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Commentary on the economic situation

The money supply determines both the exchange rate and inflation

The value of money depends on its quantity

The leaders of economic thought have understood, ever since the beginnings of their subject as an independent intellectual discipline, that the value of money is determined in much the same way as the value of any other commodity. It depends on the interaction between the supply of money and the demand for it, just as the value of apples and oranges depends on the supply of apples and oranges relative to the demand for them. If "too much" money is created, the value of money will fall through a rise in the price level (i.e., inflation). The Bundesbank, unlike Her Majesty's Treasury, appreciates the force of these ideas and has successfully based its policies on them in the last 20 years.

But the value of any particular "money" has two meanings - the external value (i.e., the exchange rate) and the internal value (i.e., the price level)

But the ideas, despite their theoretical simplicity and correctness, can be quite complex in their application to real-world problems. One difficulty is that "the value of money" is an ambiguous phrase which has two meanings, the external value of money (i.e., the exchange rate, the value of one money in relation to other monies) and the internal value of money (i.e., the price level of goods and services). In the long run the external and internal value of money move in parallel. (The price of the same product in terms of a common currency tends to be similar in all the countries where it is traded.) The majority of British economists find it easier to relate the internal value of money to movements in its external value than to changes in the quantity of money. This is a little odd, since it is the quantity of money (or rather the quantity of one nation's money supply relative to others') that ultimately explains the exchange rate. At any rate they base their inflation forecasts largely on recent changes in the exchange rate, not on monetary trends.

Money supply trends argue against inflation pessimism based on the pound's devaluation

This attitude is vital in understanding why UK inflation forecasts are being revised upwards sharply. The standard arithmetic is that, since imports are roughly 30% of demand, the 10% fall in the pound's external value since July will add 3% to inflation in the coming year or so and significantly more (the full 10% in the final analysis) over the next few years. The mistake here is to overlook that the latest UK monetary trends are relevant to the future behaviour of the exchange rate and so to inflation in 1994, 1995 and later. In the last twelve months the M3 measure of the money supply has risen by about 3% and M4 by about 5%, while the massive foreign exchange intervention of recent weeks implies that lower growth rates - or perhaps even a fall - are in prospect. The pattern of events may resemble that in the mid-1970s, when a collapse in the exchange rate and low money growth in 1976 was followed by a strong exchange rate in 1977 and a sharp drop in inflation in 1978. Recent money supply figures are saying clearly that, whatever the short-term disappointments over the next few months, underlying UK inflation is still very much on a downward track.

Professor Tim Congdon 7th October 1992

Summary of paper on

'The condition of the British financial system'

Purpose of the paper If it is accepted that the behaviour of the money supply is crucial to the macroeconomic situation, the question "what determines the money supply?" becomes very important. An argument can be made that, since bank credit growth largely determines changes in the quantity of money, the focus should be the determinants of bank credit. In this context the balance-sheet strength of the financial system is vital, since capital-deficient banks (and building societies) are reluctant to expand their assets. This paper assesses the present balance-sheet position of major UK financial institutions.

Main points

* **The level of personal bankruptcies and corporate failures is at an all-time high and is still rising. (See p. 4.) The fall in house prices and commercial property values is largely to blame for the high incidence of failures. (See pp. 5 - 6.) Banks' and building societies' bad debts will remain high in 1993 and 1994.**

* **The large UK banks were unable to increase their capital/asset ratios in 1990 and 1991, even though asset growth virtually came to a halt. (See p. 8.)**

* **Mortgage arrears are rising sharply and are likely to undermine the building societies' profitability. As a result the semi-automatic 20%-a-year expansion of building societies' balance sheets in the 1970s and 1980s (through the practice of ploughing back of profits to boost capital reserves and then increasing assets against the increased reserves) is over. (See p. 10.)**

* **The re-building of balance sheets will rely partly on the entry of new capital into financial business. But general insurance companies also are suffering from severe balance-sheet weakness, largely because of the plight of the housing market and their mistake in underwriting mortgage indemnity insurance in the late 1980s. (See p. 11.)**

* **Company finances remain weak, although - in a favourable contrast with the personal sector's position - they are not completely out-of-line with previous historical experience. (See p. 12.)**

This paper was written by Professor Tim Congdon.

The condition of the British financial system

Balance-sheet fragility in every kind of institution

Links between money and economic activity

According to the so-called "monetarist" approach to the economy, as espoused by Professor Milton Friedman, sharp changes in the rate of (broad) money growth lead changes in the rate of output growth by about six months or a year and changes in the rate of inflation by about two years. Friedman has warned that the lag between money supply movements and the inflation rate is nevertheless "long and variable". If this approach is useful in anticipating macroeconomic developments, a still more helpful analytical tool ought to be a reliable method of predicting future changes in monetary growth.

Friedman's method (and that of most other "monetarists") is to to see the quantity of broad money as a multiple of the monetary base, which is taken to be under the direct control of the central bank. However, a strong argument can be made that this line of thinking is incorrect, because - as a practical matter - commercial banks can always obtain from the central bank enough monetary base to validate their balance sheets. (The relationship between the banking system and the central bank is, at root, a business relationship of mutual benefit. Banks rebel - by pushing their business offshore - if the central bank tries to behave as a branch of government which instructs them on how to conduct their affairs.) An alternative view is that the key constraint on banks' expansion - and on that of building societies' and insurance companies' as well - is their capital adequacy. If capital is excessive in relation to balance sheet size and so to the risks contained in the balance sheet, banks are keen to expand their balance sheets by lending more or by purchasing more assets; if capital is deficient, they curtail balance-sheet growth (or even try to contract balance sheets) by turning down new loan applications and by selling assets. The consequent fluctuations in asset growth are matched on the liability side of the balance sheet by changes in the growth rate of bank deposits, which constitute the bulk of broad money. (The relationship between broad money and economic activity was discussed in the December 1991 and February 1992 issues of the *Gerrard & National Monthly Economic Review* on 'The policy relevance of broad money'.)

But there are also links between banks' capital position and money supply growth . . .

