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GERRARD

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The same old gramophone record

Excess capital in banking system driving higher money growth

Banks making good profits and now keen to expand,

The British banking system has made a complete recovery from the recession of the early 1990s. Last year the pre-tax profits of the eight large UK-owned, UK-focussed banks (i.e., the members of the British Bankers' Association, excluding Standard Chartered and adjusting for the overseas activities of the HSBC Group) probably exceeded £9b. and may have approached £9 1/2b. The profits total was an all-time record and well ahead of the £8b. achieved in 1994. After paying tax and dividends, retained profit may have been about £3 1/2b. As their combined equity at the end of 1994 was just over £29b., the effect of these retentions will be to boost equity capital by over 10%. By contrast, in 1991 and 1992 their retentions were virtually zero and their equity capital was static.

The results of the contrast in banks' capital position have been altogether logical and wholly predictable. Whereas in the early 1990s, British banks wanted to shed assets and to restrict balance-sheet growth, they are now trying to expand. If they cannot increase their assets, their capital/asset ratios will rise to unnecessarily high levels and opportunities to boost their return on capital will be missed. The mortgage market has gone "ex- growth", because the great British public has a higher ratio of mortgage debt to the value of the houses it owns than ever before. (Chancellors Lamont and Clarke have made also mortgage borrowing much less tax-efficient than in the past.) As mortgages represent almost half of UK banks' and building societies' total loan portfolio, and as the stock of mortgage debt is increasing at less than 5% a year, there has been ferocious competition for new business in all areas of non-mortgage credit.

leading to increased deal-making activity

(Only if non-mortgage credit grows at 15% a year can the capital/asset ratio be prevented from rising.) Margins in the syndicated loan market have collapsed, while banks are tumbling over themselves to finance new corporate deals of various kinds, including large takeovers.

As banks' deal aversion in the early 1990s has been replaced by the deal mania of today, companies have stopped being net repayers of bank debt and are instead becoming quite heavy borrowers. Lending to the private sector is growing at about 10% a year, and so also are banks' and building societies'

and unacceptably high monetary growth

deposit liabilities (i.e., the M4 measure of broad money). As at similar phases of past credit cycles, the excess money holdings are being concentrated in the financial sector, not the personal sector, and a number of commentators are saying "it doesn't matter". It may be an old gramophone record, but the tiresome message has to be repeated. In the long run 10% broad money growth cannot be reconciled with inflation of 2 1/2% or less.

Professor Tim Congdon

7th February, 1996

Summary of paper on

"Are money trends consistent with world recovery in 1996?"

Purpose of the paper

A reasonable generalisation, based on past experience in a large number of countries, is that changes in real broad money precede (or are associated with) changes in output two or three quarters later (concurrently). The purpose of the paper - which is similar in format to research papers in the *Gerrard & National Monthly Economic Review* of January 1993, January 1994 and January 1995 - is to assess the prospects for the world economy in 1996 and early 1997, in the light of this relationship.

Main points

* **Real broad money growth increased in the G7 last year, for the first time since 1989. If the upturn in real broad money growth is sustained, the current slowdown in world economic activity is unlikely to persist.**

* **Instead the upturn in G7 real broad money growth points to a return to trend or above-trend growth later this year and on into 1997. The current slowdown in activity has been partly attributable to the stocks cycle, but this should work its way out of the world's main economies in the next few quarters.**

* **The upturn in real broad money growth has been concentrated in the USA, the UK and (to a lesser extent) Japan. In Europe monetary growth is still extremely low (see p. 5), although this may be beginning to change and monetary policy will undoubtedly be relaxed further.**

* **The upturn in monetary growth can be largely ascribed to the improved capital position of the banking systems in the English-speaking countries. As the Japanese monetary authorities also took action in 1995 to bolster their banks' capital, the global change in credit and monetary trends will probably last for another year or two at least.**

* **The fall in German broad money growth last year has been widely noted. But even more remarkable in 1995 was the stagnation of broad money in Italy, despite the problems of refinancing its enormous public debt. (See p. 10.)**

This paper was prepared by Professor Tim Congdon, with help in the preparation of the charts from Mr. Gabriel Stein and Mr. Brendan Baker.

Are money trends consistent with a world recovery in 1996?

Pessimism about growth prospects not justified by global money supply

World slowdown in late 1995 not a surprise, in view of slow money growth,

Late 1995 saw a marked slowdown in world economic activity. This came as a surprise to many commentators, including forecasters at the leading supra-national organizations such as the Organisation of Economic Cooperation and Development (or OECD) and the International Monetary Fund. However, it was a logical consequence of rather weak broad money growth in several leading economies during 1994 and early 1995. An analysis of G7 money supply trends, published in the January 1995 *Gerrard & National Monthly Economic Review* (which followed similar work in this *Review* in January 1993 and January 1994), identified "two key messages". First, real broad money growth remained very slow, which would be "inconsistent with a global boom in 1995 and 1996". Secondly, since nominal money growth was "barely above the long-run rate of growth" of output of goods and services, the medium-term prospects for inflation remained "excellent". In retrospect, these two messages may seem rather obvious and banal. But - in fact - they challenged the consensus when they were written. (Early last year many economists expected 1995 and 1996 to be years of above-trend growth and rising inflation worldwide.)

