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A familiar pattern

UK's monetary growth running well ahead of that in European neighbours

Interest rates being cut as money growth exceeds target,

The 1/4% cut in base rates on 8th March followed a familiar pattern. The UK has decided to ease monetary policy just as the rate of money supply growth has moved above target and when a general election is due within the next 15 months. Under the existing consitutional arrangements, the proximity of the general election makes a significant tightening of policy virtually inconceivable within the 15-month period. The first implication of this conjunction of events is that monetary growth will remain rather high, and perhaps become very high, over a period at least as long as two years and possibly as long as three or four years. (Whatever the political stamp of the next Government, its attitude to the monetary excesses is unpredictable. There is no guarantee of long-run stability in British monetary policy.)

implying another business cycle and (eventually) rising inflation

The second implication, a consequence of the first, is that the UK economy is about to enter another business cycle. On the M4 measure of broad money, real money growth is now running at an annual rate of about 8%. Previous experience points to much above-trend growth of demand and output in late 1996 and early 1997. If real money growth were to remain at about 8%, the above-trend rate of demand growth would persist into 1997 and 1998, eliminating the "negative output gap" (i.e., the excess of trend over actual output). The economy would start to overheat and inflation would accelerate. If nominal broad money growth were to stay in double digits, inflation would ultimately move above 5% and might even approach 10% again. As always, the time lags would be "long and variable", but on past form a forecast of an inflation rate of over 5% by 1999 would not be silly. (Incidentally, on the old M3 measure of money, the current annual rate of increase is about 15%. See p. 11. The Bank of England no longer publishes this series, but it is easy enough to calculate from official data.)

to a rate above that in our neighbours

As so often in the past, the UK's monetary trends diverge totally from those in its European neighbours. Whereas monetary growth is high and accelerating here, it is rather low and under good control in Germany and France, and - remarkably - it is very low in Italy. The third implication of the monetary numbers is therefore that by, say, 1999 or 2000 the UK's annual inflation rate will be well above that in these three other countries, with a gap amounting perhaps to 3% or 4%. The single currency project will probably have collapsed by then, but Europe's political class will still be busy trying to assemble a fixed-exchange-rate zone. The final implication is that the case for sterling to participate in that zone will once again be expressed forcibly, and with apparent persuasiveness, in British political debate. And so the battered caravanserai moves on its way.

Professor Tim Congdon 8th March, 1996

Summary of paper on

'Will inflation remain low in the late 1990s?'

Purpose of the paper

The last six months has seen a noticeable decline in inflation expectations for 1996. The purpose of the paper - which follows roughly the same format as the *Gerrard & National Monthly Economic Reviews* of March 1992, June 1993, April 1994 and March 1995 - is to review some of the key influences on future inflation.

Main points

* **The headline annual rate of retail price inflation accelerated to 3.9% last September, hit by adverse special influences such as rising mortgage rates and higher seasonal food prices because of the hot summer. But it dipped to 2.9% in January and seems likely to fall to under 2.5%, and perhaps even under 2.0%, later in 1996.**

* **Survey evidence on the immediate prospects for inflation is encouraging, although not as good as in 1993 and 1994. The latest CBI survey had a positive 14% balance of companies planning to raise prices, a figure consistent with producer price increases at an annualised rate of 2% - 3%. (See p. 6.)**

* **Estimates carried out by Lombard Street Research suggest that national output remains 2% or perhaps even 3% beneath trend. On this basis downward pressure on inflation in goods and labour markets will persist for several quarters yet. Inflation will remain moderate in 1997.**

* **But the medium-term inflation outlook is worrying, because of the recent upturn in broad money growth. Initially higher monetary growth boosts output growth. Only after the so-called "negative output gap" (see p. 3 for explanation) has been eliminated will inflation accelerate.**

* **If broad money growth remains above 10%, a return to an inflation rate of more than 5% is inevitable sooner or later.**

This paper was written by Professor Tim Congdon and Robert Miller.

Will inflation remain low in the late 1990s?

Monetary threat to low inflation now emerging

Analysis in this *Review* similar to four previous similar analyses

Last March the *Gerrard & National Monthly Economic Review* contained a research paper on "Will inflation remain low in 1995, 1996 and later?", which followed three similar pieces of work in March 1992, June 1993 and April 1994. The main conclusion of last year's analysis was that, "Late 1995 and early 1996 will see favourable inflation surprises." At that time the "average forecast" of headline retail inflation was 3.4% in the fourth quarter (Q4) 1995 and 3.4% in Q4 1996. (The "average forecast" is compiled by the Treasury from numbers supplied by over 30 forecasting groups.) The outturn in Q4 1995 was in fact 3.2%, while the average forecast for Q4 1996 is now 2.6%. So inflation outturns and expectations have improved compared with a year ago, and - in that sense - the analysis in the March 1995 *Review* has been validated. (It is also worth noting that the Government decided, controversially, to exclude the electricity rebate from the RPI calculation. If it had been included, the annual RPI number in early 1996 would have dipped to under 1%.)

