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Contents

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Commentary on the economic situation

Whistling mendaciously through their teeth in the dark

Treasury to revise 1992 GDP forecasts down in the Budget

Pity the Treasury's hapless macroeconomic forecasters! The Autumn Statement forecast of 2 1/4% GDP growth in 1992 has already been abandoned, as pointers to the economic outlook have deteriorated since mid-November. The forecasting consensus is now moving downwards, swiftly and understandably, towards the 1/2% - 1% growth area. Since improving oil output will contribute an extra 1/4% to 1/2% to GDP this year, the message is that the recession will continue in 1992. But, according to *The Sunday Telegraph* (12th January), in the Budget the Treasury will revise down its 1992 growth forecast only slightly, to 1 1/2% or 1 3/4%. Having made a bad mistake, the Treasury has a disagreeable choice - between admitting substantial error now and being marginally wrong later, or admitting marginal error now and being substantially wrong later. As there may be a new Government when the GDP figures for 1992 are finally prepared, perhaps it makes sense to postpone the recognition of error.

A good case can be argued that the prospects for economic activity are worse at the start of 1992 than they were at the start of 1991. On the domestic front, monetary growth was appreciably slower in the second half of 1991 than in the second half of 1990. (In the six months to November 1990 M4 increased at an annualised rate of 12.1%; in the six months to November 1991 it increased at an annualised rate of 4.6%.) In a "normal" business cycle changes in money growth lead changes in output growth by six months to a year. Of course, no business cycle is "normal" and the rule should not be applied mechanically. But monetary trends are certainly negative for economic activity in 1992, not positive. Meanwhile the housing market, so crucial for consumer confidence, is in its sorriest mess since the 1930s. Data from Nationwide Anglia show that house price declines, briefly interrupted in the second quarter of 1991, resumed again in the autumn. The building societies have a lower level of mortgage commitments at present than a year ago, even though base rates are 3 1/2% less.

External influences on UK growth more hostile now than in early 1991

But it is the external influence on the UK economy which contrasts in the most marked and worrying way with early 1991. The German and Japanese economies were then still relatively buoyant, and the strength of German demand sustained activity in the European economy as a whole. This buoyancy was particularly helpful for UK manufacturing, notably the car industry. But now demand is weakening in both Japan and Germany, while business surveys for France and Italy are just as depressed as they were in early 1991. With external developments more hostile to the UK economy than a year ago, and the domestic influences at best roughly the same, there is no more likelihood of a "recovery" in 1992 than there was in 1991. Politicians have been whistling in the dark and economic forecasters have been fibbing through their teeth.

Professor Tim Congdon — 15th January 1992

Summary of paper on

'Is the world economy heading for a 1930s-style slump?'

Purpose of the paper Monetary growth, on the broad measures, has been low or falling all over the world in the last three or four years. Since broad money growth usually leads economic activity by six to 18 months (but with "long and variable lags", as Friedman has said), a case can be argued that the world is about to enter a prolonged period of weak economic activity, perhaps even a 1930s-style slump. The purpose of the paper is to assess the plausibility of this prognosis. The exercise proceeds by means of charts, showing recent monetary growth, in the G7 economies.

Main points

* **The right monetary concept for forecasting purposes is the growth rate of "real broad money" (i.e., the growth of broad money adjusted for inflation), since this measures the adequacy of actual money holdings relative to the increasing need to hold them (i.e., to match rising prices).**
* **Experience varies markedly from country to country. The USA has had falling real money growth (annualising the six-month increase) since late 1987, but real money growth remained quite strong in Germany until 1990. Monetary growth has actually accelerated in Japan and Italy in recent months.**
* **Nevertheless, the slowdown in real broad money growth in 1989, 1990 and early 1991 was virtually universal. With real monetary growth continuing to fall in recent quarters, prospects for world economic activity are worse in early 1992 than at any time for a decade.**
* **But an obvious feature of the charts for most countries is that the deceleration in monetary growth has been more gradual in the present cycle than in the world recession of 1980 and 1981. This does not support apocalyptic conclusions about a 1930s-style slump.**
* **Most fundamentally, real broad money growth is only just into negative territory for the G7 as a whole. It has not crashed to minus 10%, minus 15% or minus 20%, the sort of numbers that would justify a forecast of a 1930s-style recession.**

This paper was written by Professor Tim Congdon. Because of seasonal adjustment problems at the end of 1991, it is about a fortnight late. The second part of 'The policy relevance of broad money' will appear in the February *Monthly Economic Review*.

Is the world economy heading for a 1930s-style slump?

Real money and economic activity in the G7 economies in the early 1990s

Some forecasts of a 1930s'-style slump due to credit contraction

A number of commentators, including most notably Lord Rees-Mogg in his column in *The Independent*, have warned that the problems of the international banking system may lead to a 1930s-style slump. The essence of the argument is that, in sharp contrast to experience in the 1970s and 1980s, banks around the world are being forced to improve their capital adequacy and to cut back on new lending. Since it is lending that drives the growth of banks' assets and since assets are matched on the other side of banks' balance sheets by deposit liabilities (which are money), slower credit growth implies slower monetary growth. By various mechanisms slower monetary growth discourages people and companies from spending, and so constrains economic activity. In some countries circumstances are so extreme that banks may even reduce the stock of lending. If so, credit contraction may reduce the money supply and plunge economies into depression, as happened in the 1930s.