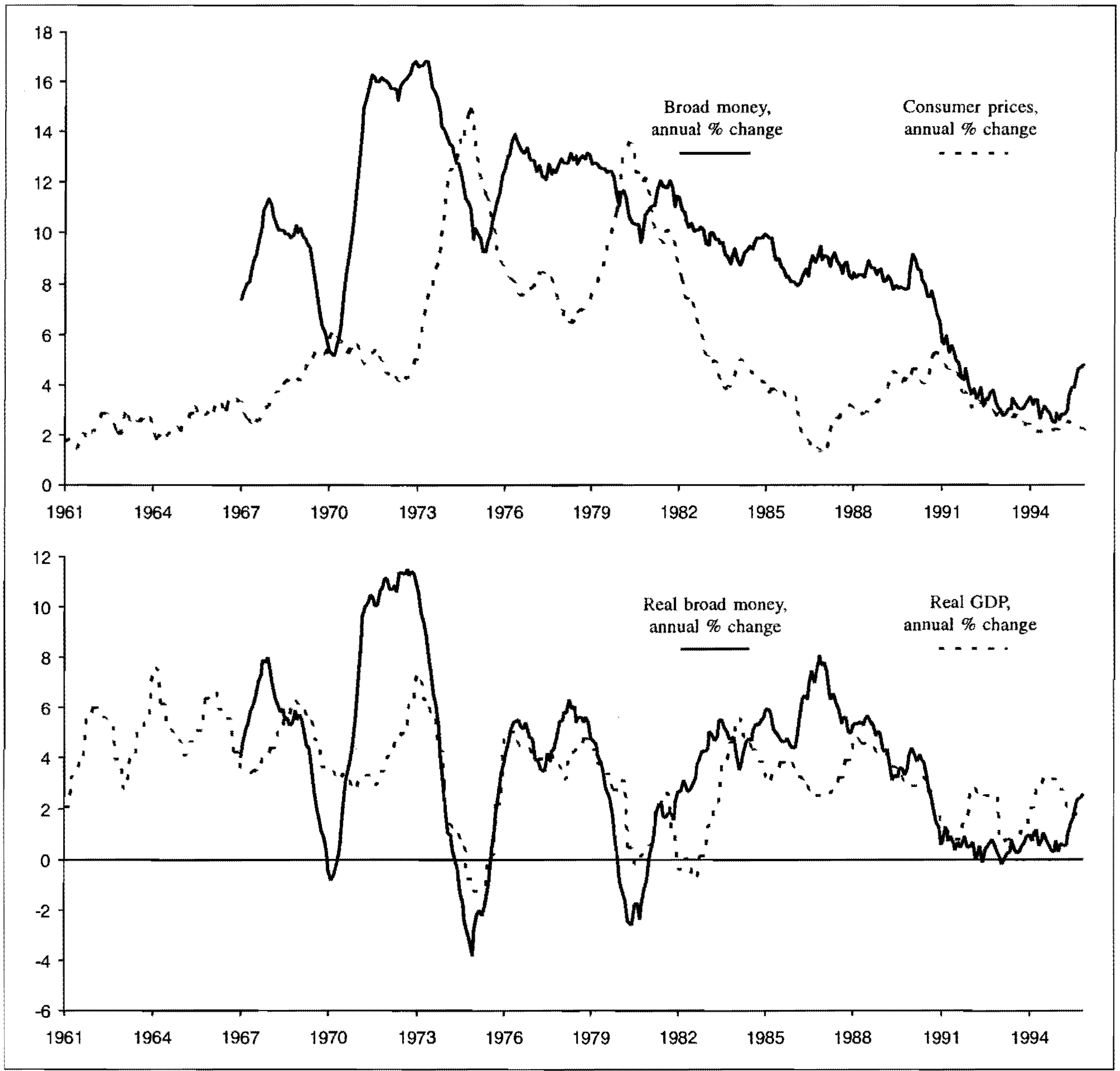
but broad money growth now accelerating in the USA and the UK,

What are the implications of the same sort of work updated to the present? The most important is that the slowdown will prove temporary. Real broad money growth across the G7 revived last year, with boosts coming particularly from the USA (where nominal M3 increased by 6%, compared with under 2% in the preceding five years, see p. 6) and the UK (where nominal M4 jumped by 10%). Sceptics might wonder whether the upturn in US broad money growth is significant, since it coincided with a deceleration in narrow money growth later in the year. But the historical record suggests that a slide into recession in the USA is now most unlikely. The upturns in monetary growth in both the USA and the UK could be represented as the result of common influences in both countries, notably the eagerness of increasingly well-capitalised banks to finance take-overs and other corporate deals. At least partly in consequence, share prices are at or close to all-time peaks.

and will probably recover in Europe

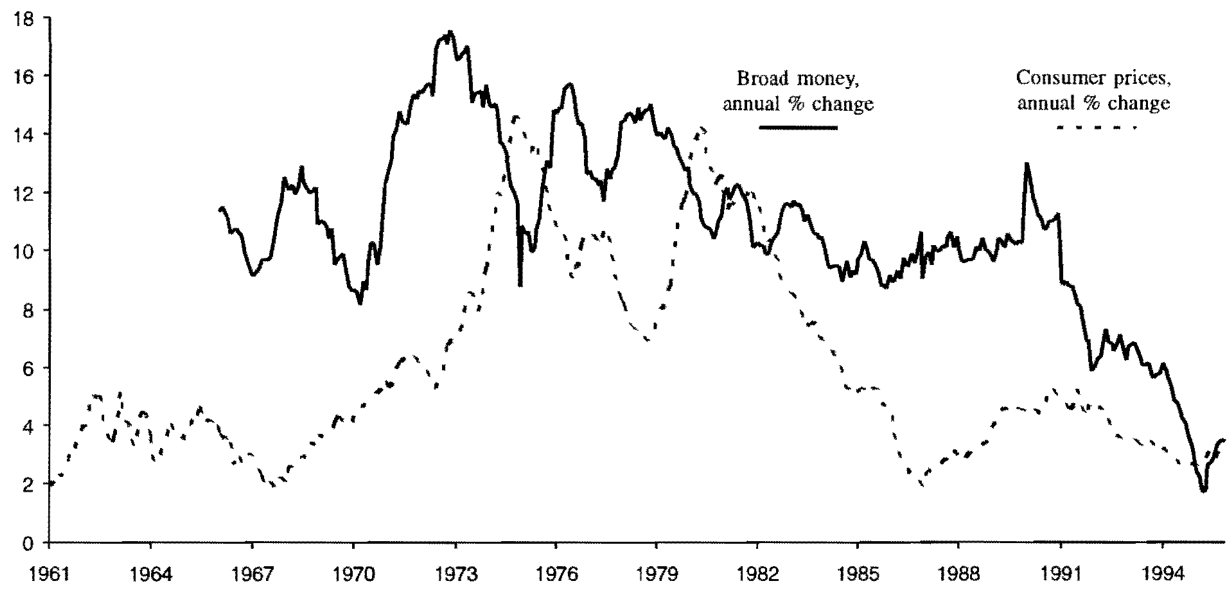
Of course, much depends on policy from now on. Monetary growth is weakest on the continent of Europe, as broad money was virtually static last year in Germany and Italy. The tightness of German monetary policy has been widely remarked and criticised, and the Bundesbank will no doubt relax policy further over the next few months. Less noticed, but even more remarkable, is the collapse in monetary growth in Italy (see p. 10), which is also an element in the present European recession. This collapse is startling, in view of the continuing strain in Italy's public finances, and goes some way to dispel fears that the budget deficit will have to be monetised.

