Central Bank errors can cause recessions

Last night I was privileged to give the inaugural annual Trustees lecture at the London Institute of Banking and Finance.

I used it to examine why we had large recessions in 1974-6, 1990-3 and 2007-10. In the UK we lost 4% of our output and income in 1974-6 (Labour), 1.1% in 1991-2 (Conservative) and 4.5% 2008-9 (Labour). In each case we lurched from rapid credit and money growth to a dramatic tightening of credit and money in an effort to curb past excesses. In each case two errors were made – the initial excessive credit build up, and the decision to stop it by rapid tightening.

In the 1974-6 period there was lethal inflation which reached 27%. Lots of jobs were lost but unemployment peaked at 5.5%. In 1990-2 inflation hit 10.9% but unemployment rose to a worrying 10.8%. In 2007-10 unemployment hit an unacceptable 8.1% whilst prices started to fall as the crisis intensified, such was the extent of the monetary tightening.

The 1990s crisis was entirely the result of the European Exchange Rate Mechanism. As I had written before we adopted it as policy, it was a destabilising system. We started with the markets trying to force sterling up, which meant printing lots of money and keeping rates low to stop them. This resulted in a surge of credit. Then the pound wanted to go down, so the reverse took place with a major tightening of money and credit leading to recession.

The 1970s and 2000s crises were the result of mistaken views of the Central Bank and commercial bankers that they could take more risk and lend more money without adverse consequences. This was followed by too rapid a change of tack. Today we do not yet face a similar policy induced recession, but we need to be aware that the Bank of England is tightening too much which is visibly slowing the economy. Money growth is also being slowed a bit in the USA and China.