GERRARD & NATIONAL

Monthly Economic Review

No. 79, January 1996

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GERRARD

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New year to start with a new debate

Will the slowdown become a recession?

Sharp change of view about the economy during 1995

The British economy slowed down during 1995. At the start of the year the majority of commentators were concerned that growth was too high and would need to be curbed by significantly higher interest rates. At the end of the year their anxieties were quite different, that growth was liable to come to an end unless interest rates were reduced. The 1/4% cut in base rates last month was an official gesture of recognition that the mood had changed. Business surveys and orders data have become steadily more pessimistic about the prospects for economic activity in early 1996. December's monthly survey from the Confederation of British Industry reported a mere 2% positive balance of companies with plans to raise output over the next four months, markedly different from the positive balances of over 25% which were common a year ago. If this news from manufacturing were not bad enough, construction orders and housing starts signal an even worse slide in output in the building industry. In recent months they have typically been running at a lower level than in 1994.

But pessimists about activity should note that real broad money growth has accelerated,

Some economists who focus on "the real economy numbers" will conclude that the slowdown is certain to become a recession. However, an alternative case can be made, emphasizing that recent monetary trends are inconsistent with a further deterioration in business conditions. A repetitive pattern in past business cycles is that, as the trough of the recession is reached, interest rates are cut, the demand for credit is stimulated and monetary growth increases. But inflation is still restrained for several quarters by the wide margin of unused resources inherited from the recession. As a result real money growth (i.e., the increase in nominal broad money adjusted for the increase in one or more of the main price indices) accelerates sharply. The economy begins to enjoy "excess real balances" (in the jargon) or, more loosely, companies and financial institutions find that they have surplus funds in their bank accounts, and they are not quite sure what to do with them. The usual sequel is upward pressure on asset prices, as companies and financial institutions try to rid themselves of the excess balances by buying shares, subsidiaries, buildings and so on. Higher asset prices boost "confidence" and stimulate spending, and the upswing begins.

which argues against a slide into recession

So real money is quite a good leading indicator of activity. At present it is rising at its fastest rate since late 1989. In the three years to end-1994 M4 rose at an annual rate of 4.2%, while inflation (as measured by the GDP deflator) was 2.9%. But in the year to November 1995 M4 went up by 9.3% and inflation on the same basis may have been 2 1/2%. Real money growth has accelerated strongly and suggests that the slowdown will not become a recession. Indeed, recent monetary trends - if sustained - imply that demand and output might again be rising at above-trend rates later this year. 1996 will see another interesting debate between monetary and real theories of the business cycle.

Professor Tim Congdon 10th January, 1996

Summary of paper on

"The internationalisation of government debt"

The purpose of the paper

The UK monetary authorities have encouraged the creation of a new gilt repo market, partly in order to increase foreign buying of gilt-edged securities. The paper reviews the global trend towards greater foreign ownership of domestic government debt and asks whether it is altogether desirable.

Main points

* **Until the early 1970s the UK's ratio of foreign-owned government debt to GDP was the highest in the industrial world. It formed part of the (alleged) problem of "the sterling balances". The Government wanted *to reduce* foreign ownership of gilts for much of the post-war period.**

* **Partly because of official discouragement of such foreign ownership, the ratio fell in the 1970s and 1980s, and is now lower than in the USA, Germany and France.**

* **The highest ratio of foreign-owned government debt to GDP is now found in Germany, where it exceeds 15%. In the 1990s the deficit on Germany's current account and direct investment has been largely covered by substantial foreign purchases of *bunds*.**

* **Arguably, the structure of Germany's balance of payments is unsustainable. Foreign ownership of government debt cannot be allowed to increase indefinitely as a share of GDP, but - when the rise in foreign ownership comes to end - the deficit on the current account and direct investment will have to be reversed.**

* **Policy-makers ought to have reservations about a high proportion of a nation's government debt being held and traded by international investors, as domestic monetary policy can become vulnerable to large swings in international financial sentiment.**

This paper was prepared by Professor Tim Congdon, with help in the preparation of the charts from Mr. Robert Miller.

The gilt repo market and the internationalisation of government debt

Does the Government want to restore the "sterling balances"? Is Germany saddling itself with a problem of the "deutschemark balances"?

Gilt repos to increase liquidity

The gilt repo market was introduced on 1st January 1996. The overriding aim of the new market is to increase the liquidity of transactions in gilt-edged securities, so that the securities become more attractive to investors and the Government can pay a somewhat lower yield. Any reduction in yields, even if very modest, is worthwhile because of the huge size of the debt. If the effect is to cut yields by only 0.05% (i.e., 5 basis points), debt servicing costs are lowered by over £150m. a year.

and thereby to stimulate foreign interest

In particular, the Government has said that it wants more foreign involvement in the gilt market. According to the official *Debt Management Review* published last July, the intention is to make the UK's new market structure similar to that already found in the USA and France. It ought therefore to appeal to the large number of institutions, banks and dealers familiar with American and French government debt. The UK Treasury may have been influenced to some extent by French experience. In 1986 the French authorities deliberately altered the organisation of their government debt market, in order to stimulate foreign buying, and over the subsequent decade international participation has increased dramatically. Indeed, the trend towards the internationalisation of government debt markets (i.e., a rising ratio of foreign-owned debt to domestically-owned debt) has been one feature of the global capital market over the last 20 years.

Paper to review internationalisation of public debt

This paper reviews the growth of public debt, in terms of both its total amount and its foreign ownership, in the major industrial economies. It also asks whether the rise in the foreign-owned share is always and everywhere desirable. There are in fact important arguments against the internationalisation of public debt ownership, particularly if governments want the state of their domestic economies to be the dominant concern in monetary policy-making.