Prospects for inflation remain good over the next few quarters,

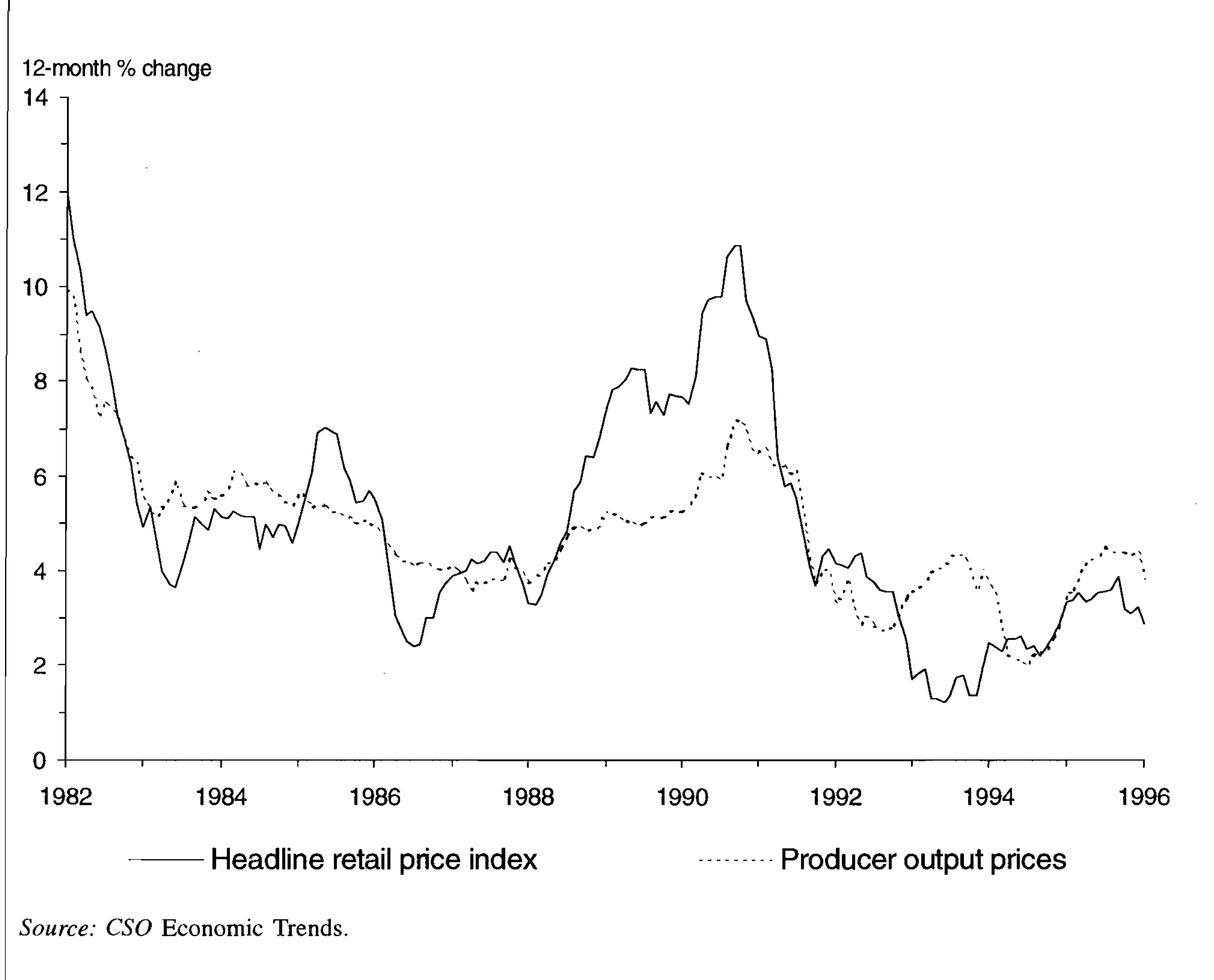
Would a similar review of the forces determining inflation reach equally sanguine conclusions today? An analysis of inflation over the next few quarters is best conducted by looking at influences on costs and business surveys on inflationary pressures, and calculating the size of the "output gap" (i.e., the divergence between actual and trend output, which can be either positive or negative). Roughly speaking, inflation is likely to decelerate if the output gap is negative and to accelerate if it is positive. On this basis, good inflation numbers are likely to be reported for the rest of 1996 and for most of 1997. After rising a little in 1995, the main measures of retail and producer price inflation are now falling, and will probably move downwards over the next few months. (See p. 4.) The CBI survey is giving a fairly reassuring message about companies' price-raising intentions until mid-1996 (see p. 6), while skilled labour shortages are still well beneath normal and capacity shortgages are much less marked than at the start of last year (see pp. 7 - 9).

but rising monetary growth raises worries about the late 1990s

But there have to be worries about inflation prospects in 1998 and, more particularly, 1999 and later. Inflation is ultimately "a monetary phenomenon", determined largely by the difference between the increase in output and the increase in the money supply over long periods of time. In the early 1990s the annual rate of monetary growth was typically under 5%, but last year it accelerated to reach almost 10% by year-end. (Indeed, on the old M3 measure (see p. 11) it increased to virtually 15%.) In view of banks' current eagerness to expand their balance sheets and so to maximise their profits, continued rather high monetary growth seems likely. There has to be a risk that, if the annual rate of money growth remains in double digits, inflation will exceed 5% by 1999 and later.

Inflation performance over the last decade

Chart shows the 12-month percentage change in the headline retail price index and in the index of producer output prices (home sales) for manufacturing.

