standards of the last 15 years, it would be regarded as a major setback for the Government. In particular, it would cast doubt on the wisdom of the strategic decision to abandon broad money targets in mid-1985 and on the tactical decision to cut interest rates in October and November 1987.

The Government made two mistakes after the Crash. The first was to underestimate the vitality of the pre-Crash economy. This is clear enough, both from the pattern of events and from official statements. The Chancellor and his colleagues failed to recognize that – in the absence of the Crash – the economy would have had considerable forward impetus. Growth, even though it might have moderated to less than the startling 9 per cent annualized rate seen in the third quarter, would still have remained much above the trend rate of about 3 per cent. The second mistake was to overestimate the effects of the Crash. A fall in share prices does – by itself – tend to slow the economy down, but its impact is marginal. As direct personal sector holdings of shares are less than a tenth of total personal wealth, it is implausible to expect changes in their value to have a particularly powerful effect on consumer attitudes or behaviour. Indirect holdings (through insurance companies, pension funds and other institutional intermediaries) are more significant, but one of the purposes of investment in these channels is to muffle the impact of market volatility on the individual saver. (Most unit trusts carry a specific 'health warning' that share prices can go up as well as down, and that investment should be regarded as long term in nature; pension funds typically determine their solvency position not by looking at the market value of their equity holdings, but by applying a discount rate to expected dividend receipts.)

In any case, direct and indirect share holdings combined are overshadowed in terms of value by the housing stock and other kinds of property (agricultural land, buildings and plant owned by unincorporated businesses, commercial buildings). In the year to October 1987 house prices, as measured by the Building Societies' Association average house price series, rose by 18.3 per cent, indicating a massively positive 'wealth effect' on consumption. Two further points should be emphasized: first, despite the October Crash, share prices were higher in November 1987 than in November 1986; and, second, since the gilt market rallied on the news of the equity slump, higher gilt prices partly outweighed the effect of lower equity prices on personal wealth.

The Crash is an important incident in the Lawson boom. But it is no more than an incident. If the 30 per cent fall in share prices had been spread over six months instead of compressed into two days, it is unlikely that economists would have made much fuss. (Most of the major macroeconomic models do not have share prices as an independent variable in their consumption or investment equations, or, indeed, anywhere else.) The key problem for the British economy today is to rein in the excessive growth of credit and so curb the rapid monetary growth which lies behind an unsustainably rapid increase in demand and output. It would be a tragedy if the Lawson boom of 1986–88 follows largely the same course as the Barber boom of 1971–73. But, in the words of the American philosopher George Santayana, 'those who cannot learn from history are condemned to repeat it.'

Even the Housing Boom can Turn to Bust

Reprinted from an article of the same name in The Spectator *of 14 May 1988.*

Perhaps this article says nothing more than 'what goes up must come down'. But it needed to be said. Four years after the article was written the residential housing market in most of England (particularly Conservative-voting England, i.e., London, the South-East, the South-West and East Anglia) was in a more traumatized state than at any time in the post-war period.

The success of market-based, free-enterprise economies depends on people with long memories and a deeply ingrained financial scepticism. If the majority of investors are instead always carried away by the enthusiasms of the moment, the economy is liable to suffer from wasteful excesses of over- or under-investment.

These remarks may seem trite. But it is remarkable how often they are forgotten. The most vivid, and the most socially costly, illustrations come from industries requiring large and bulky investments with long lead times. Property development brings out the general idea very clearly. The risk of a large error in calculating demand is compensated by the possibility of vast speculative gains for entrepreneurs who judge correctly. Over the last 20 years enormous personal fortunes (Donald Trump, the Reichmann brothers, Godfrey Bradman) have been made in real estate by borrowing to purchase cyclically unpopular and under-valued assets. The scale of these fortunes and the apparent ease of their acquisition have encouraged many imitators. Nowhere has this been more true than in North America, with the late 1970s and the early 1980s the peak period of excitement.

Office buildings received particularly favourable tax treatment in the early years of the Reagan presidency, partly as a by-product of the supply-siders' tax cuts, and were the focus of considerable tax-assisted speculation. By the second quarter of 1985 new office building in the USA was virtually three times higher than five years earlier. More space was coming on to the market than ever before. Unfortunately, the demand for new space did not stay in line. An office vacancy index compiled by Coldwell Banker, a Chicago-based real estate service, rose from 5 per cent in early 1982 to 11.7 per cent in 1983, 13.9 per cent in 1984 and 16.1 per cent in 1985. Not surprisingly, rental growth stopped.

The price of office buildings, which had been rising (apart from minor regional variations and very temporary interruptions) for over 40 years, began to fall. Even worse, in 1986 Congress, dismayed by the grotesque waste evident in so many empty buildings, passed a tax reform package which ended the indulgent fiscal treatment enjoyed by the real estate industry. Since then, financial strains in cities with particularly high office-vacancy levels, notably such former models of Sun Belt prosperity as Houston and Dallas, have intensified. Today virtually the entire Texan banking industry is crippled by bad real estate loans. Whereas in the 1960s and 1970s many Texan families grew rich by the far from arduous practice of watching their office blocks increase in value by 20 per cent a year, they are now helpless as interest mounts remorselessly on old debts. The moral of the Texan real estate misfortunes is that no asset price can forever rise faster than interest rates. The success of the astute (or lucky) few who borrow to buy at the bottom cannot be repeated by the mediocre (or unlucky) many. When the mediocre many do try to join in, they may further inflate a speculative bubble, but the bubble still has to burst sooner or later.