In Bretton Woods era the USA and the UK had two largest *international* markets in government debt

The starting-point for the review of international public debt ownership is the immediate post-war period. As agreed at the Bretton Woods conference, the two reserve currencies were the dollar and the pound sterling. Only the USA and the UK were deemed able to perform a reserve-currency role, because they had the world's two largest and most liquid markets in both government debt and money market instruments, as well as the two highest national products in the non-communist world. The central banks of other countries had long been accustomed to holding their foreign exchange reserves in New York and London. These reserves took the form of claims on the two key countries' governments or banking systems. The countries defeated in the Second World War (Germany, Japan, Italy and, in a sense, France) had little government debt, because the real value of government securities had been wiped out by rapid inflations in the war's final years and its immediate aftermath. Foreign ownership of these nations' public debt was negligible.

Countries defeated in 1945 had little foreign debt ownership

In the first 25 years from 1945 the nations defeated in the Second World War typically ran small budget deficits or surpluses, while their output grew at historically unprecedented rates. So their ratios of government debt to GDP generally remained low and less than in the USA or the UK. (But Italy had already become rather exceptional in these comparisons. The ratio of central government debt to GDP in 1970 was 7.0% in Germany, 6.8% in Japan and 12.6% in France, but it was 32.9% in Italy. By contrast, it was 29.3% in the USA and 52.9% in the UK. See OECD Working Paper *The role of the public sector*, 1983.) Much of the public debt was held by domestic banking systems as cash reserve assets or allocated, as a particularly safe asset, to insurance companies. Not surprisingly, the governments of Germany, Japan and France were indifferent to foreign interest in their debt issues, which was in any case minimal. For example, in 1970 only 1.2% of German public sector debt was held by foreigners, while France did not take the trouble to publish official statistics on foreign ownership of its government debt.

UK had difficulty in performing reserve currency role

The USA had no difficulty in performing a reserve-currency role. Throughout the 1950s and 1960s its economy was much larger than that of all of Europe, and by 1969 the foreign-held share of the US Treasury's gross public debt was down to a mere 2.8% (i.e., under 1% of GDP). The UK's position was quite different. Its share of world output declined abruptly, but its government still had substantial external debts. These had been incurred when its own economy was bigger relative to the rest of the world, much of it between 1939 and 1945 to secure the resources to fight a war which it had won. But precisely because it had won that war it had, unlike the defeated countries, to make an effort to repay the money in real terms.

and tried to unwind the sterling balances

As late as 1957 fairly liquid overseas sterling liabilities (the famous "sterling balances") amounted to 22% of national income and nearly 90% of exports. Policy-makers were obsessed by the sterling balances because a small current account deficit could provoke a capital account outflow many times larger. They regarded the threat to sterling, and so to the control of inflation, as a major policy problem. Although the UK did earn a worthwhile cumulative current account surplus in the first 25 years after the War, and although the debt became easier to service because of the increase in the national product, still in the late 1960s and early 1970s the UK had far more significant foreign involvement in its government debt market than any other country. At the end of March 1970 the national debt was £30,847m. and foreign ownership amounted to £5,253m. or 17.0% of the total (i.e., almost 10% of GDP).

Since end of Bretton Woods system a complete change in pattern

Since 1970 the pattern of foreign ownership of domestic government debt has changed almost beyond recognition. Two main forces have been responsible. First, the countries defeated in 1945 have been unable to sustain the admirable control of public debt recorded in the following 25 years, while the UK has - more or less, and with some ups and downs - held the ratio of public debt to

GDP stable. At the end of 1994 the ratio of the general government's gross financial liabilities to GDP was higher in Japan (81.7%), Germany (54.6%) and France (56.8%) than in the UK (51.6%). (In the USA the ratio was 63.2%, while Italy had moved into a different league with 122.6%. See Annex Table 34 in the June 1995 issue of the OECD's *Economic Outlook* for more details.)

UK gilt market no longer of great importance to international investors

Secondly, whereas most governments have been happy to welcome international buying of their debt, the UK tried in the 1970s to persuade foreigners not to buy its debt and for much of the late 1980s was not much bothered about their attitudes anyway because it was running a budget surplus. The result is that the ratio of foreign-owned debt to total public debt has increased sharply in Germany and France and moderately in the USA, but in the UK is much the same today as it was in the 1960s. *In 1970 the foreign-owned ratio was higher in the UK than in any other of the G7 leading industrial countries; in 1995 it was lower than in the USA, Germany, France and Canada, and not much higher than in Italy.* (See the charts on p. 7, p. 8, p. 10 and p. 12.)

In 1970s UK authorities actively *discouraged* foreign holding of gilts

Indeed, the UK Government's current enthusiasm for foreign involvement in the gilt market is a remarkable somersault from its position in the 1960s and 1970s. At that time it wanted *to reduce* foreign ownership of UK gilts, in order to limit the vulnerability of British macroeconomic policy to fluctuations in international sentiment. In 1968 it reached an agreement with the Bank for International Settlements in Basle that rapid withdrawals of sterling balances could be countered by equivalent borrowing from the BIS to sustain the UK's foreign exchange reserves. A further similar agreement, with a $3,000m. standby facility, was reached in 1977, with the Prime Minister, Mr. James (now Lord) Callaghan, who described the sterling balances as "this millstone around our necks". The Bank of England was at that time making representations to foreign central banks to dissuade them from holding their foreign exchange reserves in the form of claims on the UK Government and banking system.