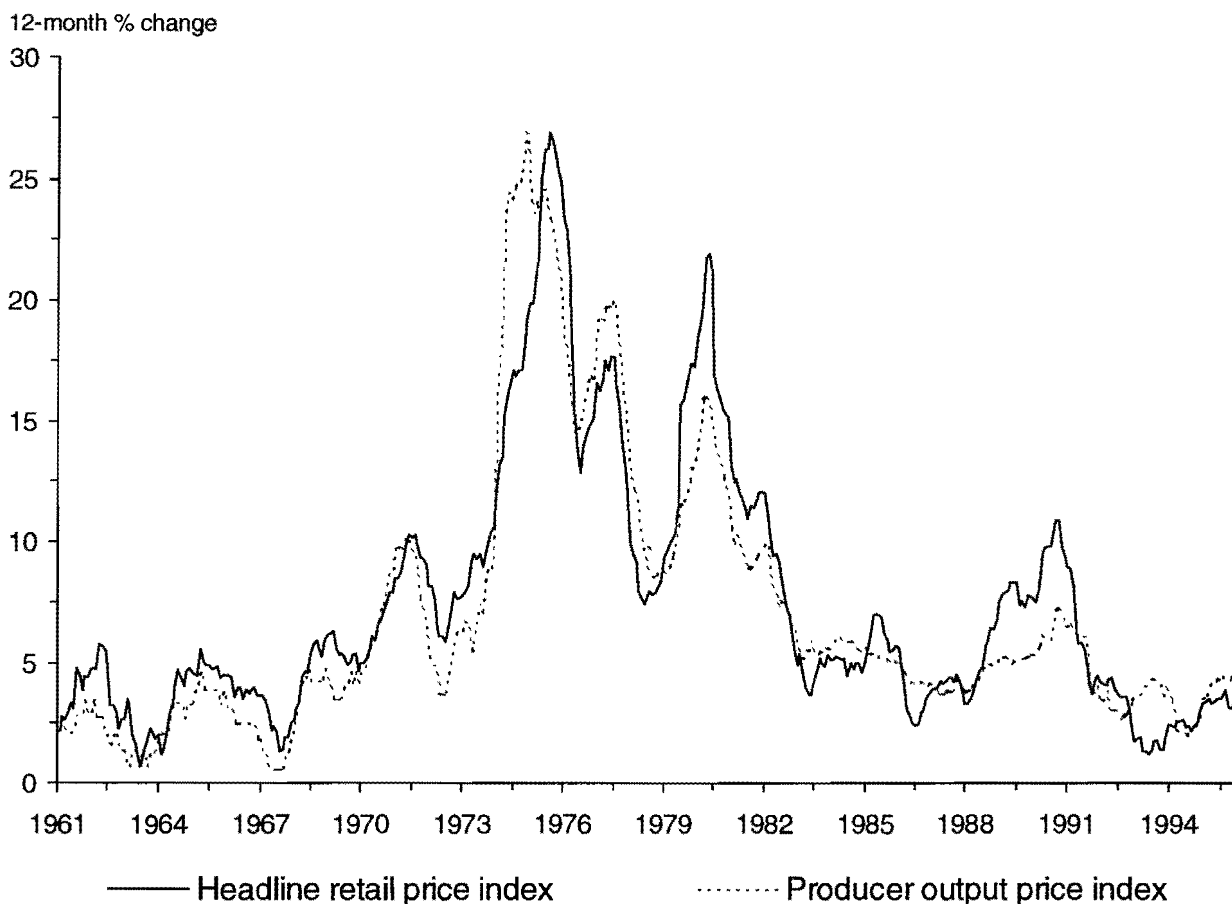


Source: CSO Economic Trends.

Headline inflation accelerated during 1995, from 2.9% in December 1994 to 3.5% by March 1995 and 3.9% by September. Producer output price inflation also accelerated, rising from less than 3.0% at the start of 1995 to 4.5% by mid-year. This increase in inflation, alongside falling unemployment, raised the concern that the economy was operating above its potential level, i.e., that any negative output gap which had existed in 1992 and 1993 had closed. However, calculations by Lombard Street Research show that the output gap remains negative and actually widened during 1995 as growth in GDP slowed. Headline inflation has eased since September and, by January 1996, was below 3.0% as a result of cuts in utilities prices and lower mortage interest rates. The rise in inflation last year has therefore proved to be a temporary "blip."

A long-term perspective

Chart shows the 12-month percentage change in the headline retail price index and in the index of producer output prices (home sales) for manufacturing.