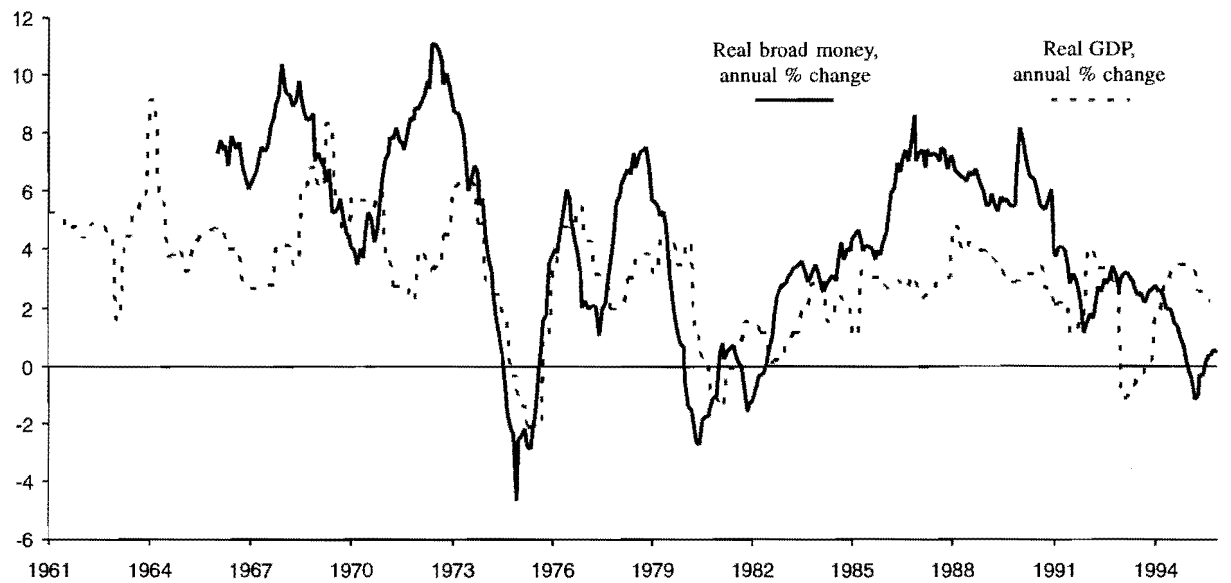
Group of Seven



The lower chart is fascinating. It shows that the four periods of relatively buoyant economic activity since the mid-1960s (i.e., 1968, 1972 and 1973, 1976 to 1979, and 1983 to 1988) were preceded by or associated with high growth in real broad money. Admittedly, the correspondence is not outstandingly close, but the general pattern stands. At present real broad money growth appears to be reviving, after a long period of stagnation in the early 1990s. The conclusion has to be that the current sluggishness in world economic activity is only a passing phase. Late 1996 and 1997 will see a return to trend or even above-trend growth, while inflation remains subdued. Nevertheless, there is a marked contrast between, on the one hand, negative real money growth in Germany and Italy, and, on the other, accelerating real money growth in the USA, the UK and to a lesser extent Japan.