Somersault in official attitudes a little puzzling

Today, by contrast, the Government is taking steps *to stimulate* foreign ownership of UK gilts and the Bank of England is extending a warm welcome to foreign securities houses that sell gilts to foreign institutions. Have the Government and the Bank forgotten that less than 20 years ago they had exactly the opposite intention? To ask this question is not to say that either the active discouragement of foreign participation in the gilt market in the past or the deliberate encouragement at present is misconceived. Both approaches might be defended given the circumstances of the time. But at least the extremity of the swings in official attitude ought to make policy-makers pause. Are they really doing the right thing? Is it possible - given their preferences in the quite recent historical past - that they are making a mistake?

The answer depends in part on the international investors' motives for holding gilts. By the mid-1970s the steps taken by British officialdom to reduce the extent of foreign ownership were in fact rather bizarre, as the sterling balances (i.e., gilts, Treasury bills and money market instruments in overseas hands) had already dwindled into relative insignificance. Moreover, their character had changed. In the late 1940s and 1950s the sterling balances were held predominantly by official bodies, such as governments and central banks. Even at the end of 1962, when the balances were 14.9% of GDP (at current factor cost), official monetary organisations accounted for 8.9% of this and other holders 6.0%.

In mid-1970s foreign holdings of gilts quite low as share of GDP, but somewhat higher today

But by early 1977 the sterling balances were only 5% of GDP and holdings by foreign central banks and governments were roughly the same (at about 2 1/2% of GDP) as holdings by others. Thereafter foreign central banks and governments reduced the proportion of their assets in sterling, although their sterling assets continued to increase in absolute amount and even compared with the UK's GDP. Other investors increased quite rapidly their sterling deposits and (to a lesser degree) their holdings of gilt-edged securities. (See the chart on p. 9.) Today foreign non-official claims on the UK government and banking system are almost 15% of GDP, while foreign official claims are a little over 4% of GDP.

In 1950s Germany against high foreign ownership of its government debt, but this now almost 50% of central government debt

While the motives of the UK authorities can be discussed and perhaps criticised, the activities of the German government and the Bundesbank raise even more fascinating long-term policy issues. The Germans avoided government debt issuance after 1945, particularly debt issuance to foreigners, largely for historical reasons. They had bad memories of large American capital inflows in the 1920s being abruptly reversed in 1929 and the early 1930s, leading to depression, Hitler's accession to power and the sequel. But since 1970 German public sector debt has risen from under 10% of GDP to almost 60% of GDP. Even worse, the foreign-owned share of this debt has increased more rapidly than domestic. Foreigners now hold almost half of German central government debt (i.e., *bunds*).

and the structure of the balance of payments is unsustainable

An argument could be made that the structure of Germany's balance of payments is unsustainable. Since re-unification German has consistently run a current account deficit, typically of between 20b. and 35b. DM or almost 1% of GDP. Moreover, it has had a deficit on direct investment (i.e., claims on physical capital) of similar size, as German companies relocate their production to lower-cost centres. The deficit on the so-called "basic balance" (i.e., the combination of the current account and direct investment account) has averaged about 2% of GDP over the last five years.

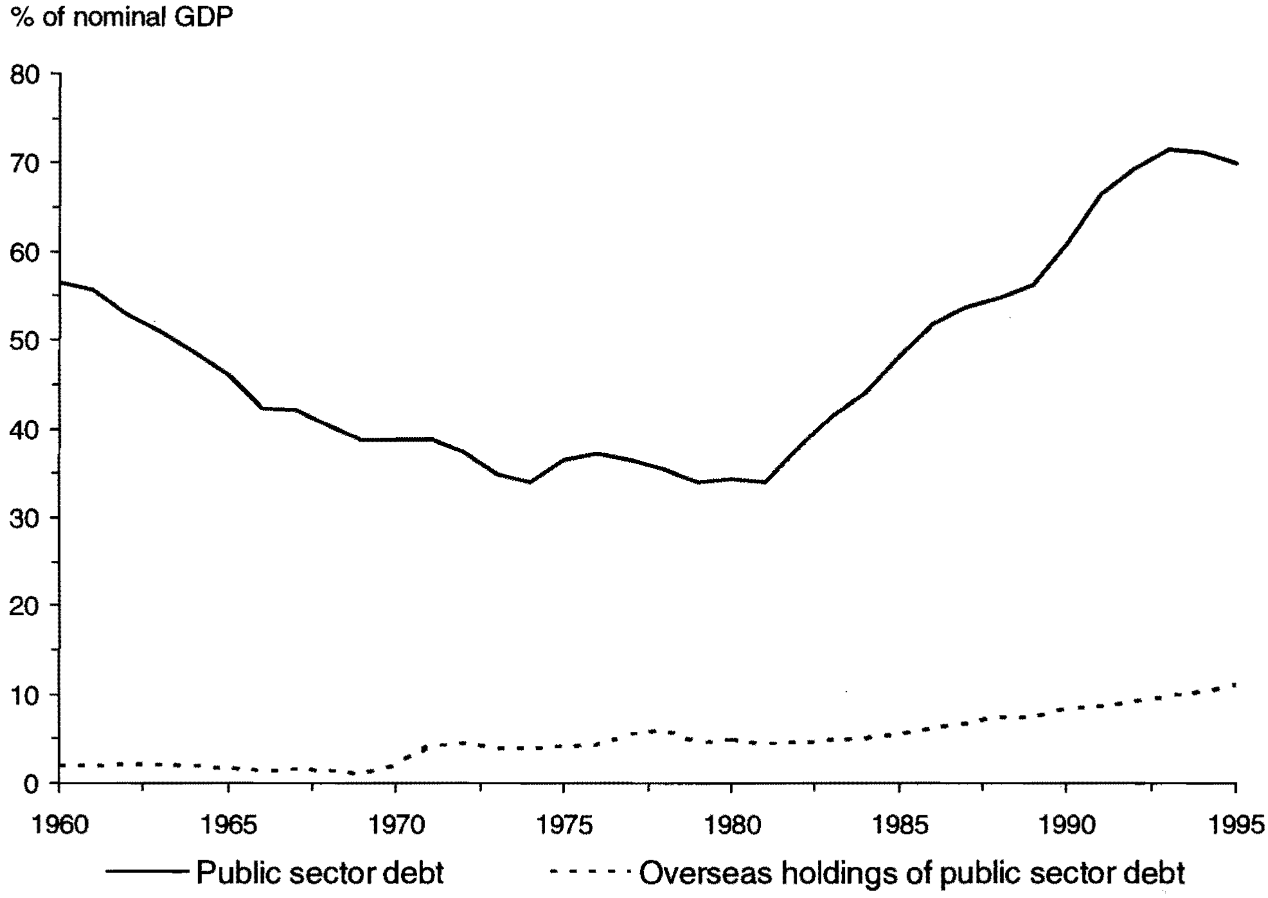
Could financial markets start to worry about the "deutschemark balances"?