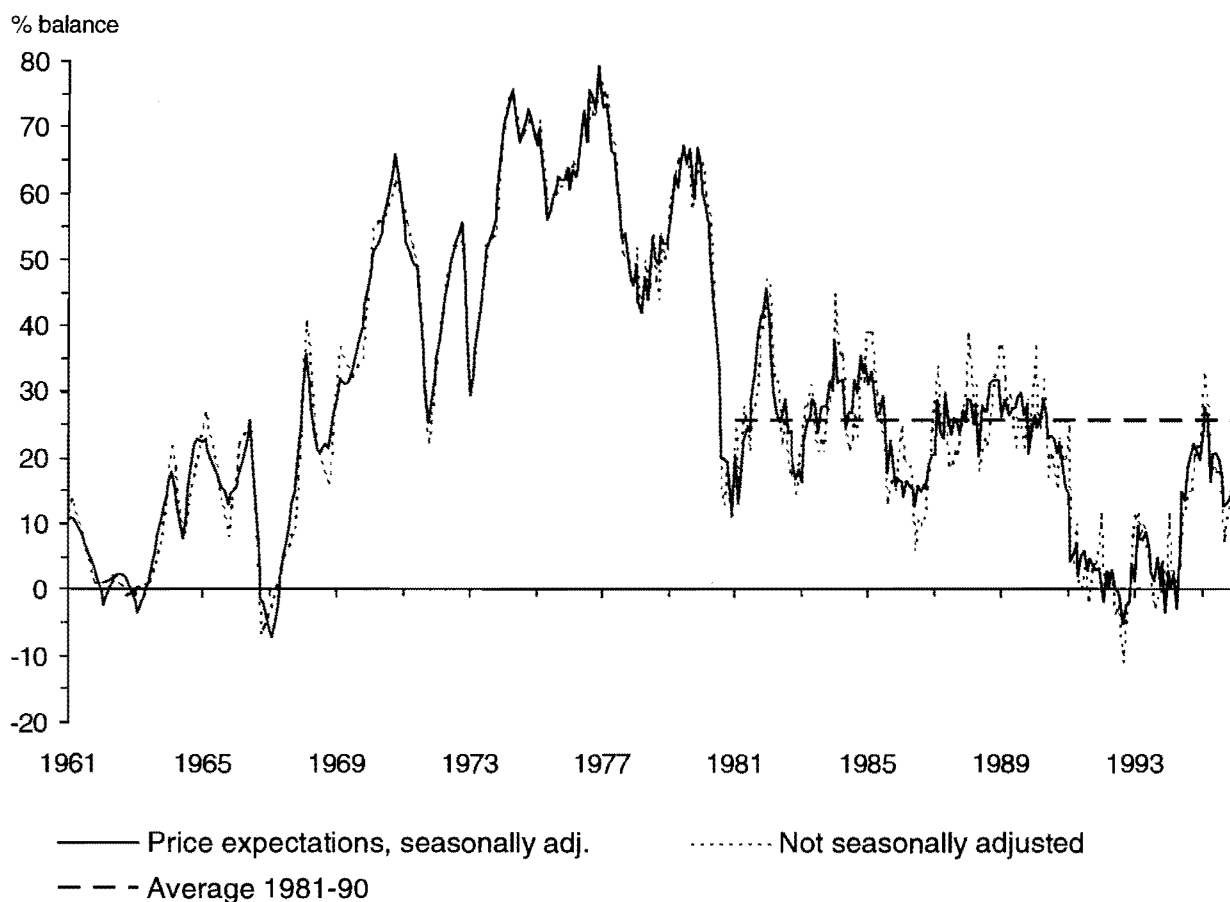


Source: CSO Economic Trends.

The existence of a negative output gap implies that underlying pressure on inflation will be subdued over the near term. It is likely that headline inflation over the next year or so will be similar to that experienced during the late 1950s and early 1960s, although without necessarily matching the lowest rates witnessed during the early 1990s. Nor is it likely that prices will fall, as occurred briefly in late 1959 and early 1960. However, the Government should meet its inflation target of 2.5%. The acceleration in broad money growth since the spring of 1995 raises concerns over the longer-term path for inflation. Growth in GDP should be above-trend by the second half of this year. It is therefore possible that the negative output gap will be eliminated by late 1997/early 1998, threatening higher inflation thereafter.

CBI price expectations balance

Chart shows the percentage balance of manufacturing companies expecting to increase the average prices at which domestic orders are booked over the next four months. Data seasonally adjusted using EZX11 program.