A survey of the capital strength of banks, building societies and insurance companies is therefore crucial to an assessment of the future of economic activity. The main point to emerge from the following pages is that the British financial system is more fragile today than it has been for many decades. As the current high levels of bankruptcies and corporate failures (see p. 4) are outside previous historical experience, balance-sheet weakness will hamper economic recovery throughout the early and mid-1990s.

Bankruptcies and failures

1992 and 1993 will see a record number of bankruptcies, personal and corporate

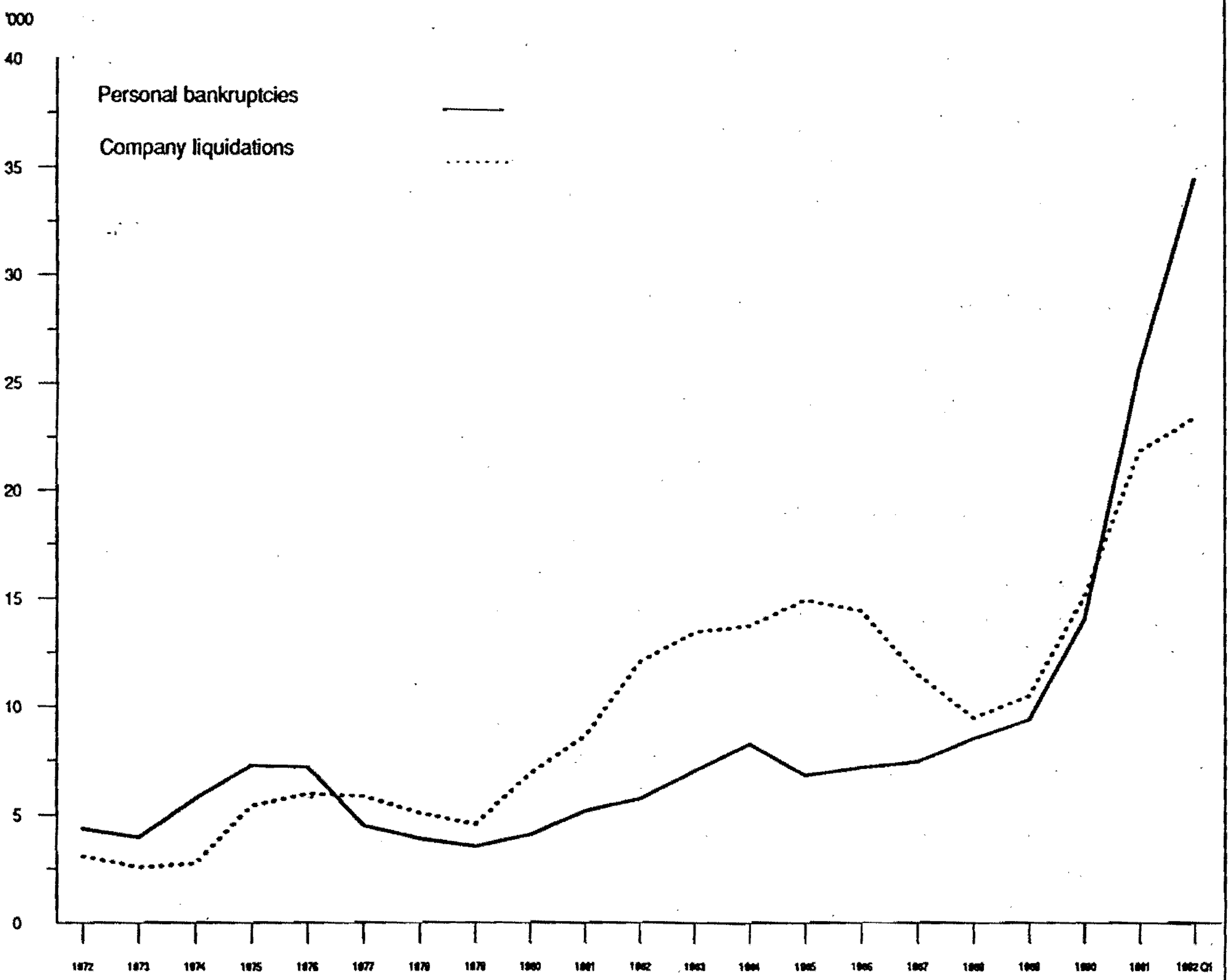


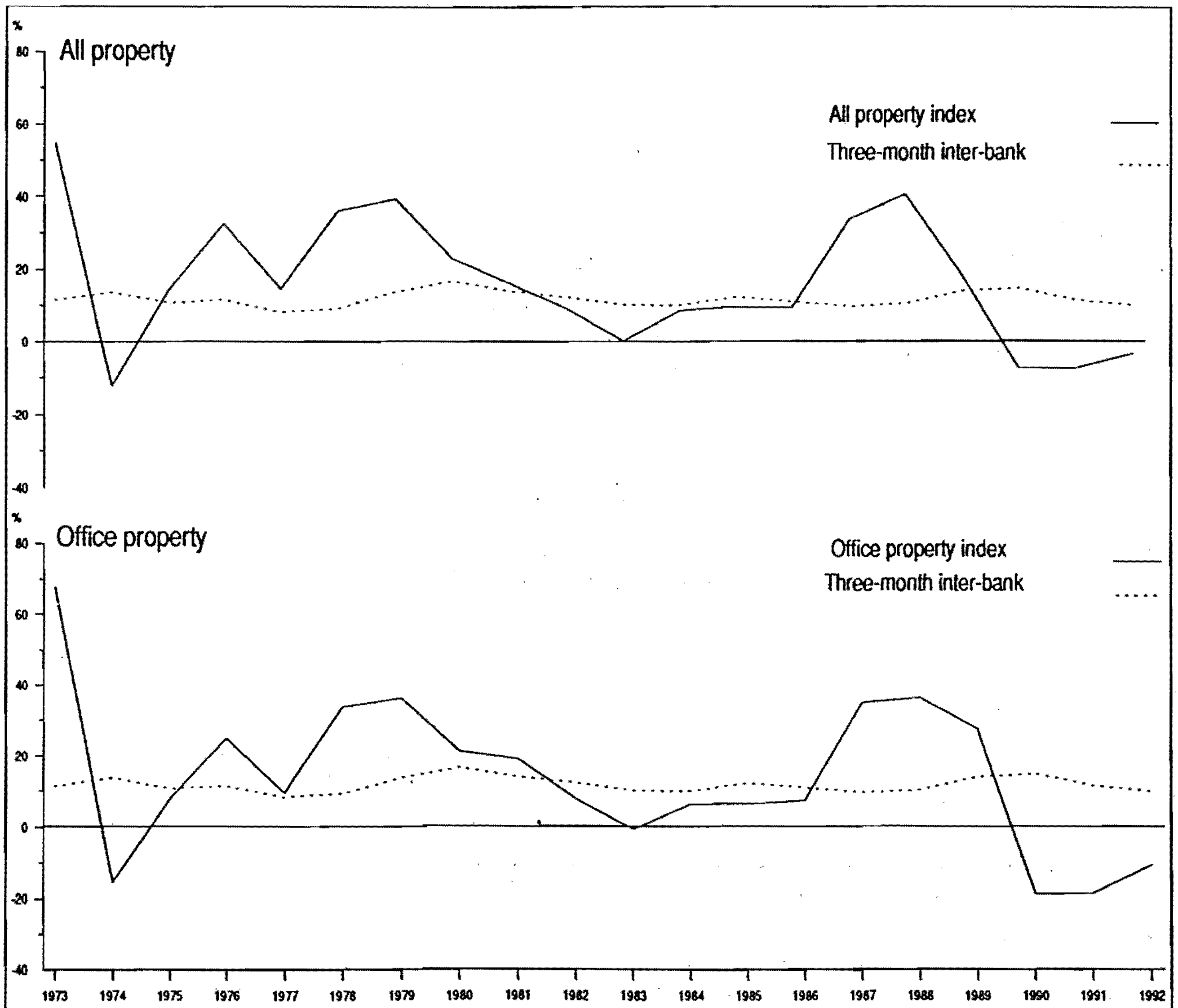
Chart shows the annual number of personal bankruptices and company liquidations, according to the DTI. (The figure for 1992 is the first quarter, seasonally adjusted and multiplied by four.)

Comment

The number of both personal bankruptcies and company liquidations in 1992 is certain to be an all-time high, and 1993 will probably be worse. The deterioration is bad enough on the corporate side, where the 21,827 company liquidations in 1991 exceeded the previous peak in 1985 (14,898) and a figure between 25,000 and 30,000 is likely in 1992. But the dramatic change is in the incidence of personal bankruptcies, which reflects the unprecedented situation in the housing market. (See p. 6.) A standard pattern is that the cyclical peak in bankruptcies comes as the recovery is starting, not at the trough in activity. So the omens for 1994 and even 1995 are poor.

The state of the commercial property market

"The toughest property market in living memory" (Mr. Gerald Ronson)



Charts compare total returns on property, in years to November according to the Investors Chronicle-*Hillier Parker indices, with three-month inter-bank rates, %, averages for years.*

Comment

The relationship between total returns on property and the interest rate is crucial to assessing the property market, since most purchases are financed by borrowing. As the chart shows, between 1973 and 1981 base rate was above total returns in only one year, 1974, which saw a severe property crash after the Barber boom of 1972 and 1973. Base rate was above total returns for five years between 1982 and 1986, but total returns were always positive. The present situation is altogether different, as total returns have been negative for two years in a row while base rates have been 10% or above.