This hole has been filled by massive foreign buying of *bunds* and other net capital inflows, some of them very short-term in nature. Are the claims that foreigners are now accumulating against the German government and banking system similar to the "sterling balances" which were (allegedly) such a problem for the UK in the 1950s and 1960s? As Germany's demographic situation deteriorates over the next 20 years, will financial markets become alarmed about the excessive "deutschemark balances"? Is the internationalisation of government debt really such a Good Thing?

Debt/GDP ratio in the USA

Debt remains predominantly in domestic hands

Chart shows the gross public debt of the U.S. Treasury and foreign holdings of gross public debt as a share of nominal GDP at market prices.



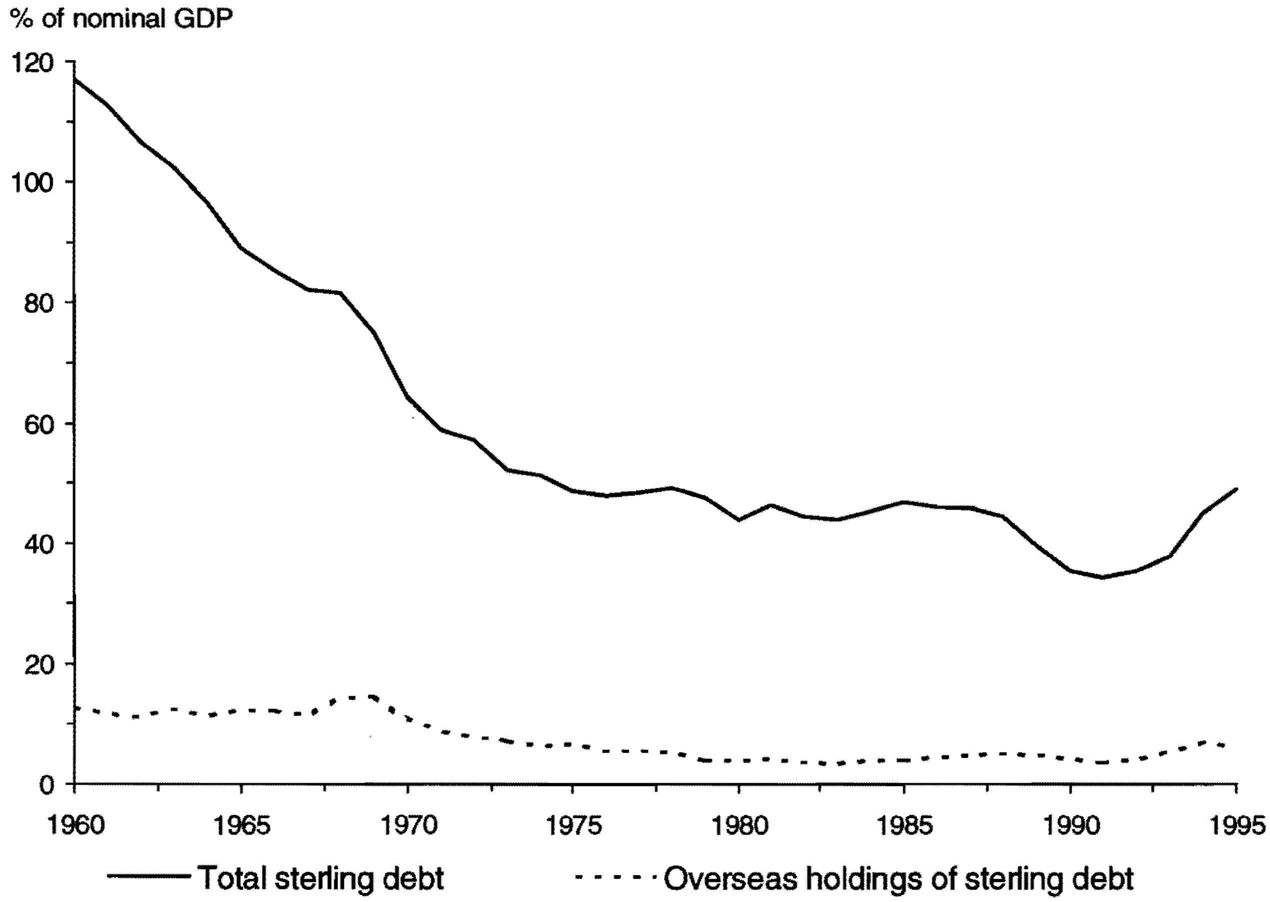
Source: Federal Reserve Bulletin.