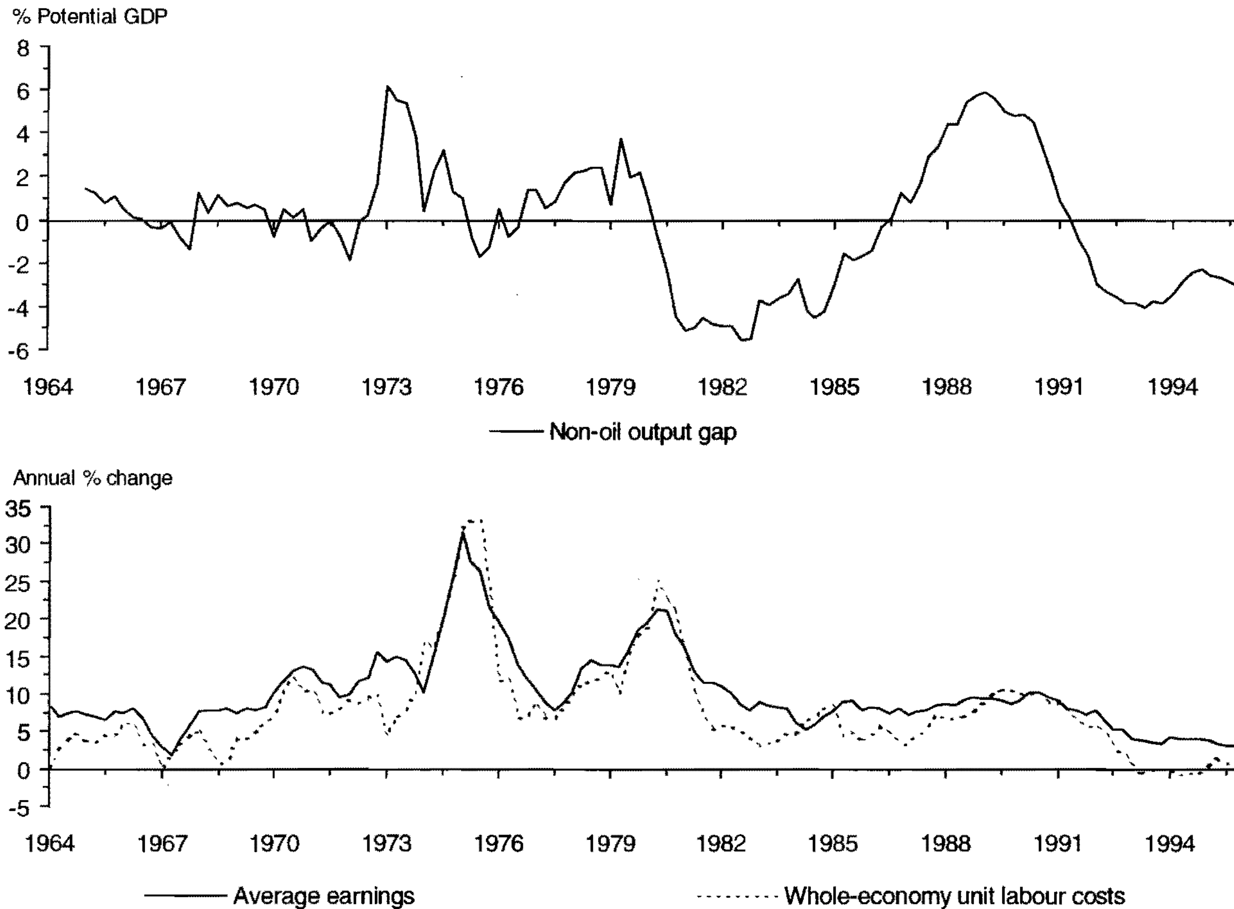


Source: CBI Monthly Trends Enquiry.

Manufacturers' expectations of future price increases, as measured by the CBI *Monthly Trends Enquiry*, grew alarmingly in late 1994. The balance expecting to increase prices grew from -1% in April 1994 to +31% by February 1995, as manufacturers were faced by a falling exchange rate and rising commodity prices. By early 1995 the price balance was consistent with output price inflation of around 5%. However, the price balance has since fallen sharply and by this February had reached +14% on an unadjusted basis, a result in part of subdued demand preventing manufacturers from passing on increased raw material costs. This decline in price expectations also serves to highlight the temporary nature of last year's increase in headline inflation. Even so, the price balance has yet to return to the levels seen between 1992 and 1994.

Labour cost developments

Upper chart shows the % deviation of non-oil GDP from its potential level. The lower chart shows 12-month percentage changes in average earnings and in unit labour costs for the whole economy.