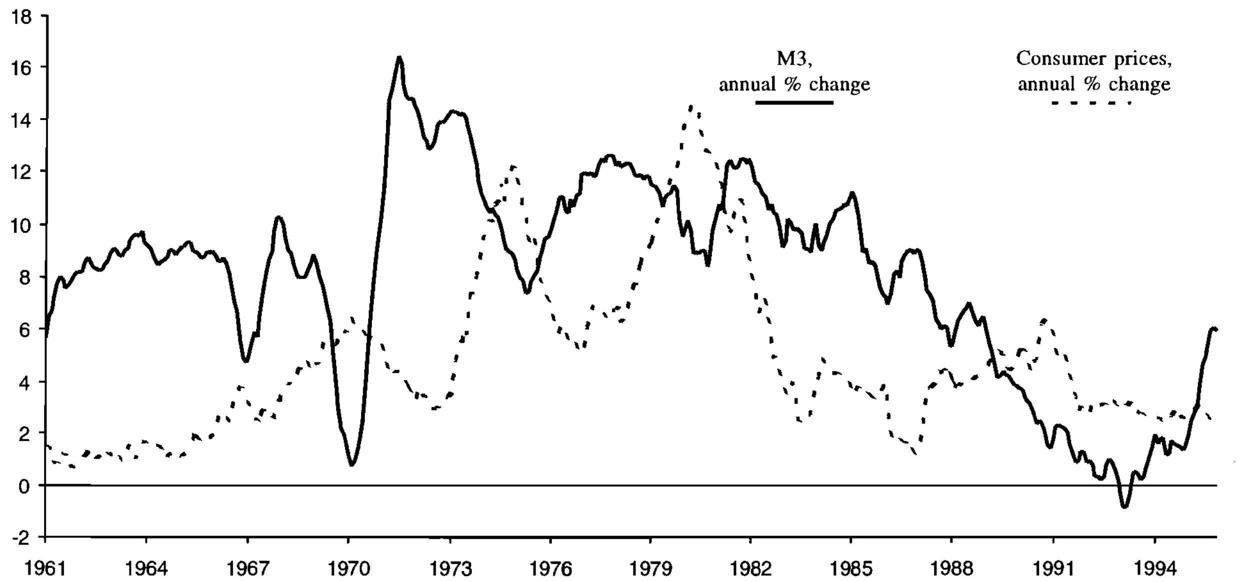
Europe – Major Four Economies

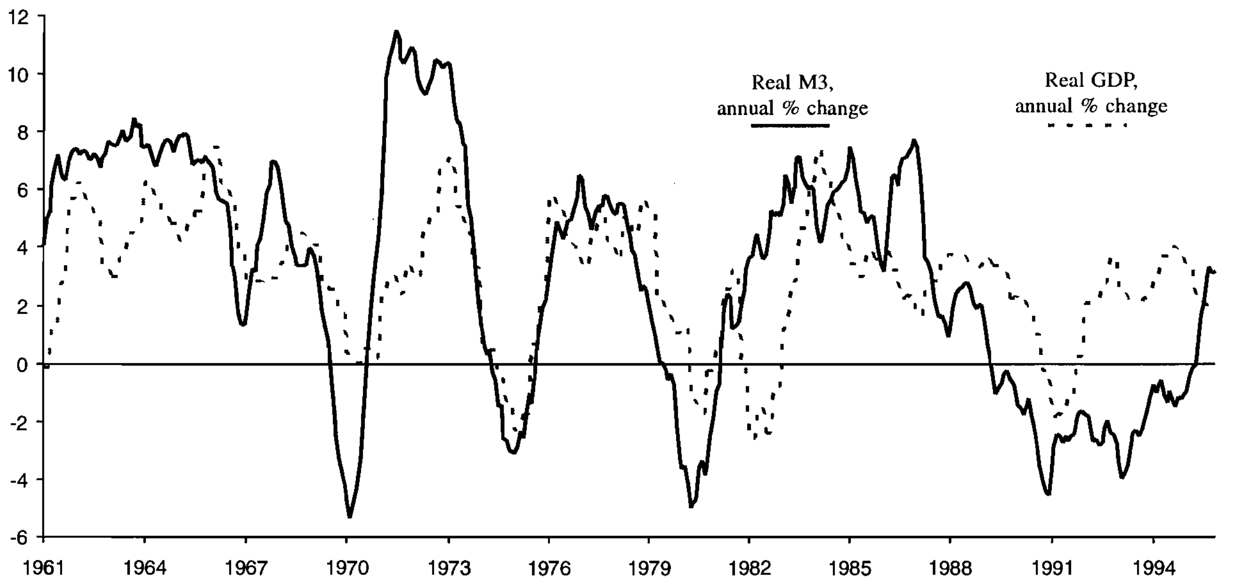




Apart from a spike upwards in the late 1980s (almost entirely due to monetary excesses of the UK), broad money growth has been on an underlying downward trend in the four large European economies since the boom of the early 1970s.As a result, inflation has also been in decline and is now back to the levels achieved in the 1960s. The charts show that the deceleration in nominal monetary growth was particularly sharp in the early 1990s. In accordance with the usual cyclical pattern, inflation did not respond quickly enough and real broad money growth fell. The result was a sequence of recessions, which hit different countries at different times, depending on their own particular circumstances, exchange rate movements and so on. The main message of the lower chart is that Europe will be slow to climb out of its current recession, with the UK leading its neighbours. (See p. 11 for UK details.)