As a proportion of nominal GDP, the gross public debt of the U.S. Treasury was on a downward trend throughout the 1960s and 1970s, falling from 56.5% in 1960 to 34% by 1979 and 33.9% by 1981. Following the tax-cutting policies of the Reagan administration after 1981, however, debt grew rapidly as a proportion of GDP as insufficient control was maintained over government expenditure. By 1988 the debt/GDP ratio at 55% had returned to its level of the early 1960s and by 1993 it had reached 71.5%. The ratio could stabilise at its current level, or even fall, if recent budget negotiations between Congress and the President are successful. Foreign holdings of debt were negligible until the early 1970s, averaging 1.8% of GDP between 1960 and 1971. Since then this ratio has risen steadily, reaching 4.8% by 1979 and 11.0% by 1995, reflecting the dollar's role as a reserve currency.

Debt/GDP ratio in the UK

Dwindling importance of foreign holders since the 1960s

Chart shows total sterling national debt (including official holdings) and overseas residents holdings of the sterling national debt as a share of nominal GDP at market prices. Data refer to position at end-March each year. Changes in definition and coverage mean that pre-1970 data are not strictly comparable.



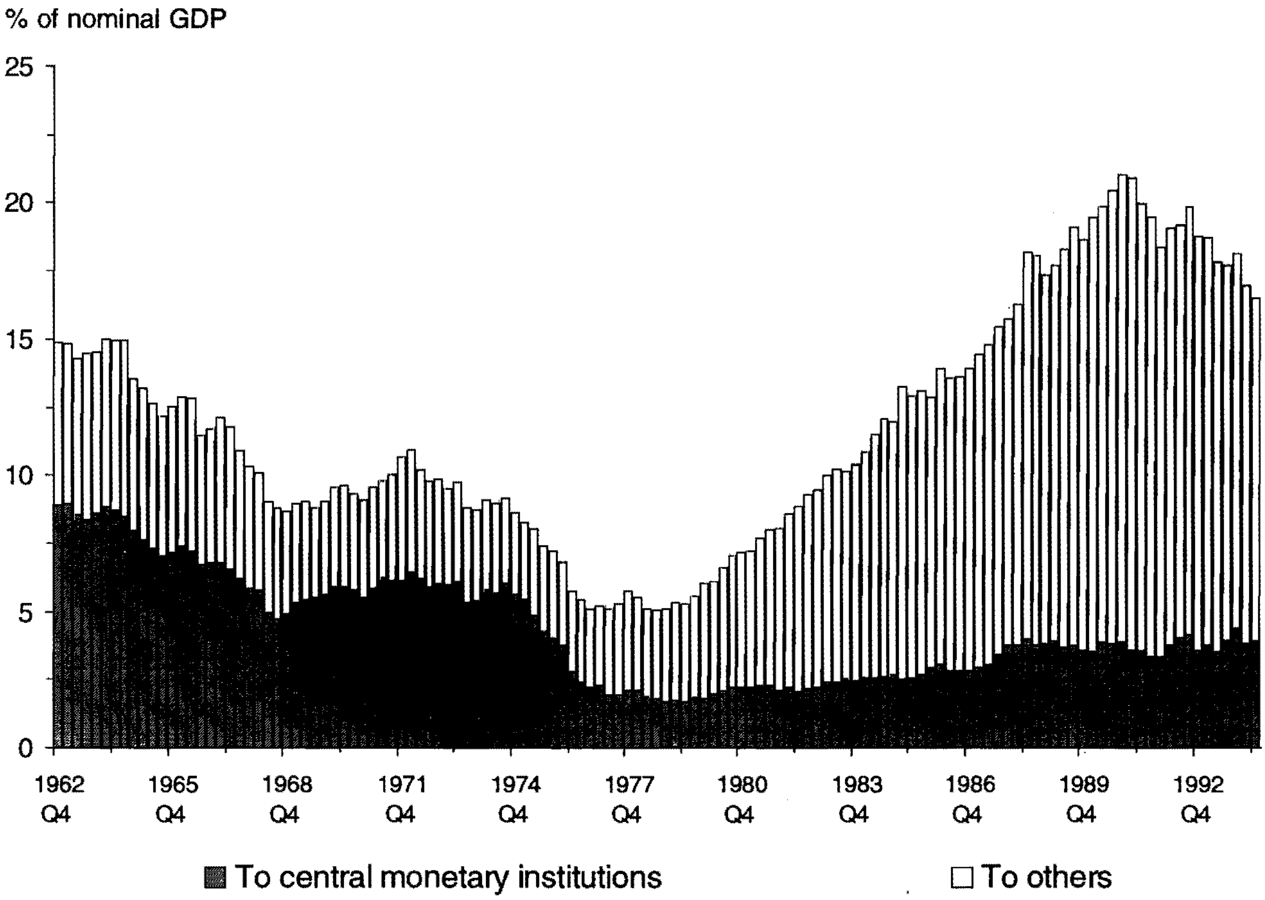
Sources: 1970-1995:Bank of England Statistical Abstract 1995; *1960-69: Bank of England* Quarterly Bulletin *articles on "Distribution of the sterling national debt."*

At the start of the 1960s total sterling debt outstanding amounted to 117% of nominal GDP, largely due to debt incurred between 1939 and 1945. This ratio fell rapidly during the 1960s and early 1970s and by 1976 had reached 47.8%, due mainly to the impact of high inflation on the value of debt outstanding. The ratio has been held broadly stable since the early 1980s at around 45%-50%, apart from the late 1980s when surpluses brought about a reduction in debt outstanding. Currently the sterling debt/GDP ratio stands at just under 49% and, on the basis of projections in the *1996/97 Financial Statement and Budget Report*, is already at its peak. Official hostility to overseas holdings of sterling debt saw its ratio to GDP fall from 14.5% in 1969 to 5.4% by 1978. Recent steps to encourage foreign ownership of gilts could see this ratio rise above its current 6.1%.