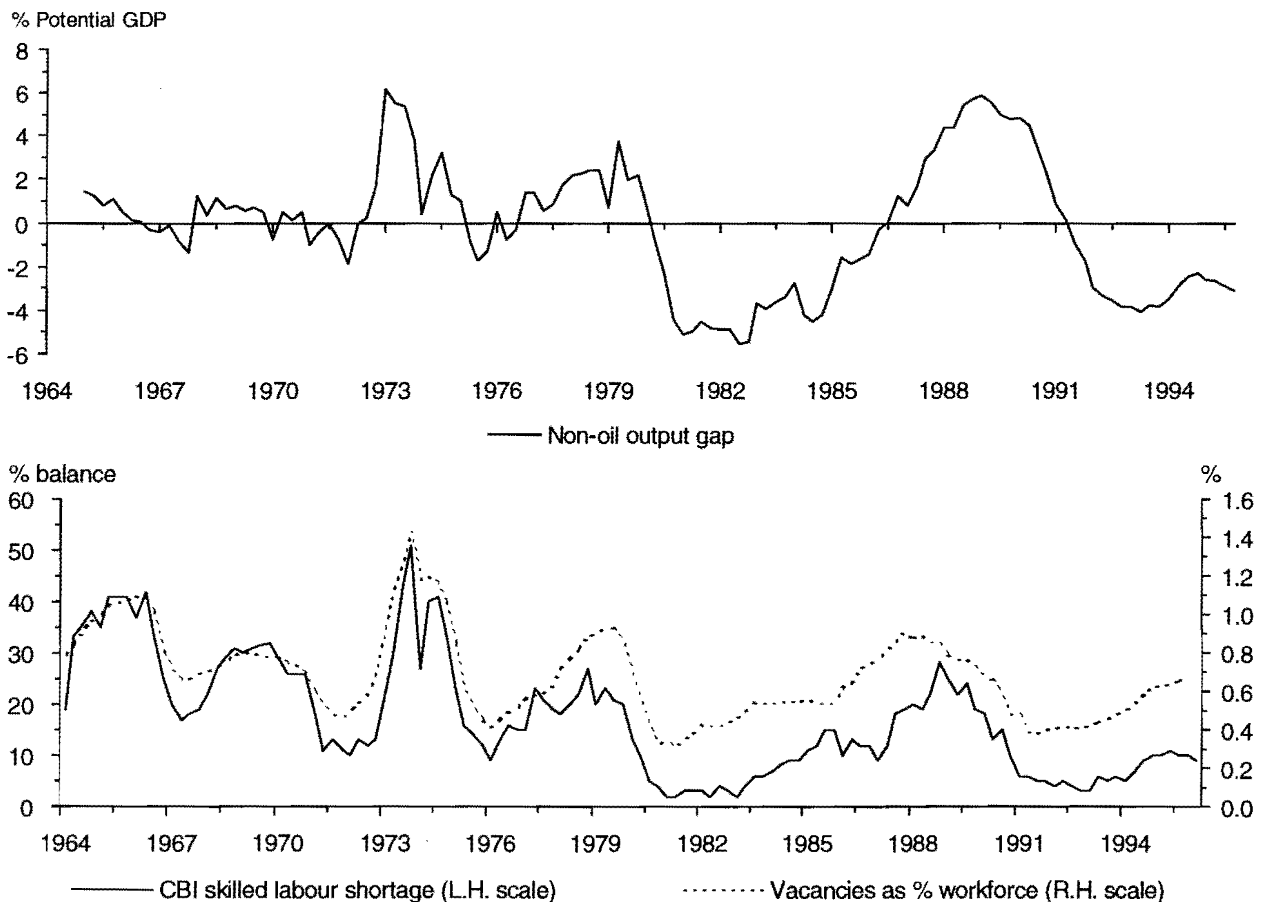


Source: CSO Economic Trends *and Lombard Street Research calculations.*

Unemployment fell by the equivalent of 0.6% of the workforce during 1995. However, growth in average earnings continued to ease, falling from around 4.0% a year at the end of 1994 to 3.2% a year by the fourth quarter of 1995. Unit wage costs for the whole economy, which were little changed during 1994 and the first half of 1995, accelerated during the second half as output growth moderated, but their growth rate of barely 1.0% a year is the lowest for over twenty years. This failure of earnings growth to respond to a significant reduction in unemployment - which, at 8.0%, is at its lowest since early 1991 - suggests that actual unemployment is still above the natural rate, which may be around 6% of the workforce. A further factor ensuring subdued growth in labour costs could be the increase in part-time relative to full-time employment.

Two measures of labour market slack

Upper chart shows the % deviation of non-oil GDP from its potential. The lower chart shows the balance of manufacturing companies reporting shortages of skilled labour to be a constraint on output over the next four months and unfilled vacancies at job centres as a % of the workforce.

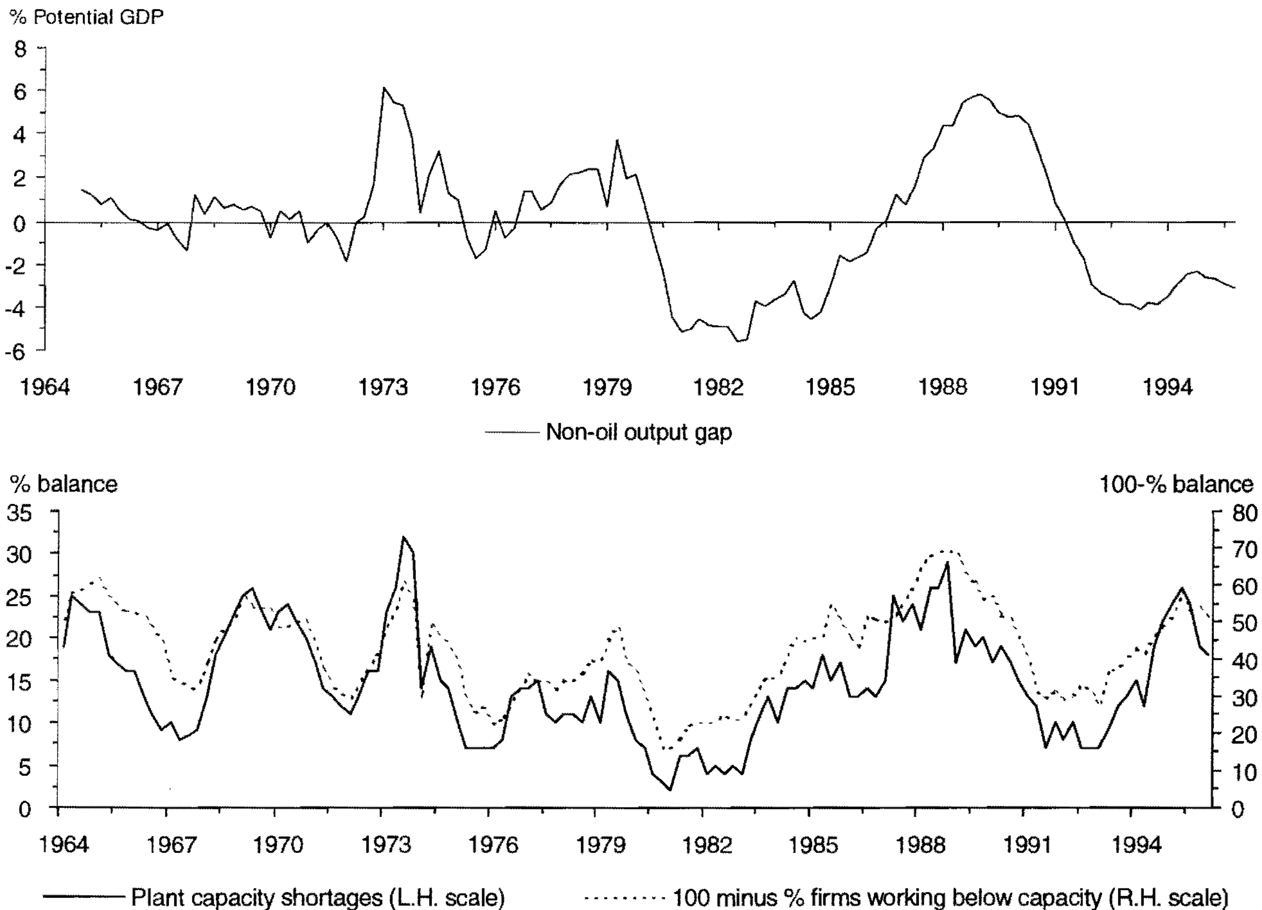


Source: CSO Economic Trends, *CBI* Quarterly Industrial Trends Survey *and Lombard Street Research calculations.*