This story accurately captures important aspects of the financial situation in several major industrial nations at present. But is it the whole picture? Is the world economy really heading for a cataclysm as bad as that in the early 1930s? The purpose of this *Review* is to provide background information relevant to answering these questions. In particular, it surveys the behaviour of real broad money in the all of the G7 large industrial economies in recent years. If our (very simplified) description of the forces driving the economy is correct, real broad money is the best summary measure of the thrust of monetary policy. The level of interest rates is obviously relevant, but an interest rate of x % does not have the same meaning for future economic activity at all times. In some years an interest rate of x % may be associated with rapid growth of credit and broad money, in others with slow growth. Equally, nominal broad money growth should not be interpreted in a mechanical way as an influence on future demand and output. Nominal money growth of 20% in an economy with nil inflation has a very different significance for prospective demand from nominal money growth of 20% in an economy with 40% inflation.

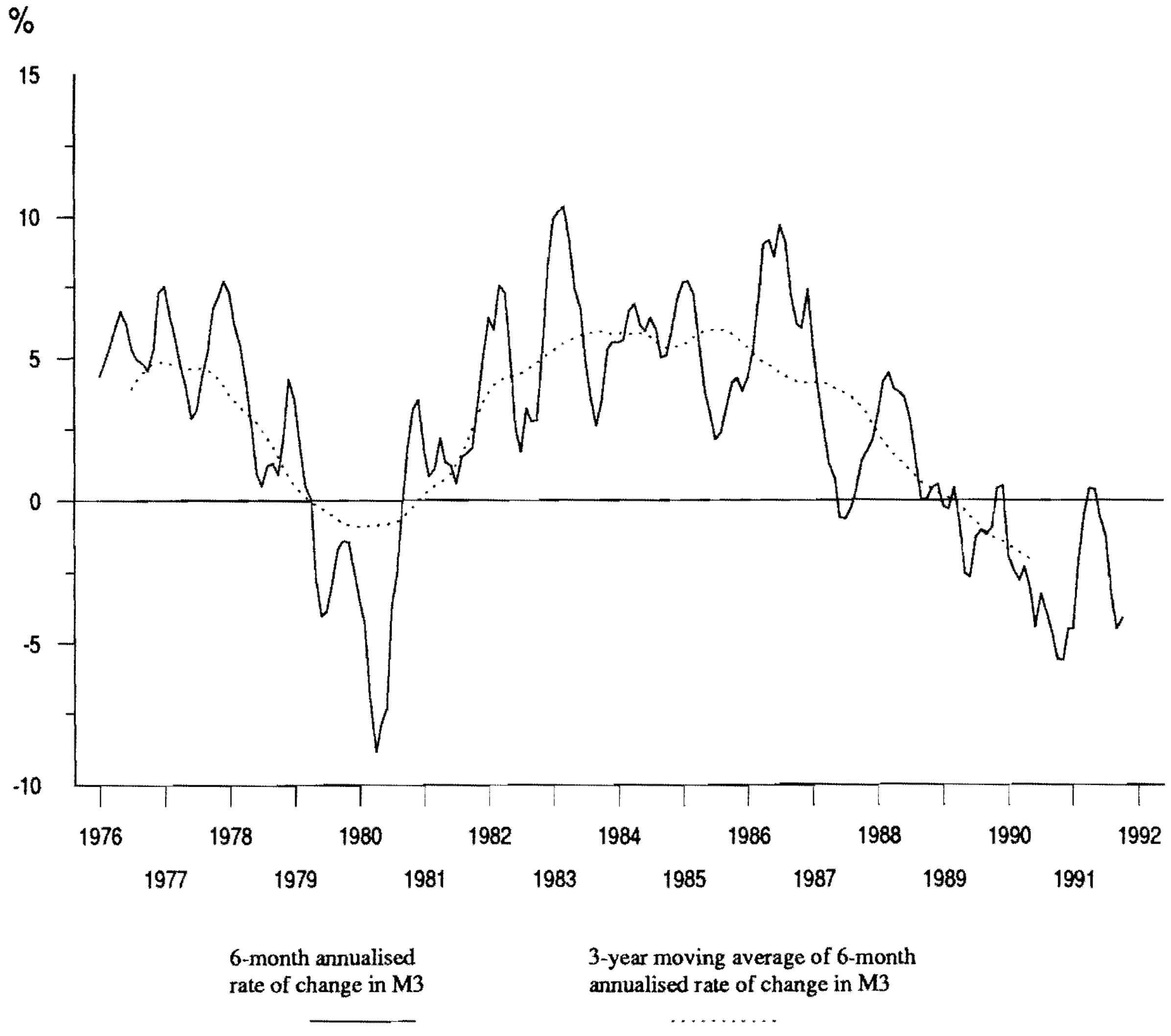
Real broad money the best summary measure of the thrust of monetary policy

We survey each of the seven countries in turn on the following pages. Different broad money measures are used in different countries, depending on what is most convenient. Two ways of measuring "growth" are considered - annualising growth in the latest six-month period and taking a three-year moving average of the six-month annualised growth rate. The annualised six-month figure gives a guide to the latest behaviour. (Three months is perhaps too short a period to draw meaningful conclusions, one year too long.) The three-year moving average of this figure is taken to represent "normality" in relation to which the latest trend should be judged. Finally, we spell out the implications of the country surveys for the world economy as a whole.