Sterling balances no longer a problem?

Foreign official holdings decline sharply relative to GDP

Chart shows ratio of the "sterling balances" to GDP at current factor cost. Sterling balances consist of, first, sterling exchange reserves held by central monetary institutions and international institutions (i.e., gilts and banking and money market liabilities) and, secondly, banking and m.m. liabilities to other holders.



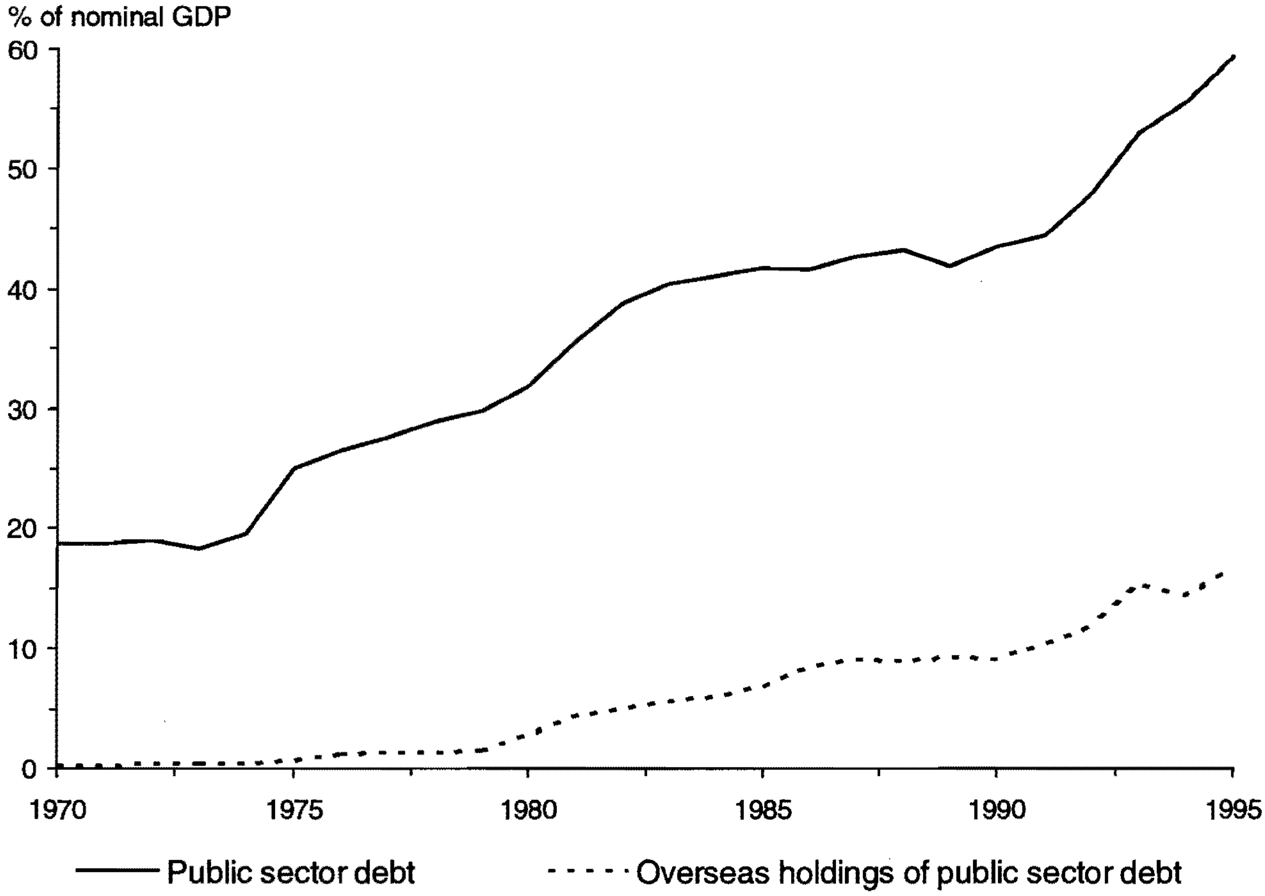
Source: CSO Financial Statistics.

In order to counter the impact of changes in foreign investor sentiment on the exchange rate, the Government tried in the 1960s to persuade overseas investors not to hold UK government debt. As a consequence, the ratio of "sterling balances" to GDP fell throughout the 1960s and first half of the 1970s. By the mid-1970 the "sterling balances" had fallen to around 5% of GDP, with holdings divided roughly equally between foreign central banks and other foreign investors. Official overseas sterling claims on the UK have remained relatively stable since at between 3% and 4% of GDP. Foreign non-official claims currently stand at around 15% of GDP. The government's new-found enthusiasm for foreign participation in the gilts market, stated in the July 1995 *Debt Management Review*, raises the question of which group of investors are to be targetted. Non-official foreign holdings of gilts, for example, could be seen as being more volatile than official holdings.