Growth in GDP slowed to a below-trend rate during the course of 1995. As a result, the negative output gap (estimated by Lombard Street Research) widened from a litle over 2.3% at the end of 1994 to around 3.0% by the fourth quarter of 1995. This number, which is broadly in line with estimates from the OECD, should ensure subdued inflation during 1996 and early 1997. Labour market pressure in the manufacturing sector, as measured by the CBI *Quarterly Survey* question on skilled labour shortages, increased during 1994 as exporters in particular reacted to strong overseas demand. But the balance of companies reporting difficulties in obtaining skilled labour as a constraint on output remains well beneath the long-run average. On the other hand, vacancies at Jobcentres as a proportion of the workforce have now risen to levels last seen in the late 1980s and early 1990s.

Two measures of capacity utilisation

Upper chart shows the % deviation of non-oil GDP from its potential level. The lower chart shows the % balance of manufacturing companies reporting a lack of plant capacity as a constraint on output over the next four months and 100 minus the % of manufacturing companies working below capacity.

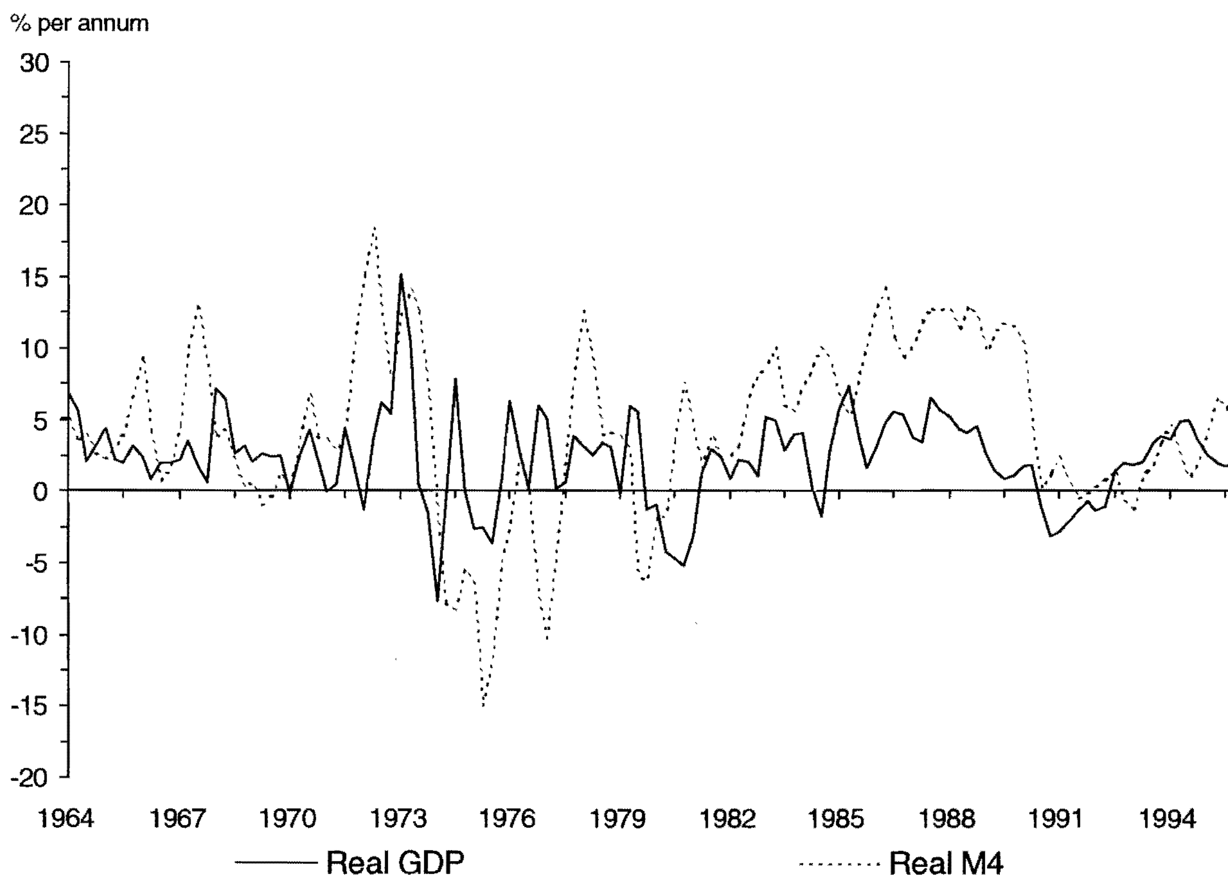


Source: CBI Quarterly Industrial Trends Survey *and Lombard Street Research calculations.*

Both measures of capacity utilisation in manufacturing peaked in the second quarter of 1995. According to the CBI *Quarterly Trends Survey*, the proportion of manufacturing companies working below capacity reached 42%, the lowest since the third quarter of 1989. The balance of companies reporting a shortage of plant capacity as a constraint on output reached +26%, the highest positive balance since the fourth quarter of 1988. Growth in manufacturing output slowed sharply during 1995, from 3.7% a year in the first quarter to 0.4% a year by the fourth quarter. Capacity shortages have eased in line with this slowdown in output. Although the output of the service sector has not slowed to the same degree, equally there is little evidence of a widespread shortage in capacity, as rising yields and low rental growth in the commercial property sector show.