USA

Real M3 growth in the United States 1976-1991

Real M3 = Nominal M3 deflated by the CPI



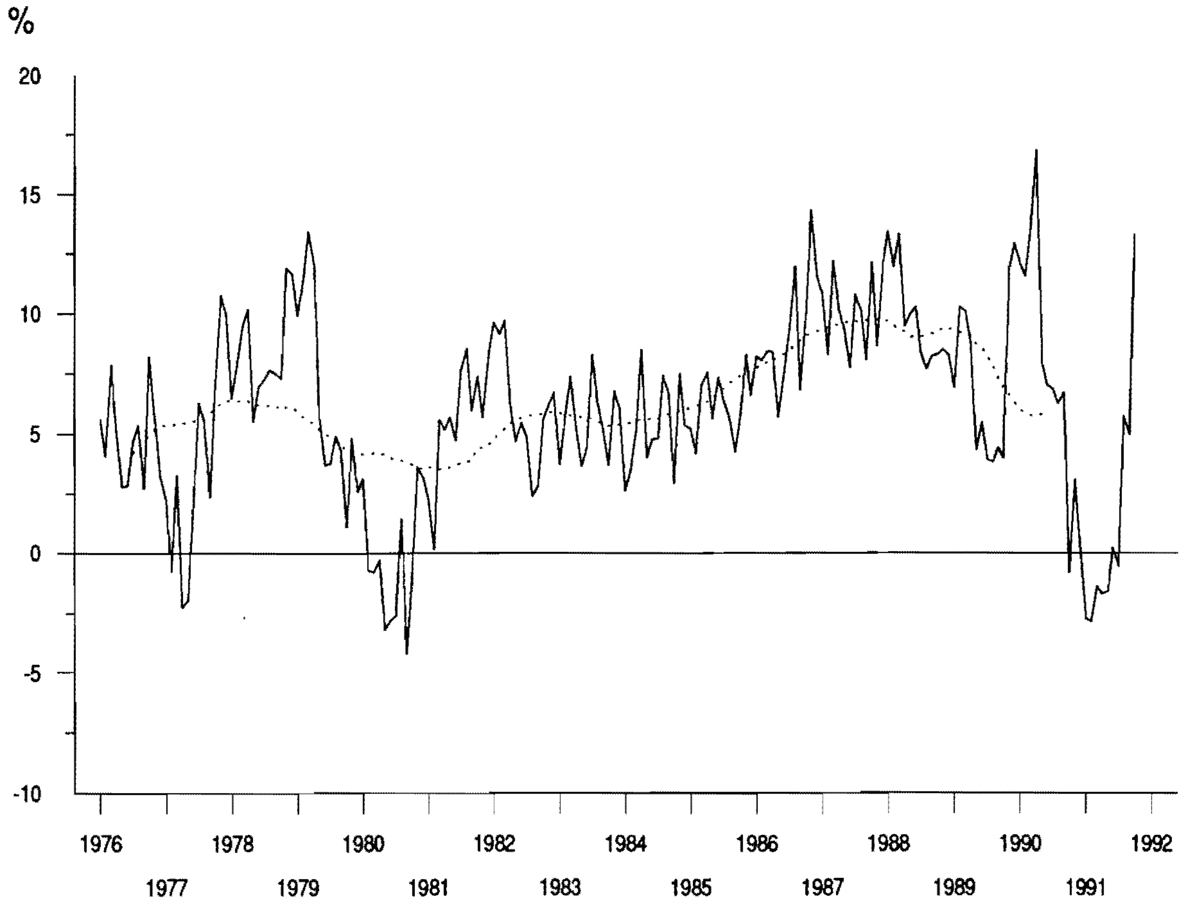
Comment:

Over the very long run real broad money grows in the USA by 2% - 4% a year, in line with real output. In the last three years US real broad money has been declining most of the time. Thus, our three-year moving average measure is in negative territory and seems certain to remain so for several quarters to come. The current experience is most unusual and there is an obvious contrast to the last noticeable dip in real broad money growth ahead of the recession of 1980 and 1981, which was clearly more transient. The latest annualised six-month figure shows no break from the very weak growth of the last few years. (But there has been an acceleration in money growth in the last six weeks, which is not picked up in our series.)

Japan

Real M2 + CDs growth in Japan 1976-199

Real M2 + CDs = Nominal M2 + CDs deflated by the CPI



6-month annualised rate of change in M2 + CDs

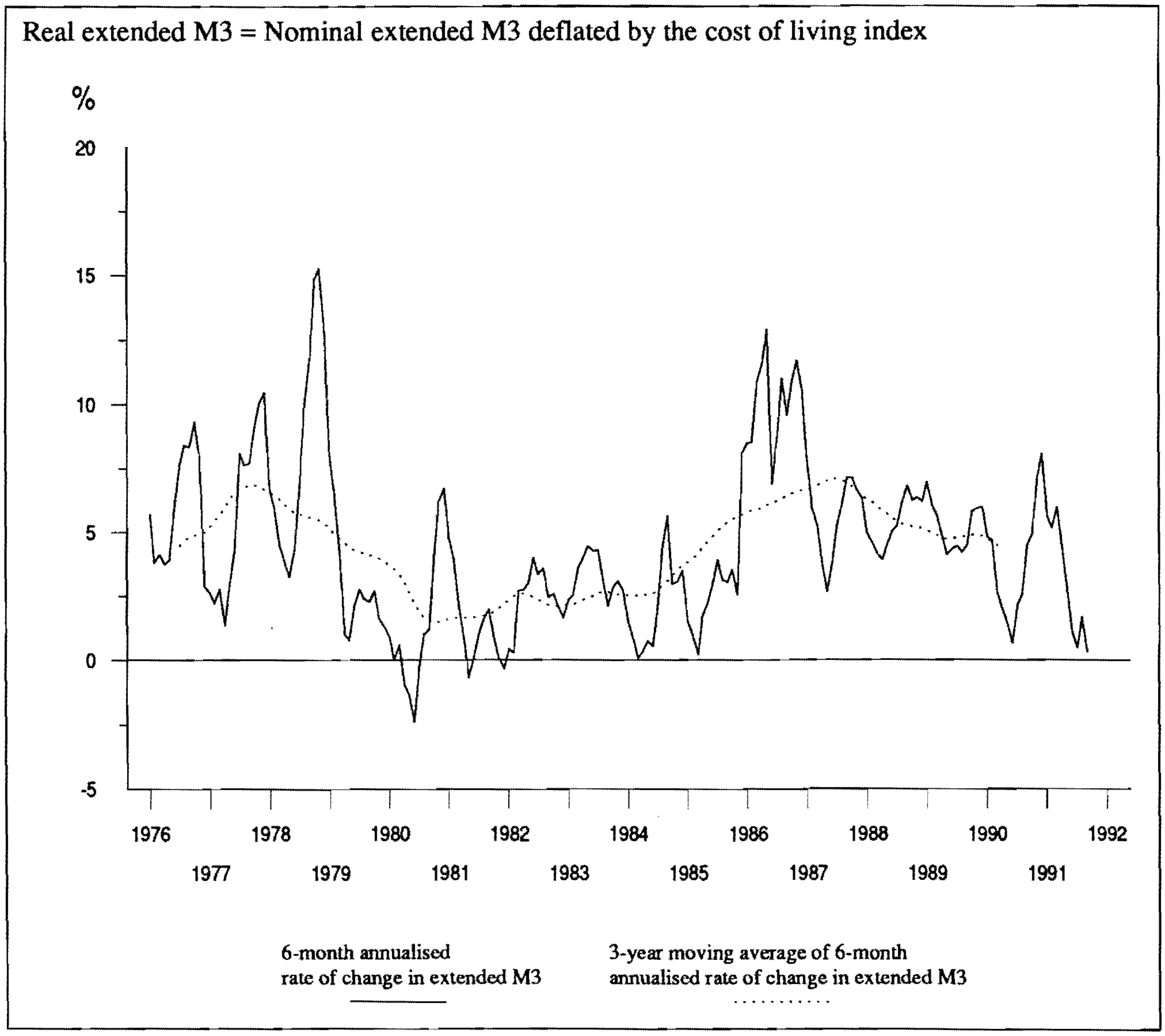
3-year moving average of 6-month annualised rate of change in M2 + CDs