Debt/GDP ratio in Germany

Is Germany burdening itself with "the deutschemark balances"?

Chart shows total public sector debt and foreign holdings of public sector debt as a share of nominal GDP at market prices.



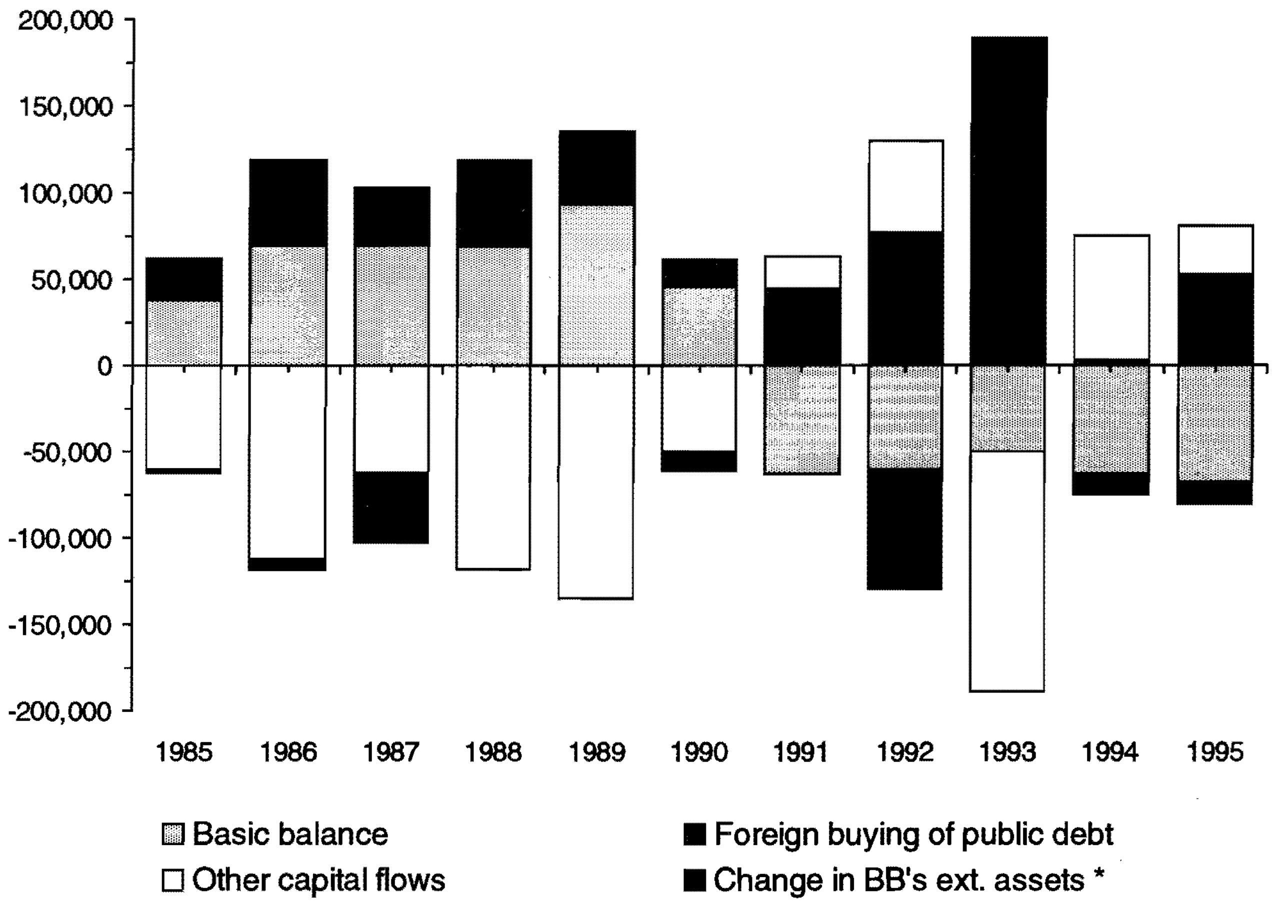
Source: Deutsche Bundesbank Monthly Report.

German public sector debt has tripled as a proportion of GDP since 1970, rising from 18.6% to 55.6% in 1994. Reunification in 1991 in particular has had a significant impact on the debt/GDP ratio. Between 1980 and 1990, the ratio was on a rising trend, climbing to be almost 45%. However, following reunification, the debt/GDP ratio grew rapidly from 44.3% at the end of 1991 to around 59.0% in 1995. Overseas holdings of German public sector debt were negligible until the late 1970s. Between 1980 and 1989, however, the ratio of non-resident holdings of public debt to GDP grew from 2.8% to 9.2%. A consistent deficit on the balance of payments since reunification, with a deficit on direct investment as German firms have relocated to lower-cost countries, has seen foreign holdings of public debt rise further. Between 1990 and 1995, foreign holdings have risen from 9.1% to 16.5% of GDP.

Germany's growing dependence on "hot money"

Deficit on "basic balance" covered by foreign bond purchases

Chart shows four items in the balance of payments - the "basic balance" (sum of current account and direct investment flows), foreign purchases of public debt, capital flows excluding direct flows and public debt purchases, and net change in Bundesbank's external assets. All figures in m. of DM.