The state of the housing market

1. The relationship between house price changes and the mortgage rate

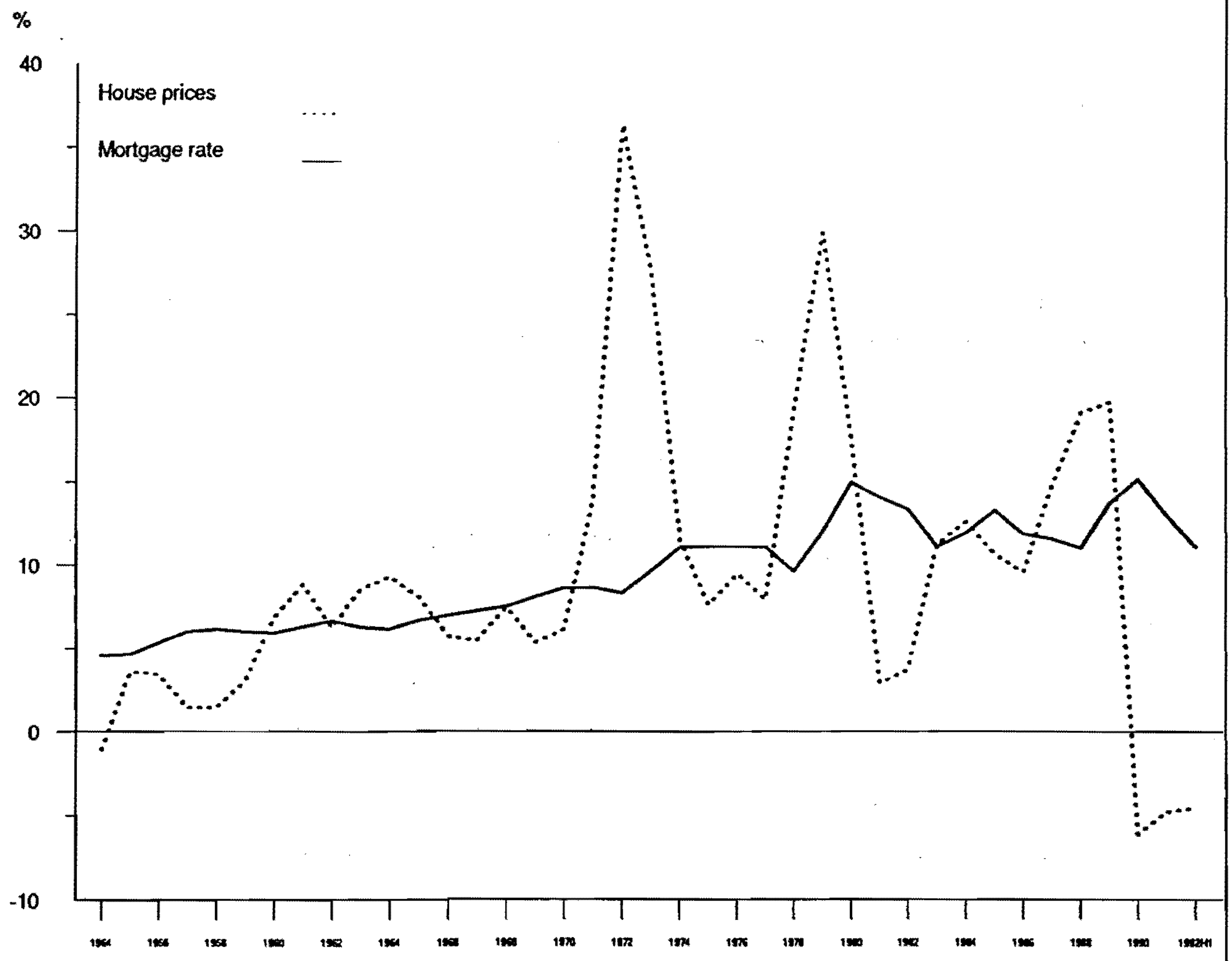
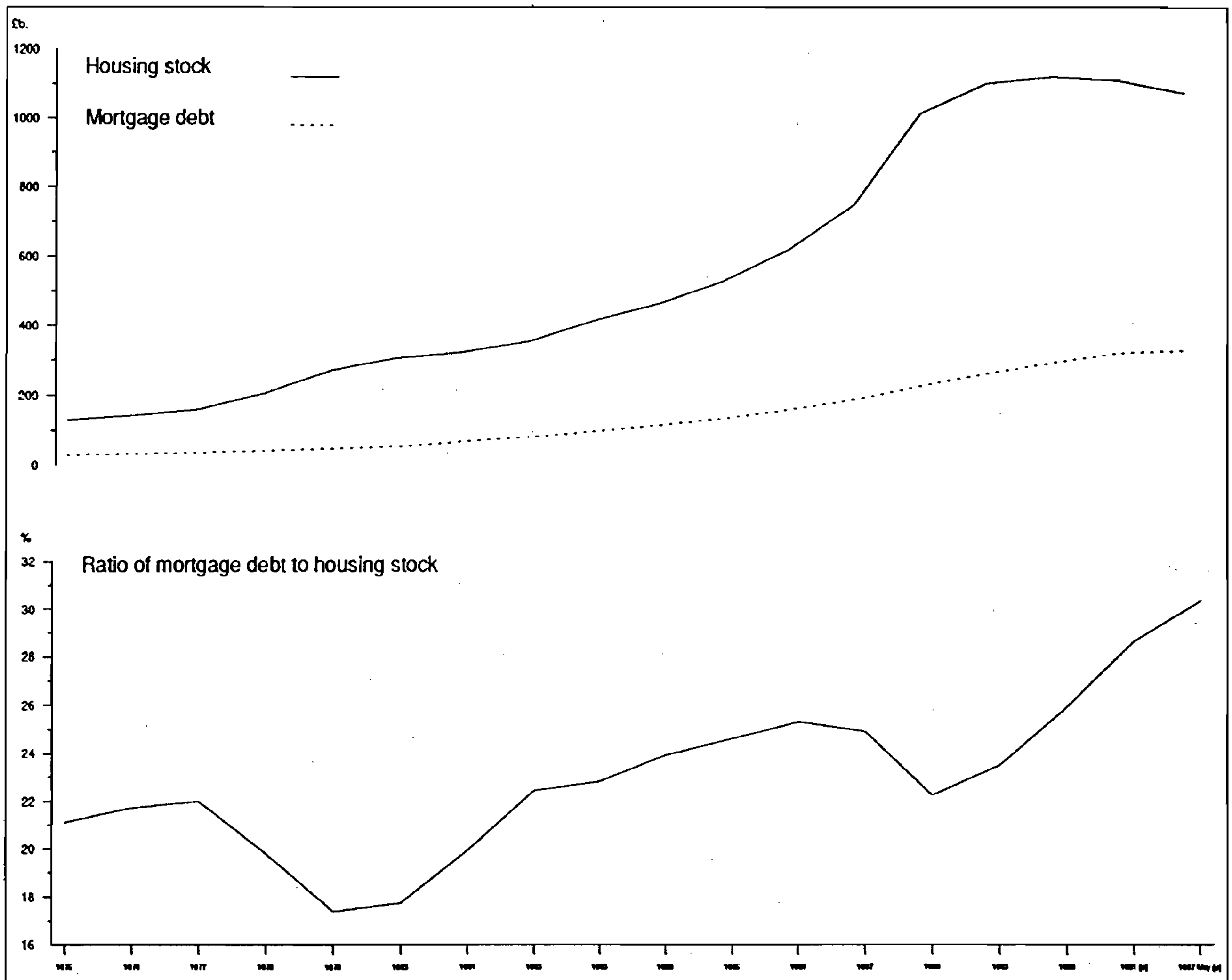


Chart shows the % mortgage rate (annual average from the Compendium of Building Society Statistics and other building society sources) compared with the annual % change in the Nationwide Anglia "all houses" index. (The first half of 1992 is partly estimated.)

Comment

The housing market is crucial to the personal sector's behaviour, since houses are its most important asset and mortgage debt represents about 70% of its total debt. A key determinant of the growth of debt (relative to the housing collateral) is the difference between the mortgage rate and the change in house prices, as it is more difficult to put together the money for repayments when interest rates are high. The chart shows that since mid-1989 house prices have been falling, while mortgage rates have remained at above 10%. (The average mortgage rate charged by building societies was still 10.86% in May.) The contrast with previous experience in the post-war period is dramatic.