Comment:

The Japanese numbers are fascinating. As is well-known, the annual growth rate of nominal broad money (i.e., M2 + CDs, the favoured measure in Japan) has been down to 2 1/2%, the lowest figure since modern records began. This is reflected in the the collapse in real broad money, with the annualised six-month rate of growth tumbling from over 10% in late 1989 to negative values for most of 1991. As intended by the Bank of Japan, the monetary squeeze has punctured the asset price bubble of the late 1980s. Perhaps more intriguing is that in the last few months real broad money growth has accelerated sharply. In part this has been due to the fall in inflation, but stronger credit expansion also seems to have stimulated faster nominal money growth.

Germany

Real extended M3 growth in Germany 1976-1991

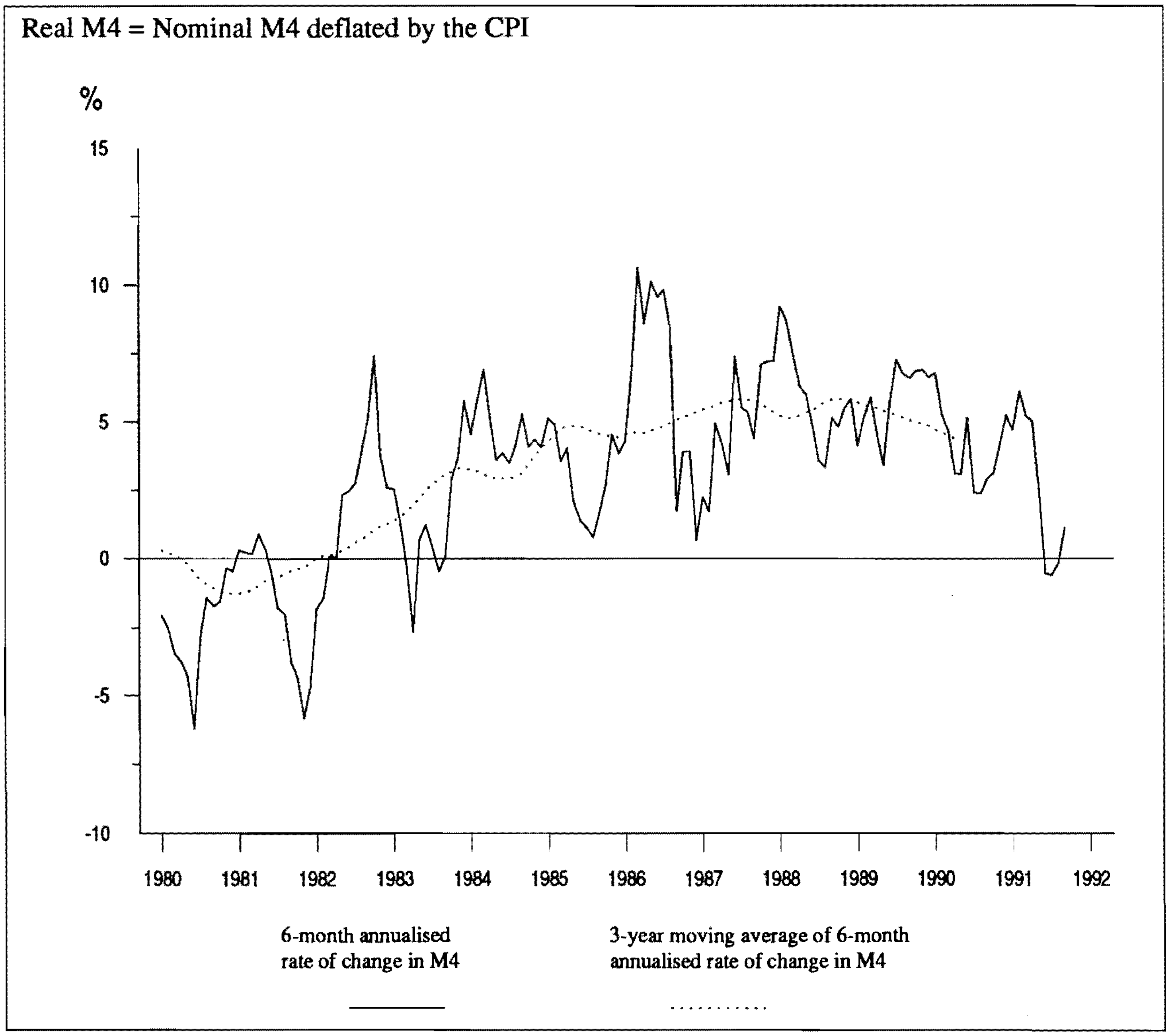


Comment:

The German statistics show a definite move towards monetary restraint, with real broad money growth (on an annualised six- month basis) now virtually nil, compared with over 5% in early 1991. The impressive stability of German monetary policy is demonstrated most clearly in the early 1980s, when real broad money growth oscillated closely either side of a steady three- year moving average line, which was itself for 2% - 3% real money growth. (This is as about as perfect a recipe for stable economic activity as it is possible to imagine.) But real broad money growth accelerated in 1986 and 1987, and, with the extra disturbance from re-unification, a contractionary adjustment has been necessary. But real broad money growth is still positive.

France

Real M4 growth in France 1980-1991

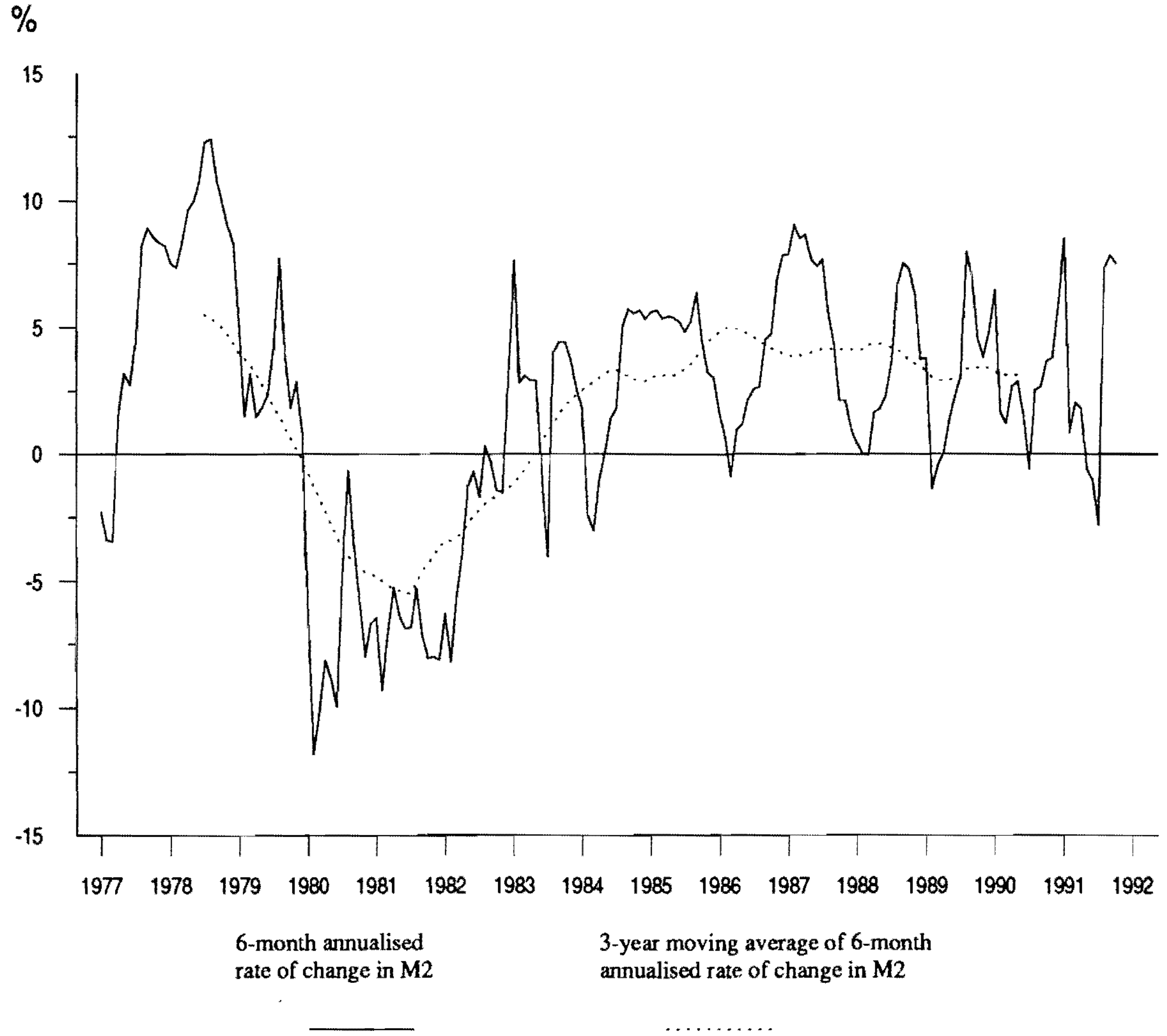


Comment: The rather erratic course of French macroeconomic policy in the early 1980s emerges from the chart, with large swings in real broad money growth in 1981 and 1982. A period of stability was then maintained from 1983 to 1990, with the three-year moving average line steady at about 5% and moderate fluctuations in the the annualised six-month rate around it. Since 1990 there has been a marked deceleration in real broad money growth, which briefly went negative a few months ago. The slight upturn in mid-1991 should not be taken too seriously, as it has been followed by a slowdown in the very latest data and the Banque de France's increase in interest rates in December. But real broad money growth should not be as low in 1992 as it was in the early 1980s.