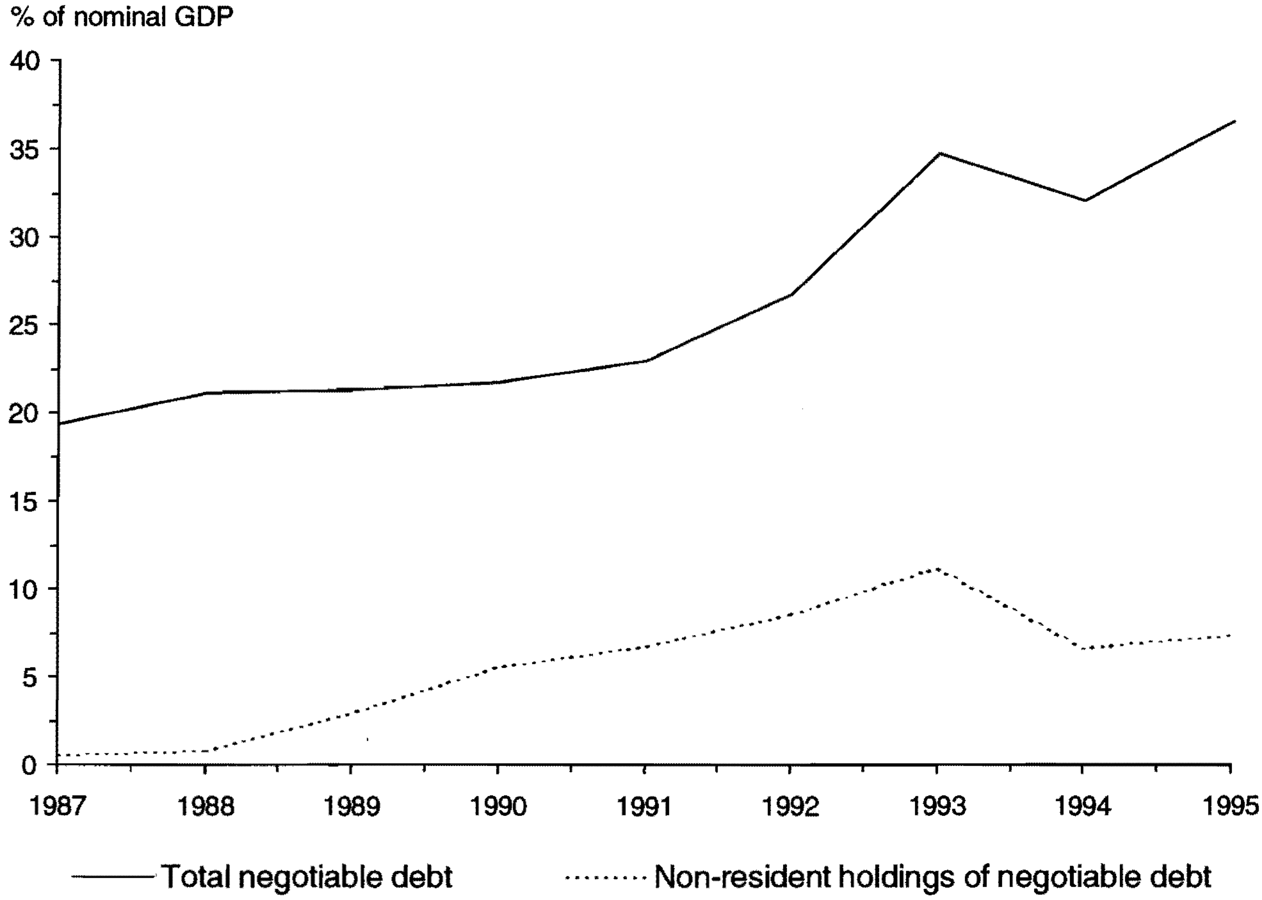
*1995 is Lombard Street Research estimate, based on first three quarters. * 'Minus' sign indicates increase*

During the second half of the 1980s Germany consistently recorded a surplus on the "basic balance" - i.e., the sum of the current account balance and direct investment - and it averaged over 60b. DM a year. Foreign buying of public debt averaged around 26.5b. DM a year between 1985 and 1990. This picture changed markedly after reunification in 1991. The "basic balance" has recorded a consistent deficit, averaging 60.6b. DM between 1991 and 1995. Foreign purchases of public debt grew rapidly, contributing to the DM's strength, and were particularly strong in 1992 and 1993 at 76.5b. DM and 153.4b. DM respectively. Such heavy reliance on overseas funding raises the possibility of the deutschemark becoming a hostage to sharp swings in international investor sentiment, as with sterling in the 1950s and 1960s.

Debt/GDP ratio in France

Dramatic increase in foreign interest since 1987

Chart shows negotiable government debt and non-resident holdings of negotiable government debt as a share of nominal GDP at market prices.



Sources: Bank of France Bulletin *and Bank of France Balance of Payments Department.*

The ratio of negotiable debt to GDP for France has risen steadily since 1987, from 19.4% to around 37% at the end of 1995. Before 1987 non-resident holdings of negotiable government debt were negligible, at less than 1% of GDP. However, during the second half of the 1980s the domestic bond market was restructured in order to encourage foreign investment. Most notably, withholding tax on on government bonds for non-residents was abolished in 1984, while foreign exchange controls were lifted in 1987. Between 1988 and 1993 the ratio of non-resident holdings of negotiable debt to GDP had risen from 0.9% to 11.2%, at which point foreigners held almost one third of all debt. The bond market crash of 1994 saw a significant reduction in non-resident holdings of debt to 6.7% of GDP and the ratio rose only marginally, to around 7.3%, in 1995. This highlights the vulnerability of internationalised government debt markets to swings in sentiment.