2. Mortgage debt and the housing stock



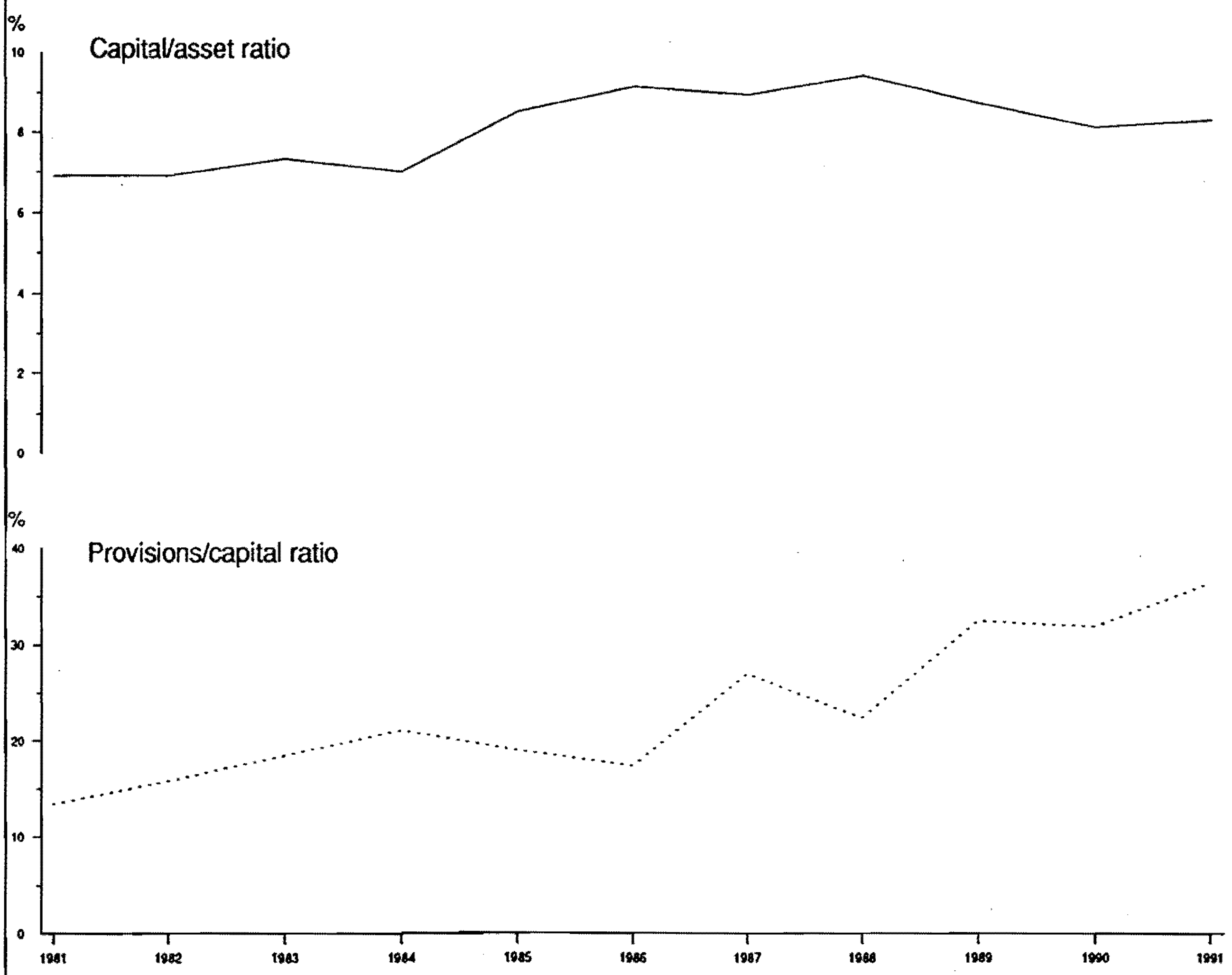
Top chart shows the end-year value of mortgage debt and the housing stock, in £b.; bottom chart shows the ratio of the value of mortgage debt to the housing stock, in %. The value for 1992 relates to mid-year and is partly estimated. The main source is Financial Statistics.

Comment

The current recession differs from all previous recessions since the 1920s in that it has been accompanied by large house price declines. The consequent fall in the value of the housing stock has not prevented further rises in the personal sector's mortgage debt. The ratio of mortgage debt to the housing stock has therefore increased to almost 33%, completely out-of-line with previous experience. (As the chart shows, a more typical figure in the 1970s and 1980s was between 20% and 30%.) As developments in the tax system have surely made mortgage indebtedness less tax-efficient, the personal sector will try hard to reduce its mortgage debt in the next few years and - in the absence of a large cut in interest rates - the savings ratio will remain high.

The condition of the banking system

1. Capital ratios have been weakening



The top chart shows the ratio of the capital base of the nine largest UK banks to their assets; the bottom chart shows the ratio of all provisions (i.e., specific and general) to their capital. Both series are expressed as %ages.

Comment

Discussion of the banks' capital position tends to concentrate on the Basle guidelines, with their requirement that Tier 2 capital be 8% or more of assets and that Tier 1 capital (mostly, equity) be at least half of all capital. But banks had to watch their capital/asset position centuries before the invention of the Basle rules. The chart shows that - on the definition of "the capital base" favoured by the clearers themselves - their capital/asset ratio fell from 9.1% in 1988 to 8.1% in 1991. This fall occurred, even though the growth rate of assets in 1991 (3.3%) was markedly less than in 1988 (13.8%). The ratio of provisions to capital also climbed remorselessly from 1987 onwards, implying increased write-offs in future.