Italy

Real M2 growth in Italy 1977-1991

Real M2 = Nominal M2 deflated by the CPI

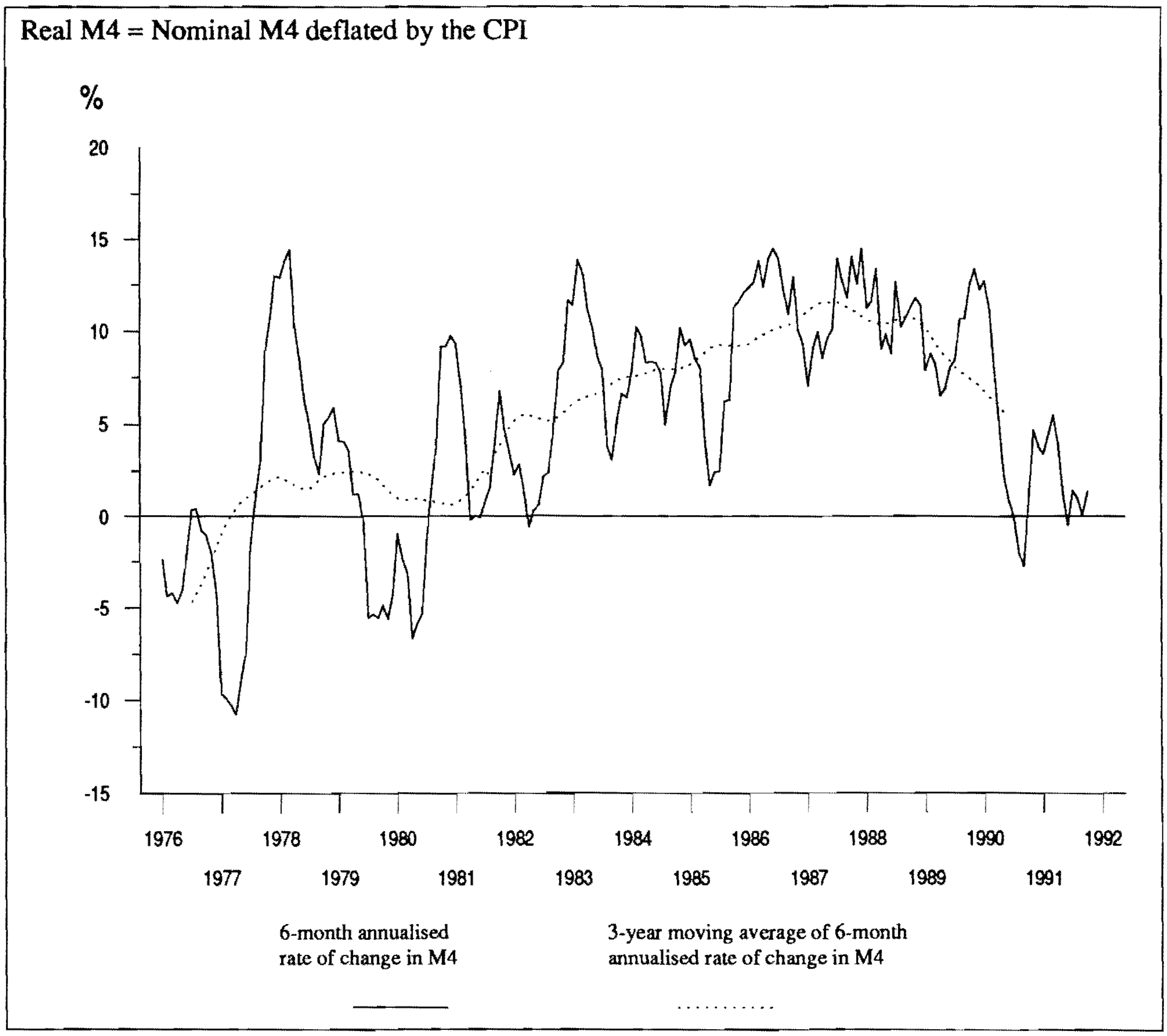


Comment:

Italian methods of monetary control are different from those in other G7 nations, with reliance on administered credit ceilings. This is partly due to the large budget deficit, as the banking system is required to help in its financing. However, as is clear from the chart, Italian monetary policy was reasonably stable in the mid-1980s, with the three-year moving average of real broad money growth steady at a little under 4% from 1984 to 1990. There were quite wide fluctuations in the annualised six-month rate around the three-year trend, but none of them persisted for long. Interestingly, the latest data show a deceleration in growth in 1991, but little different in magnitude from other decelerations in recent years, and lately a sharp rebound.