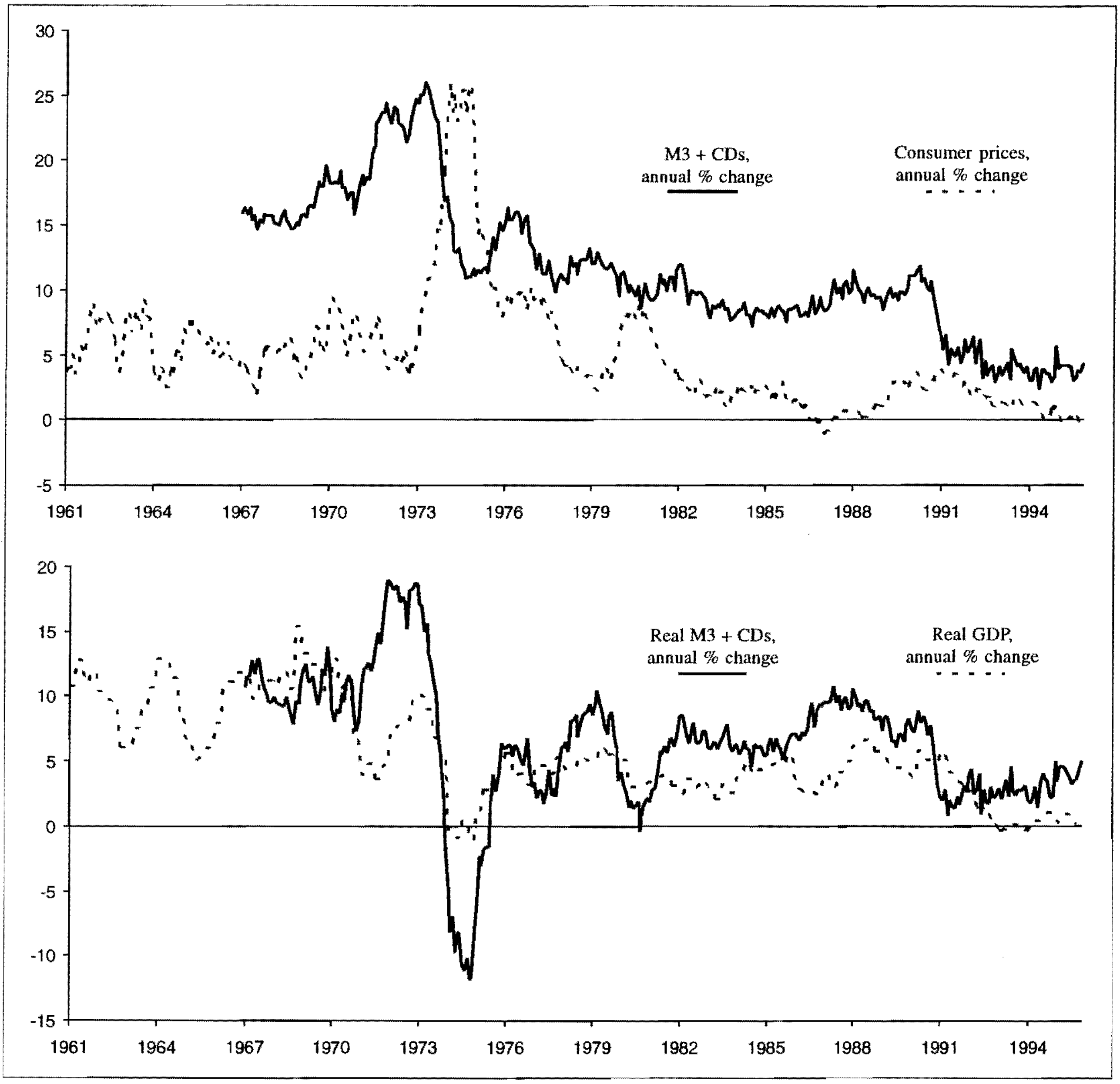
United States





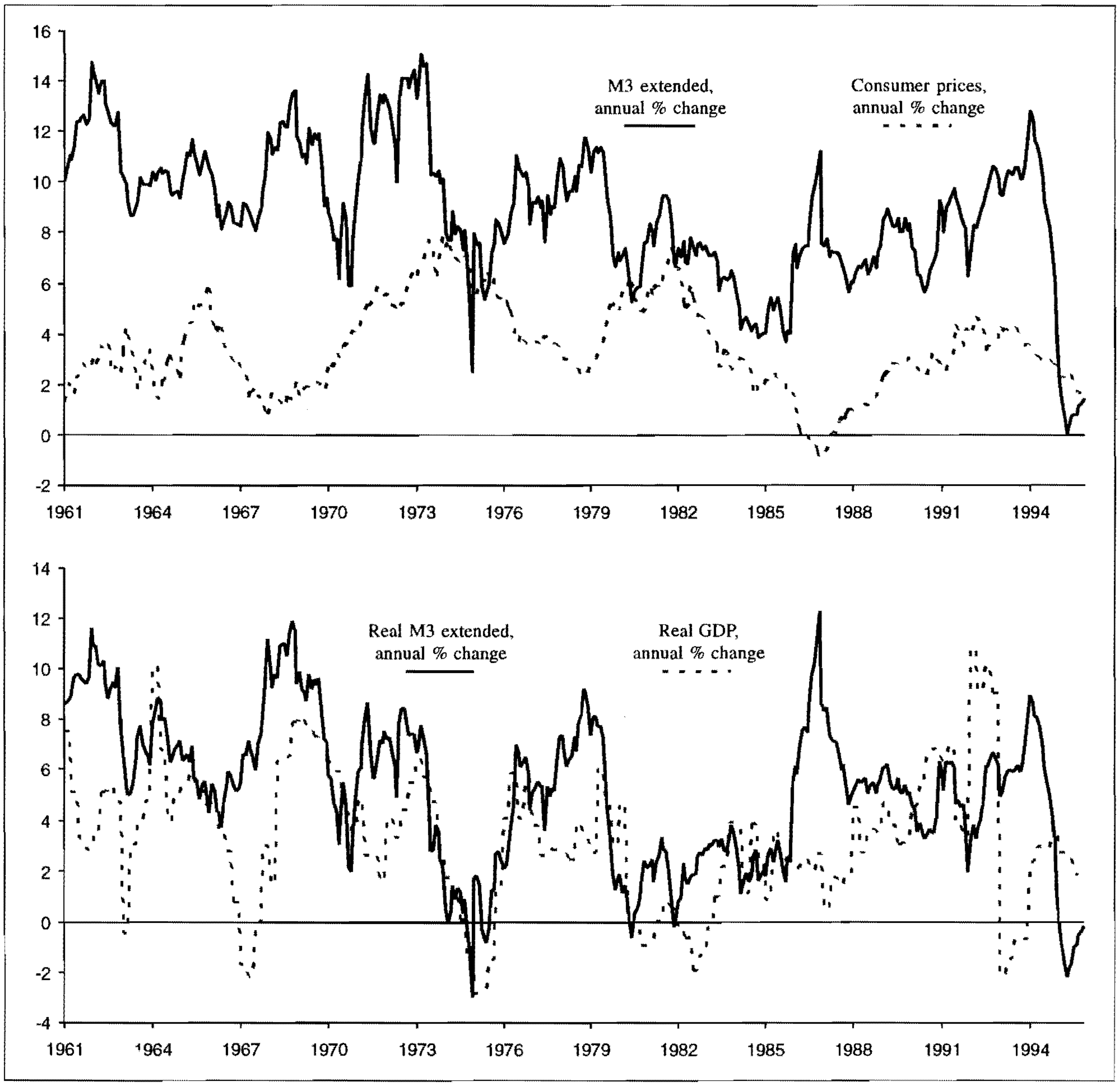
Broad money growth in the USA has accelerated in recent quarters. Whereas M3 was barely growing at all for most of the early 1990s, it increased by about 6% in 1995. (Indeed, for a few months in mid-1995 it was growing at an annualised rate almost into double digits.) The acceleration is logical, in view of the over-capitalisation of the American banking system and its renewed eagerness to expand. The M3 measure might be criticised, on the grounds that it includes large time deposits issued by all depository institutions (not just banks) and Eurodollar deposits. Most analysts prefer the M2 measure which grew by under 5% in 1995. But even M2 growth was higher in 1995 than in 1993 and 1994. The key message is that the current slowdown in US economic activity will prove transient and some data, affected by the weather, may be giving a misleading impression of weakness.