2. Lending growth has been decelerating

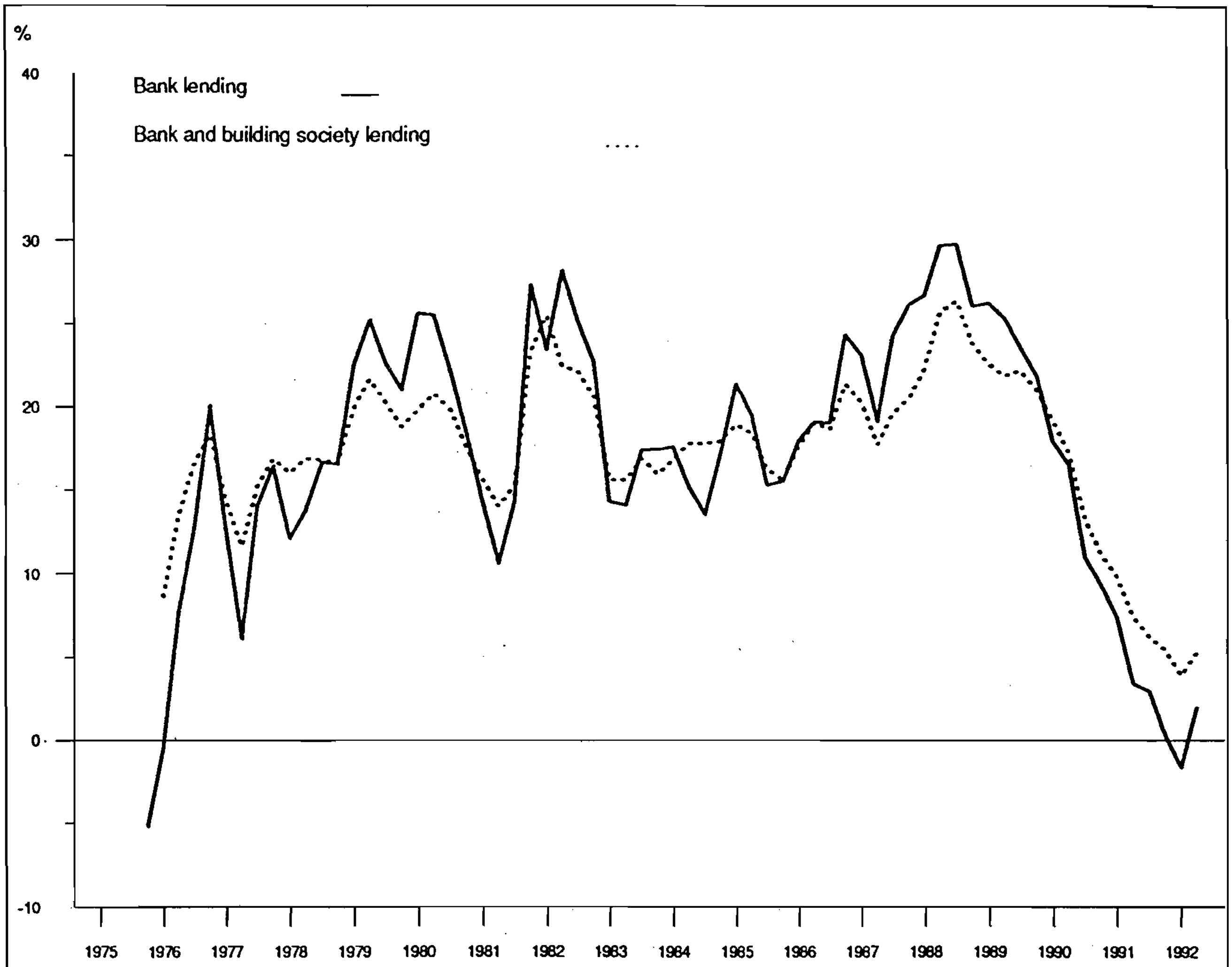


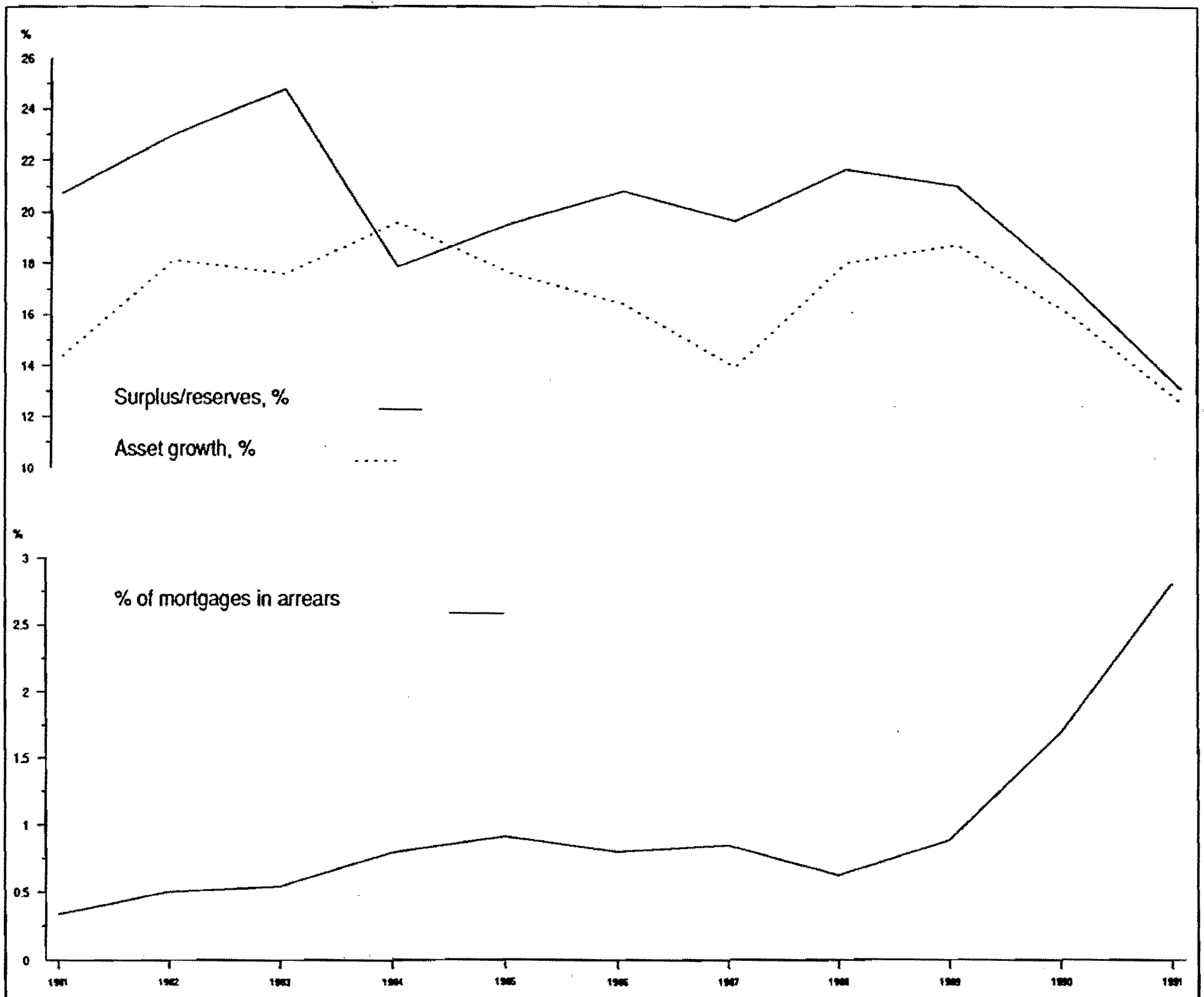
Chart shows % change in six months, at annualised rate, in bank lending alone, and bank and building society lending combined.