United Kingdom

Real M4 growth in the United Kingdom 1976-1991



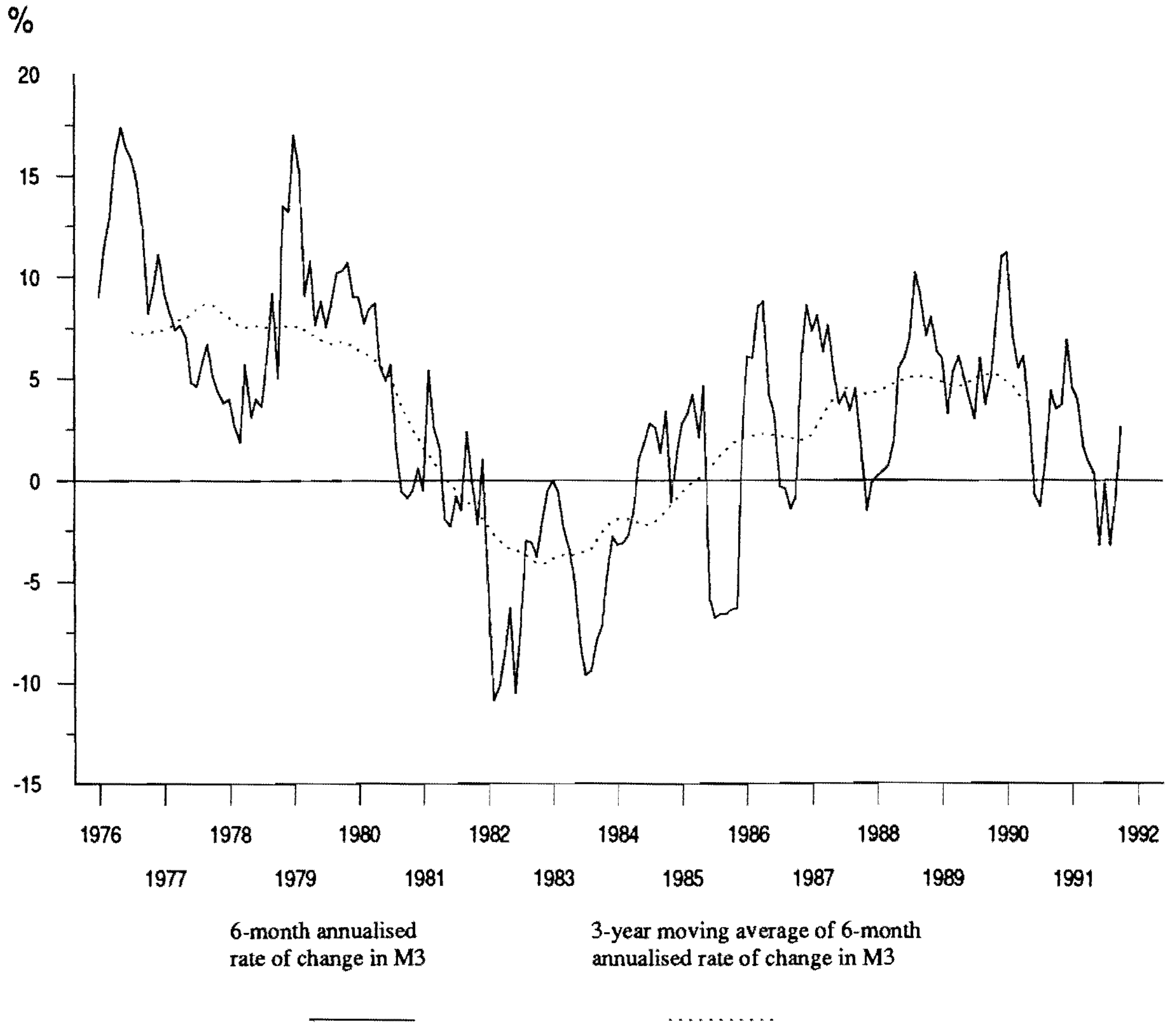
Comment:

As in other industrial countries, real broad money growth was reasonably stable in the UK in the early and mid-1980s. Although there was a recovery from the negative real broad monetary growth of 1979 and 1980 (which led to the recession of 1980 and 1981), this may not have had particularly strong implications for economic activity. Because interest rates on money balances were more attractive, economic agents probably wanted to increase their real money balances in the early and mid-1980s. However, the shift from 10%-plus positive real broad money growth (on the annualised six-month measure) from 1985 to 1989 to negative growth in recent quarters is marked. If the usual lags work, no easing of the recession is in prospect in 1992.

Canada

Real M3 growth in Canada 1976-1991

Real M3 = Nominal M3 deflated by the CPI



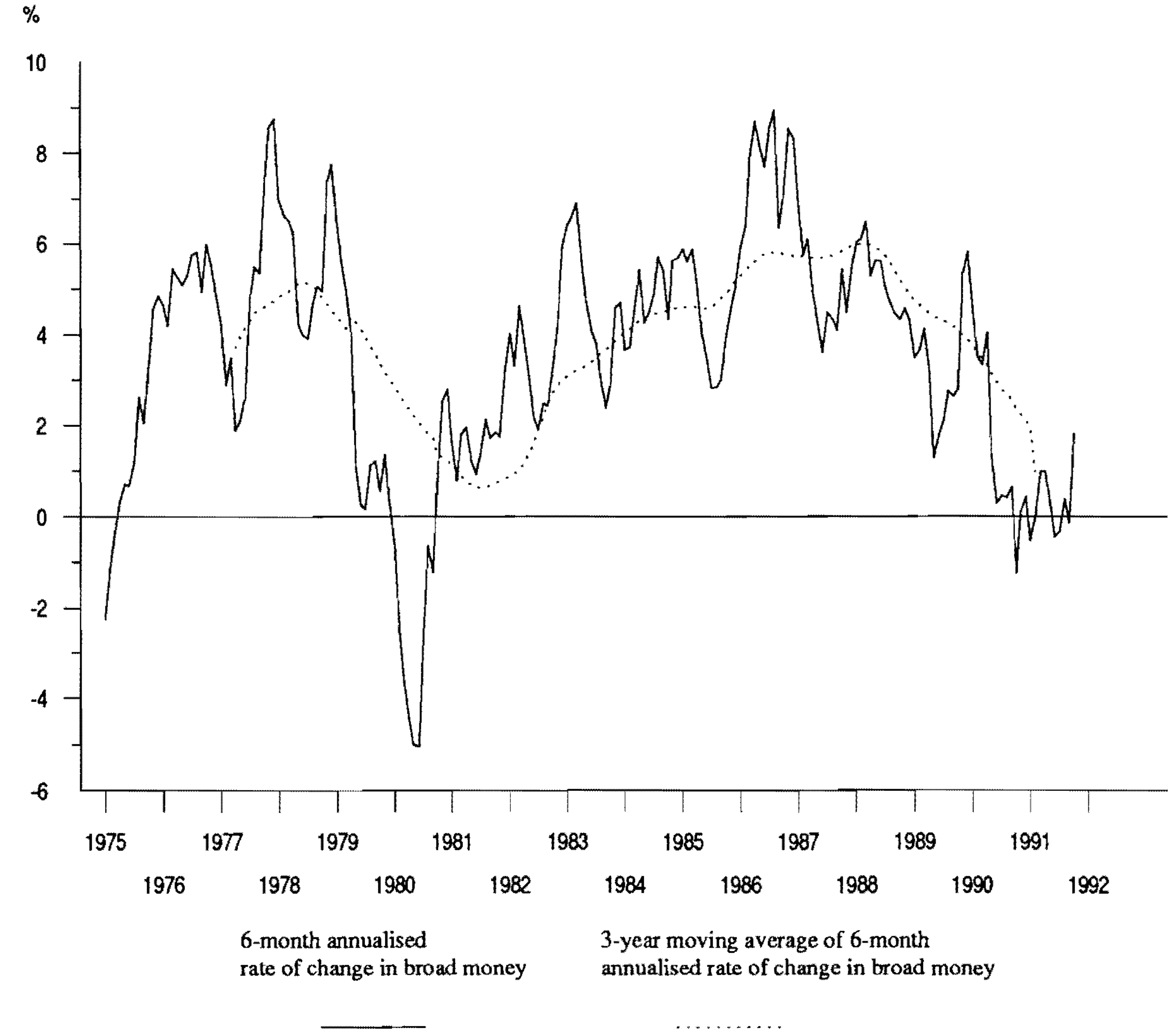
Comment:

Canada is the smallest of the G7 countries in GDP terms, while its monetary policies are largely subordinate to those of its much larger southern neighbour, the USA. However, the Governor of the Bank of Canada has been more emphatic about the virtues of price stability in recent years than his counterpart at the US Federal Reserve. This contrast has been reflected, at least to some extent, in the conduct of Canadian monetary policy. Canada had a big squeeze on real money balances in 1990, somewhat ahead of other G7 economies (particularly in Europe), and then something of a rebound in early 1991. The middle quarters of 1991 saw a return to very low broad money growth (on the annualised six-month basis).

Group of Seven

Real broad money growth in G7 countries 1975-1991

Real broad money = Weighted nominal money deflated by the CPI



Comment:

This chart summarises the message of the charts on the previous seven pages. The conclusion is vivid, that "world" real broad money growth has fallen steadily from virtually 5% in 1986 and 1987 to roughly nil in the last 18 months. As usual, the behaviour of real broad money has given a good advance warning of an economic slowdown. 1991 did see the lowest G7 growth rate since the recession of 1980 and 1981. The weakness of real broad money growth has also been more persistent than in the early 1980s. However, alarmism should not be taken too far. G7 real broad money is only slightly negative, whereas it was heavily negative in late 1980. Moreover, policy-makers in the USA and Japan have already reacted by large interest rate cuts.

Real money slowdown comparable with previous cycles

Our survey of the seven largest industrial economies is now complete. The first point to make is an obvious one, that there has been a very definite deceleration in real broad money growth over the last two years. However, the current slowdown in world broad money growth is no more dramatic than that which preceded the recession of 1980 and 1981. Sure enough, the recession of 1980 and 1981 was a bad one by post-war standards, roughly matching that in 1974 and 1975. (Combined OECD output rose by only 1.7% in 1980 and fell by 0.1% in 1981, whereas in 1974 it had risen by 0.8% and in 1975 fallen by 0.1%.) But - assuming the real money stock does not collapse in the next few quarters - the prospect is not remotely comparable with the Great Depression of the 1930s. The early 1930s saw thousands of American banks closing their doors, because they were unable to repay their depositors, and real broad money declined by 40% or 50%. (So did GDP and industrial production.) Nothing like that is going to happen in the early 1990s.

Risk of full-scale monetary collapse remains small

Could the real money stock collapse in the next few quarters? Of course, if central banks mismanage the situation totally, the real money stock could collapse. It is certainly true that in the USA, the UK and Japan the immediate incorporation of real estate/property losses (i.e., losses implied by current surveyors' valuations) into banks' balance sheets would cause dangerous erosion of their capital and require them to start calling in loans in a highly destabilizing fashion. But that risk is present in most cyclical downturns. In practice, banks ride out the worst phase of the business cycle and only take the losses when their balance sheets are sufficiently strong to absorb them. The sharp declines in interest rates in the USA and Japan in recent months show that their central banks are fully aware of the dangers, and are trying to anticipate the problems. (Monetary growth has, in fact, picked up in Japan and Italy in recent weeks, and may be doing so in the USA.) Moreover, the deceleration in world real money growth in the last three years has been more gradual than before the 1974/75 and 1980/81 recessions, arguing against a particularly cataclysmic interpretation of the situation.

The uniqueness of the current situation is that the private sectors (i.e., companies and individuals) of many countries are heavily-borrowed, while banks are confronting quite tight capital adequacy constraints. Bank lending to the private sector is likely to be sluggish (i.e., growing at under 5% a year or perhaps, at times, even falling) in the early 1990s. Faster growth of bank balance sheets (and so of the money supply) may require increased bank lending to the public sector (i.e., that budget deficits are under-funded). There have already been steps in this direction in the USA. But this is a relatively minor adjustment to monetary policy. Although the world economy faces many dangers, there is at present no justification for predicting a return to the wrenching economic instability of the inter-war period.