Japan



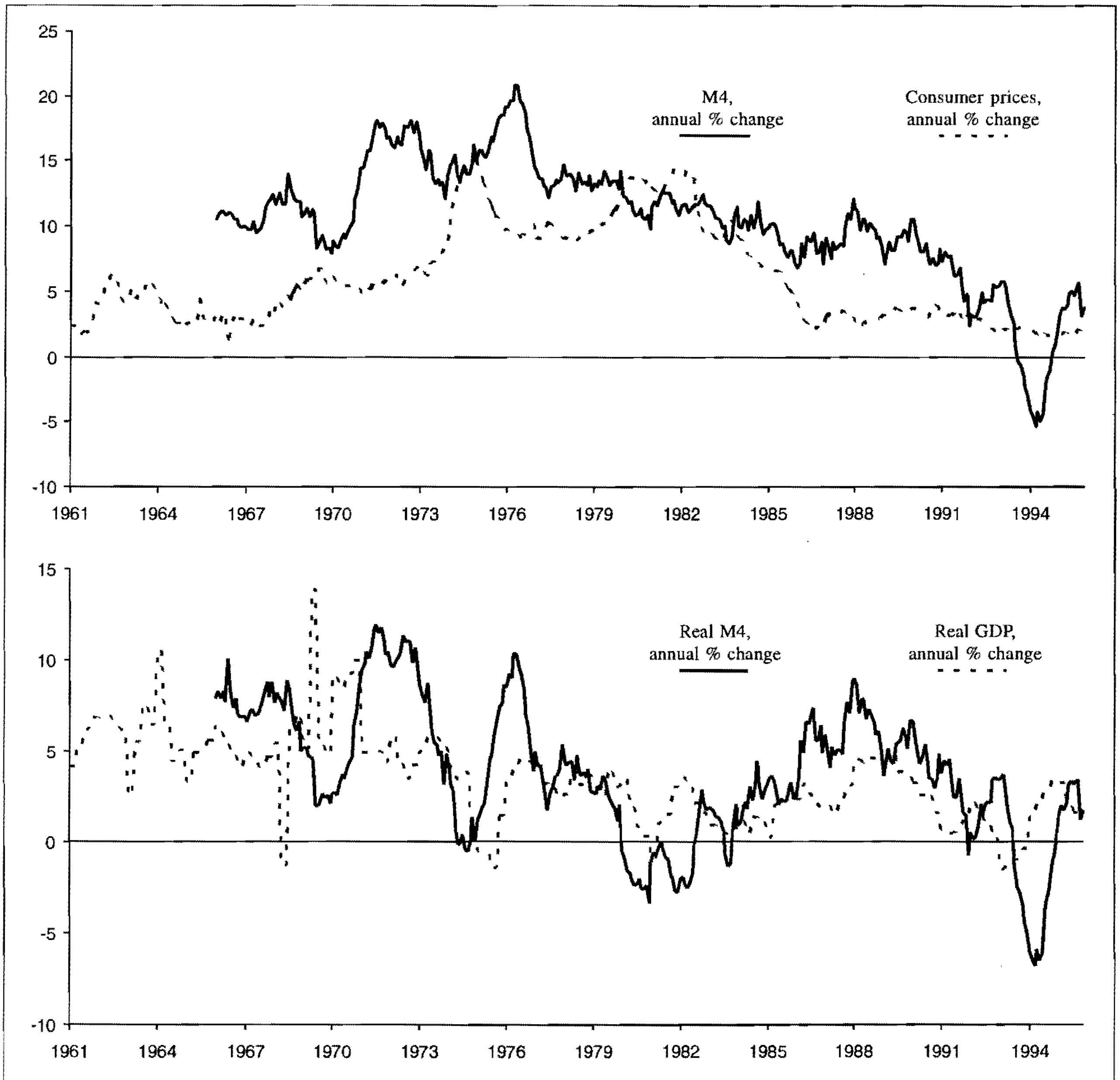
In mid-1995 the Japanese monetary authorities decided that they had to try to resolve the banking system's bad debt problem. With the virtual exhaustion of the capital of the Deposit Insurance Corporation, public money was injected into the housing loan companies (or *jusen*). So far credit growth has not recovered, but the stock of credit is at least stable. Heavy intervention to drive the yen down on the foreign exchanges was carried out during the summer and also served to prevent monetary growth going negative. Nevertheless, annual broad money growth (on the favourite "M3 plus CDs" measure) continues to hover around 3% or 4% and does not yet appear to be increasing. So the (slight) upturn in real money growth is mainly due to (small) falls in the price level. It is consistent with the mild economic recovery now under way, but not with anything stronger.

Germany



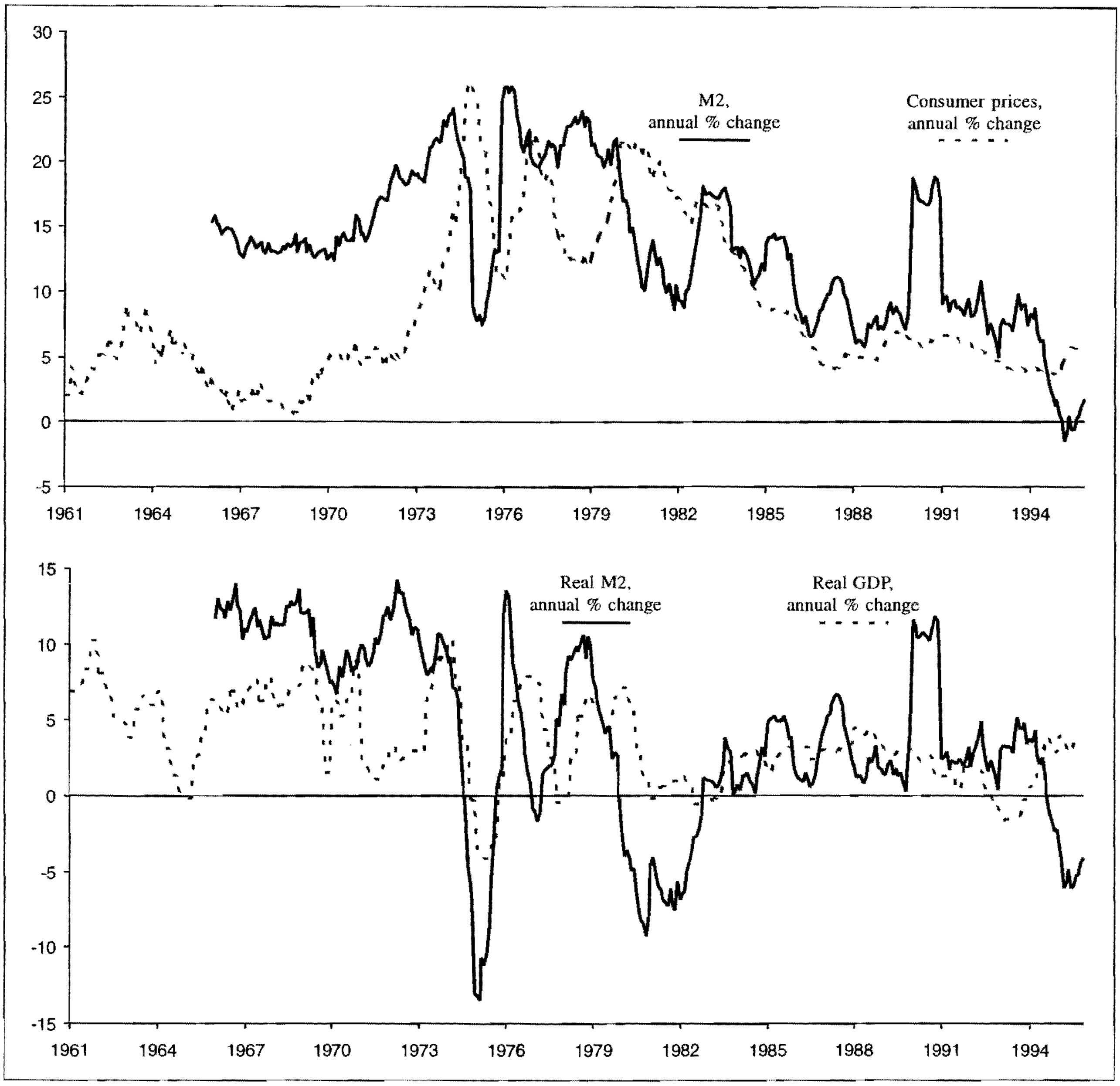
For most of the 1990s growing credit to the private sector was the main asset counterpart to rather high monetary expansion in Germany. Much of the credit was motivated by fiscal incentives to borrow to invest in East Germany. These incentives have been reduced and 1995 saw lower growth of "lending to enterprises and individuals" than in any of the previous four years. Moreover, the German public - which had been holding large sums in interest-bearing deposits during the period of the flat yield curve in 1993 and 1994 - committed itself heavily to buying *pfandbriefen* (i.e., bank bonds) in 1995. This shift from deposits into bonds had the effect of reducing the money stock. Broad money declined in early 1995 and, logically, Germany is now in recession. However, broad money growth began to move into positive territory again towards the end of the year.