Comment

Fluctuations in the growth rate of bank lending have been much greater than in the growth rate of bank and building society lending combined. (Part of the explanation may have been continuous excess demand for mortgages and the semi-automatic growth of building society balance sheets in the late 1970s and early 1980s. See p. 10.) Even so the deceleration in both series has been remarkable since the boom years of 1988 and 1989. Whereas the stock of bank lending grew at an annualised rate of almost 30% for most of 1988, it was static between mid-1991 and mid-1992; whereas the stock of bank and building society lending was increasing at an annualised rate of 25% four years ago, it is now rising by about 5% a year. The slowdown in credit growth marks a clear break from almost 20 years of continuous rapid expansion.

Trends in the building society movement

Rapid expansion is over, as new concerns emerge over balance sheets



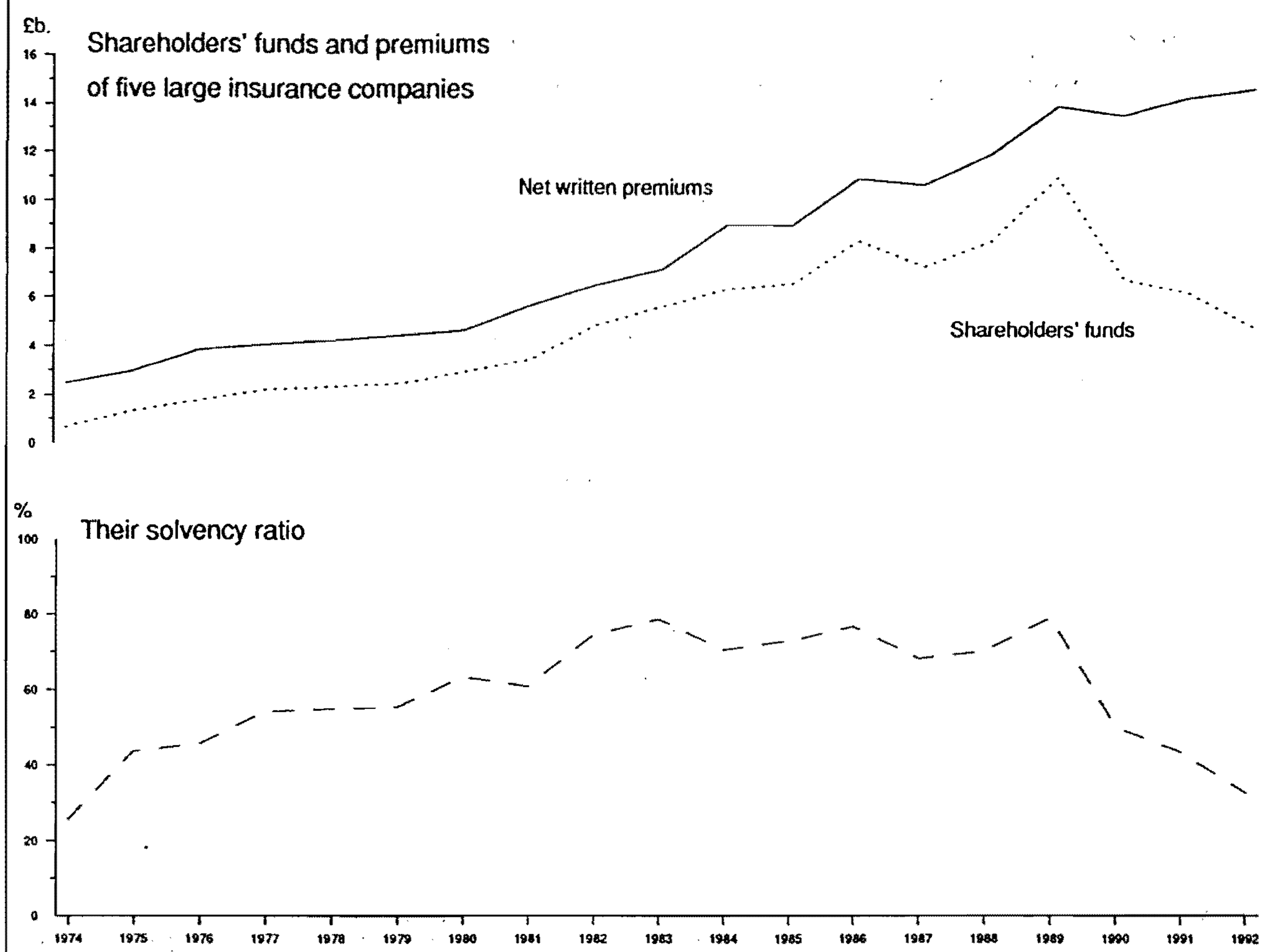
Top chart shows building societies' surplus added to reserves (as % of reserves) and % growth rate of building societies' assets; bottom chart shows % of building societies' mortgages six months or more in arrears.