Empty office space in Texas may seem remote from the problems of the British economy today. But there is mounting evidence that a speculative boom is also under way in this country. It is not as wild or as extreme as the mania for Houston office blocks in the late 1970s. Nor will it be followed by such a precipitous slump in the value of the assets which are the object of the speculative excitement. But it is driven by a similarly unsustainable pattern of expectations. Moreover, whereas credit-based purchases of Houston office buildings involved only the rich (or the once rich), the boom in the UK affects – at least indirectly – millions of people. The boom is in credit to purchase houses and other forms of property, particularly in the southern half of England. The existence of this credit boom, and of the related surge in property values, has been recognized by the media for some time. But they do not yet seem to have noticed that the boom, far from fading away, is set to gather extra momentum in the next few months.

In Greater London the price of residential property rose on average by 17.3 per cent a year between 1982 and 1987. Over the same period the cost of borrowing to buy a house – as measured by the mortgage rate adjusted for tax relief – averaged a little less than 8.5 per cent. In other words, someone who took out a 100 per cent mortgage in 1982 typically received, in each of the next five years, an increment in wealth equivalent to almost 10 per cent of the value of the property. If the mortgage was originally set at two-and-a-half times income (as would be common), this increment in wealth amounted each year to about a quarter of income. This bonus was achieved without effort and was free of tax.

The potential for capital gains on residential property in London is a matter of common observation. It is a constant topic of conversation at dinner parties and business lunches, and is encouraged by glossy controlled-circulation property magazines and estate agents' sales material. Outside London the enthusiasm for property is also intense, if a little less frenzied. In the South-East house prices rose by 14.8 per cent a year between 1982 and 1987, in East Anglia by 13.4 per cent, in the South-West by 12.3 per cent and in the East Midlands by 10.3 per cent. The numbers are lower than in London, but they are still above the post-tax mortgage rate.

Because of this background the middle class in the south of England takes it for granted that the rate of appreciation on their houses will always exceed the rate of interest. In other words, here is another example of a widespread expectation, indeed almost an assumption of thought, that a major asset will continue to rise in price at a faster rate than the cost of borrowing to purchase it. This set of beliefs has permeated so widely and become so firmly entrenched that mortgage credit has risen in every year since 1974. In 1987 net mortgage advances were five times higher than in 1979.

It might have been reasonable to expect that, in the first year of its third term, the Thatcher Government would want a cooling-off period in the housing market. However, because of the Chancellor's anxiety about the dangers of a strong pound for British industry, interest rates have been cut to the lowest level since 1978. In response, mortgage credit is growing more rapidly than ever before. In February the building societies promised an astonishing 74.9 per cent more in new mortgage commitments than a year earlier. This seemed a bit freakish, but in March the figure approached 85 per cent. When account is taken of the role of the banks and specialist mortgage intermediaries, net mortgage advances in 1988 are likely to be £40 billion – £10 billion more than in 1987 and nearly seven times higher than in 1979.

Of course, it would be far-fetched to claim that house prices in southern England could behave in as erratic a fashion as the price of Texan office buildings. House prices have never fallen by much in the UK and their rate of change is sedate compared with most commodity or financial markets. It should be noted, nevertheless, that the bouyancy of the London property market has recently attracted an adventurous form of speculation, the property futures market. The standard operation is to put up the deposit (of, say, 10 per cent) on a flat or house still in the course of construction and then to sell it some months later when prices are higher. (If prices have risen 10 per cent, the profit is 100 per cent.) There is some similarity to highly geared trading in American real estate, particularly if the 'purchasers' of the properties are financing the deposits with borrowed money.

It is inescapable, almost as a matter of logic, that the mortgage credit boom of 1987 and 1988 will have to be followed by a few years in which house prices rise by less than the post-tax mortgage rate. Unless house price increases fall behind the cost of borrowing, the temptation to borrow more will overwhelm the Government's attempts to moderate credit demand and destroy its anti-inflationary monetary policies. The unfortunate truth is that the English middle class looks on continually rising house prices with considerable affection. It does not want to understand that rising house prices are an aspect of more general inflation. Nor will it like to be told – either by Mr Lawson's successor (whoever that may be) or by a Prime Minister who has extolled the virtues of home ownership – that a serious attempt to restore price stability must mean a few years with a less overheated housing market. But Conservative Cabinet ministers with long memories and a deeply ingrained political scepticism ought to have realized months ago (and perhaps even before June 1987) that the sequel to the current housing boom was bound to be electorally inconvenient. They must be hoping that the belt of affluence now covering most of southern England does not end up in a financial mess similar to that in such former bywords of economic dynamism as Houston and Dallas.