France



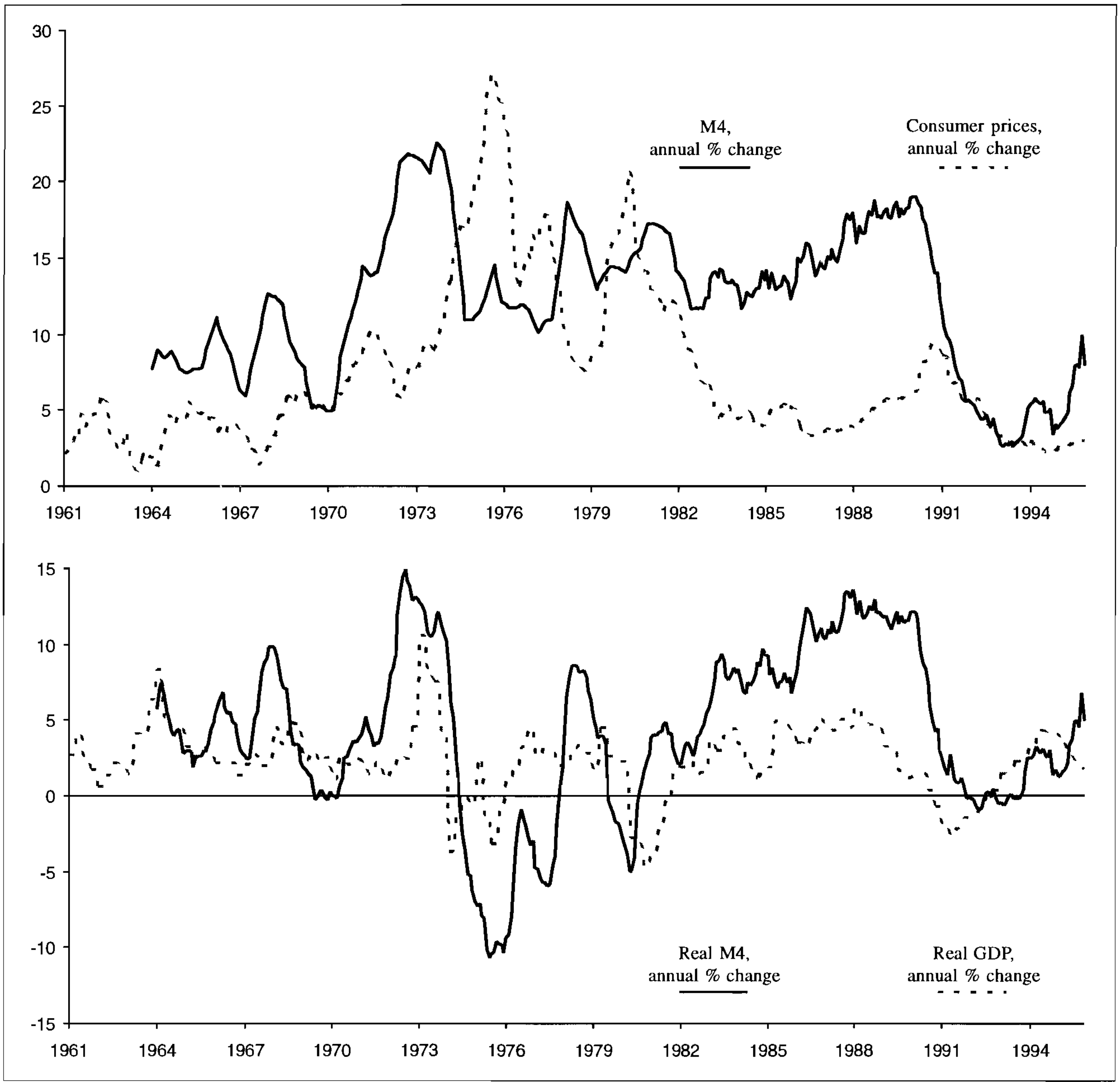
Broad money contracted in 1993 and 1994, which appeared to imply a tight monetary squeeze. However, French monetary data in recent years need to be interpreted with care, because the introduction of money market mutual funds led to a large switch into them out of bank deposits. After adjusting for this special influence, the underlying annual rate of broad money growth has probably been quite stable in the 2% - 4% area in the 1990s, roughly in line with the trend growth rate of output. The latest numbers suggest that this continued in 1995 and will persist into 1996. The banking system continues to be plagued by bad debt problems, with the crisis at Crédit Lyonnais capturing the headlines last year, and credit growth is sluggish. Although the budget deficit is above the Maastricht target, the monetary authorities have had no diffculty in financing it mostly outside the banking system.