Comment

Building societies' expansion in the 1980s was rapid, uninterrupted and virtually automatic. With general reserves (i.e., capital) equal to about 3 3/4% of assets and the surplus (i.e., profit) at roughly 3/4% of assets, the rate of return on capital approximated 20%. The surpluses were routinely added to reserves, which therefore grew by 20% a year, and the balance sheet then also expanded by 20%. This pattern came to an end in 1991, when the societies' profitability was hit by exceptional losses due to rising mortgage arrears. As mortgage arrears are still increasing, the surplus will be squeezed in the next few years and balance-sheet growth will be much slower, perhaps even negligible.

The insurance industry in crisis

Worries about solvency ratios



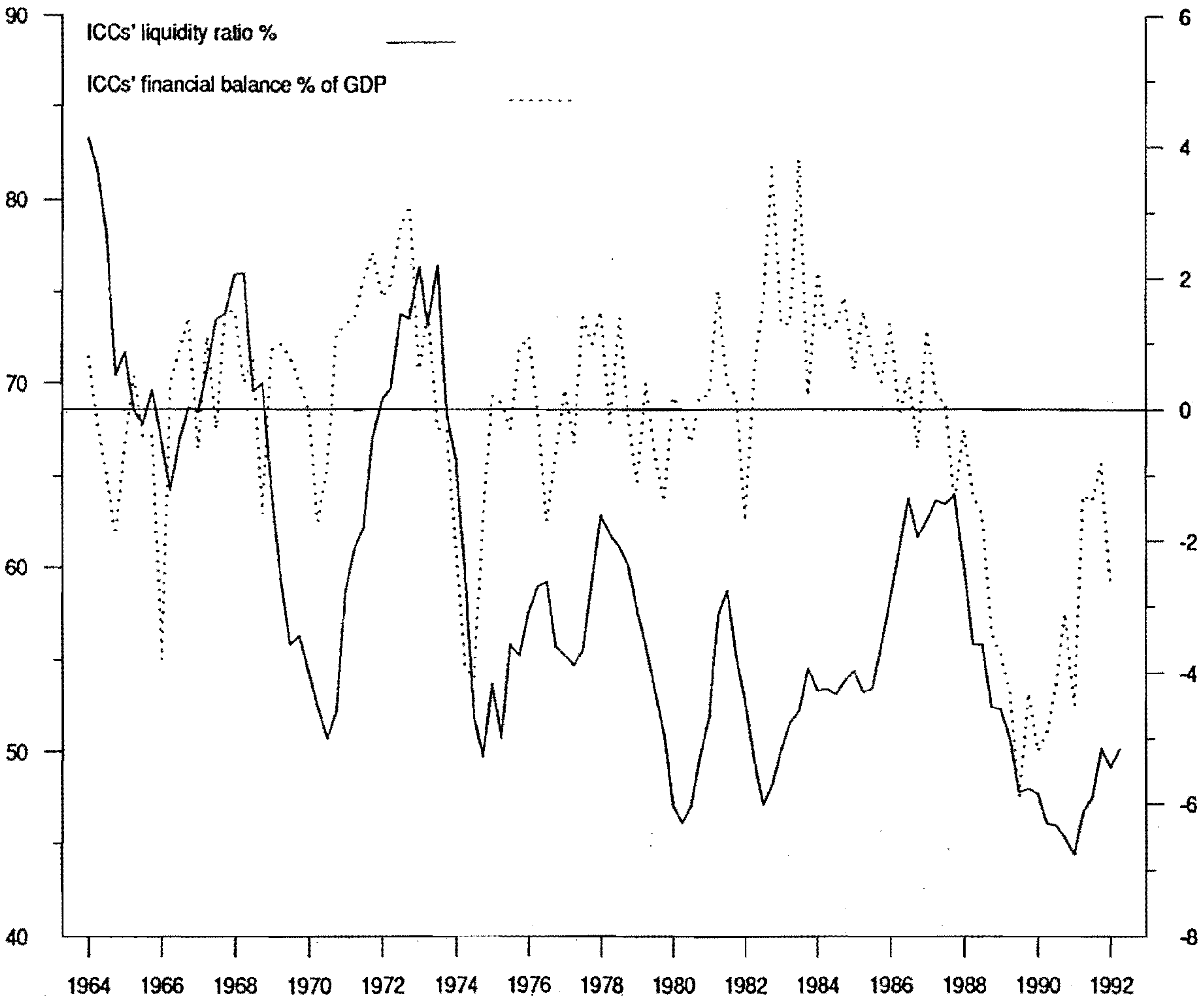
The chart relates to five large composite insurance composites (Commercial Union, General Accident, GRE, Royal, Sun Alliance), which account for over half of UK general insurance. Sources are annual reports and accounts, and Gerrard Vivian Gray estimates.

Comment:

The insurance industry needs capital to support its underwriting of risks. The solvency ratio (i.e., the ratio of capital to net written premiums) is a widely-used measure of capital adequacy. It has been hit in the last three years by the combination of heavy underwriting losses, particularly from mortgage indemnity business, and weak equity prices. The solvency ratio for the five leading composite insurers, who account for over half of the UK market in general insurance, has collapsed from 78.7% in 1989 to an estimated 32.5% in 1992. These companies have responded by capital raising (e.g., preference issues) and accounting devices in order to boost their solvency ratios. But a deteriorating housing market (and so increased mortgage indemnity losses) will hamper the industry for years to come.

Company finances

Still under pressure



Charts show liquidity ratio (i.e., ratio of M4 deposits to M4 borrowings) of industrial and commercial companies, and their financial deficit/surplus. The liquidity ratio is expressed as a %age and the financial deficit/surplus as a % of gross domestic product.

Comment:

The corporate liquidity crisis of 1990 and 1991 was similar in intensity to the crises of 1974 and 1980, although there were some differences in form. (The financial deficit was exceptionally large in 1990, but the lowest values of the liquidity ratio were much the same at all the cyclical troughs, in the 45% - 50% area.) The interest rate reductions in 1991, the equity issues in the second quarter of 1991 and cuts in capital spending have helped improve the financial position. However, both the financial deficit and the liquidity ratio remain much beneath the average levels in the last 30 years.