Italy



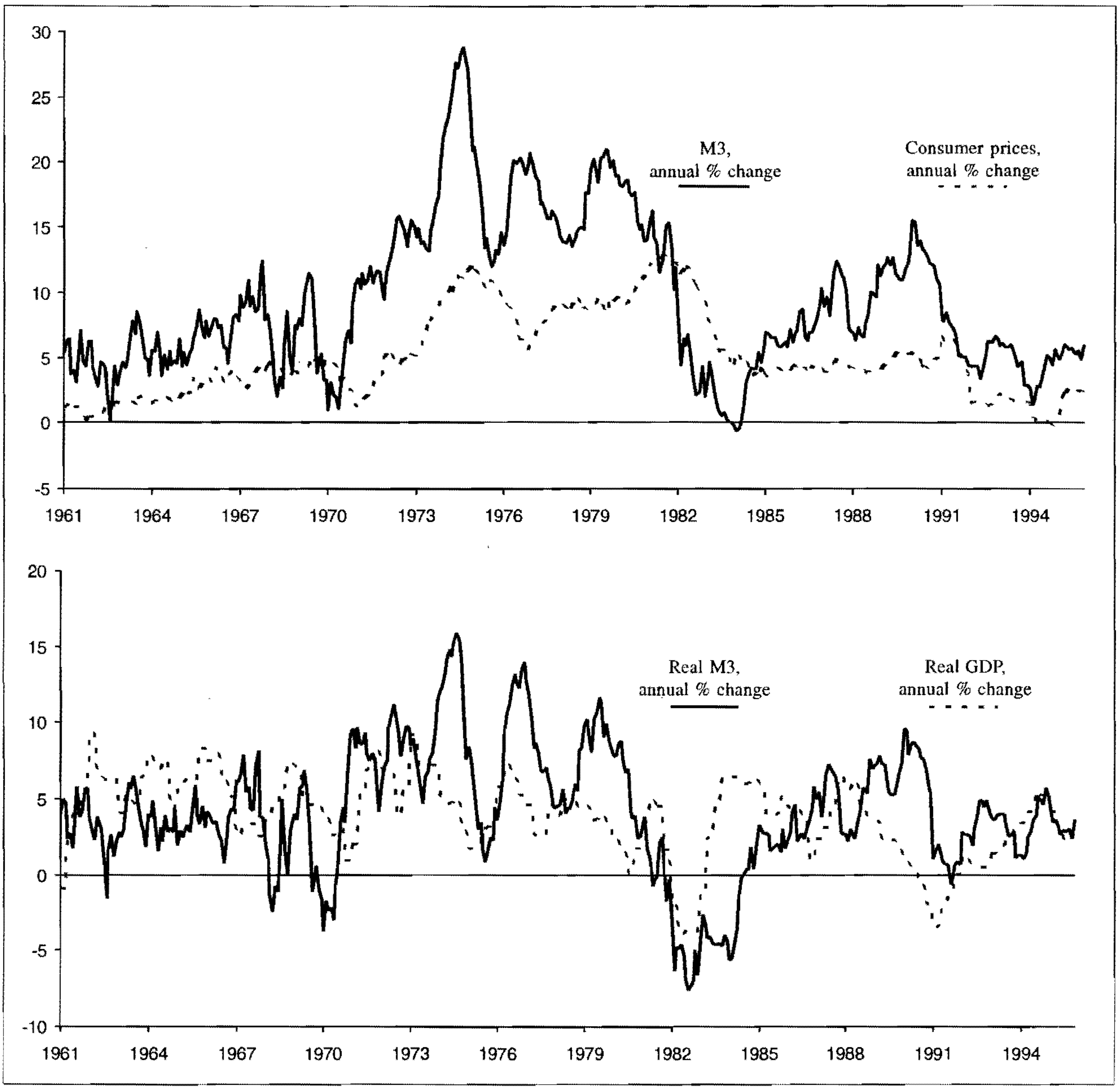
Italy's monetary record in 1995 was remarkable. It was the peak year for redemptions of its enormous national debt, implying the risk of substantial debt monetisation. In fact, March andApril were very painful for the Banca d' Italia, with the lira collapsing on the foreign exchanges and a sharp rise in bond yields. Fortunately, agreement was then reached with the unions to reduce state pension spending and confidence returned. Bond yields fell heavily in the second half of the year. As parts of Italy's fragmented banking system have severe bad debt troubles, new credit to the private sector was negligible. Monetary growth collapsed to the lowest levels in the post-war period, an interesting and often overlooked ingredient in the current European recession. In view of the government's huge refinancing needs, it would not be difficult to raise monetary growth, if that is what the monetary authorities wanted.

United Kingdom



As so often in the past, the UK has the highest growth rate of broad money among the G7 countries. The banks have overcome the trauma of the recession of the early 1990s, their bad debt provisions are behind them and arguably they now have too much capital instead of too little. In their chase for new business, they have driven down margins on new loans and stimulated a dramatic surge in take-over activity. Lending to the corporate sector has revived, and broad money growth has accelerated. It appears still to be accelerating. This trend is unlikely to be reversed before the general election, which will probably be in the spring of 1997. The behaviour of the UK's monetary aggregates, while hardly encouraging for its own long-term inflation prospects, is one (rather minor) reason that the current world slowdown will not become a recession.

Canada



As is well-known, Canada's macroeconomic outlook is dominated by the USA. Nevertheless, it has its own currency and interest rates, and so exerts some independent influence on world economic activity. (As Mexico demonstrated to financial markets in December 1994, events in a relatively small economy could change the USA's own economic prospects and even those of the world as a whole.) In fact, Canada's broad money growth has been quite stable at an annual rate of about 5% in recent years, and this has been consistent with moderate growth and low inflation. The budget deficits, at both the federal and provincial levels, are being curbed, which should facilitate the task of monetary control in the future. There does not appear to be a significant message here for either the US economy or the world economy.