Real broad money and the business cycle

Chart shows 6-month annualised growth rates in real GDP and in real M4, calculated by deflating nominal M4 by the RPI excluding mortgage interest payments (RPIX) after seasonal adjustment.

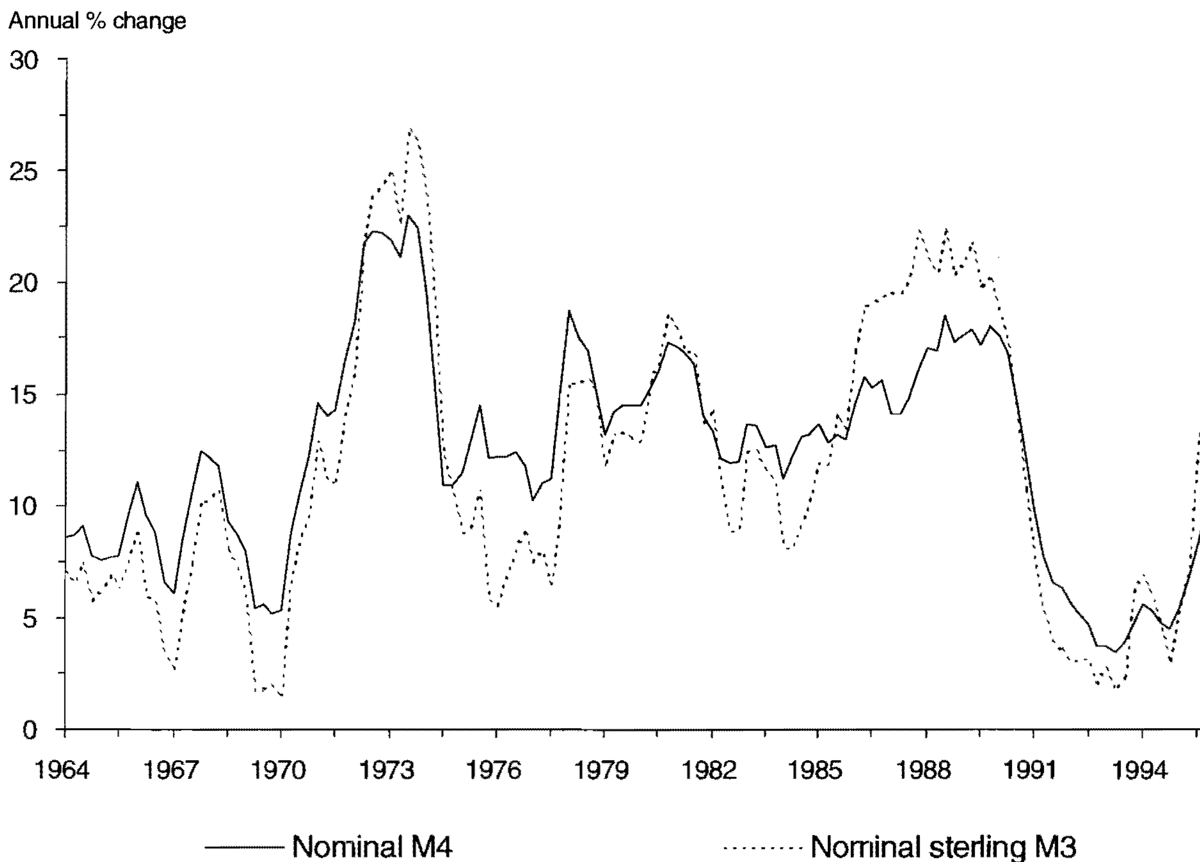


Source: CSO Economic Trends *and Bank of England* Monetary Statistics.

One of the best-attested principles in economics is that, in the long run, the demand to hold real money balances depends only on real forces. An acceleration in real money growth is usually followed, after a lag of a few quarters, by an upturn in output growth. Above-trend output growth eventually puts pressure on the economy's resources and inflation rises. The rise in inflation then reduces the value of real money balances, so that - over the whole cycle - real money balances and real output move together. At present real money growth is accelerating strongly. A few months ago this upturn suggested the forecast that the UK, unlike its European neighbours, would not suffer a recession in late 1995 and early 1996. That forecast has already been validated. More controversial is the implication that in late 1996 and early 1997 UK output growth will move to an above-trend rate.

Broad money growth over the long run

Chart shows the annual % change in nominal M4 and in sterling M3 quarterly since 1964.



Source: Bank of England Statistical Abstract.

Different measures of the money stock sometimes give contrasting messages. M3 includes notes, coin and bank deposits; M4 includes M3 and building society deposits. So a sharp divergence between the behaviour of banks and building societies may be associated with quite a wide gap between M3 and M4 growth. At present the demand for mortgages is depressed, because the personal sector's mortgage debt is excessive relative to the value of the housing stock. On the other hand, corporate lending is buoyant, much of it to support take-over activity. As a result banks' balance sheets, and their deposit liabilities, are increasing much more rapidly than building societies', and M3 is growing at a faster rate than M4. The Bank of England no longer compiles separate data for M3, but it is easy enough to calculate M3 growth from official releases. The acceleration in M3 growth today is not dissimilar from that in 1977 and 1986.

Recent monetary trends

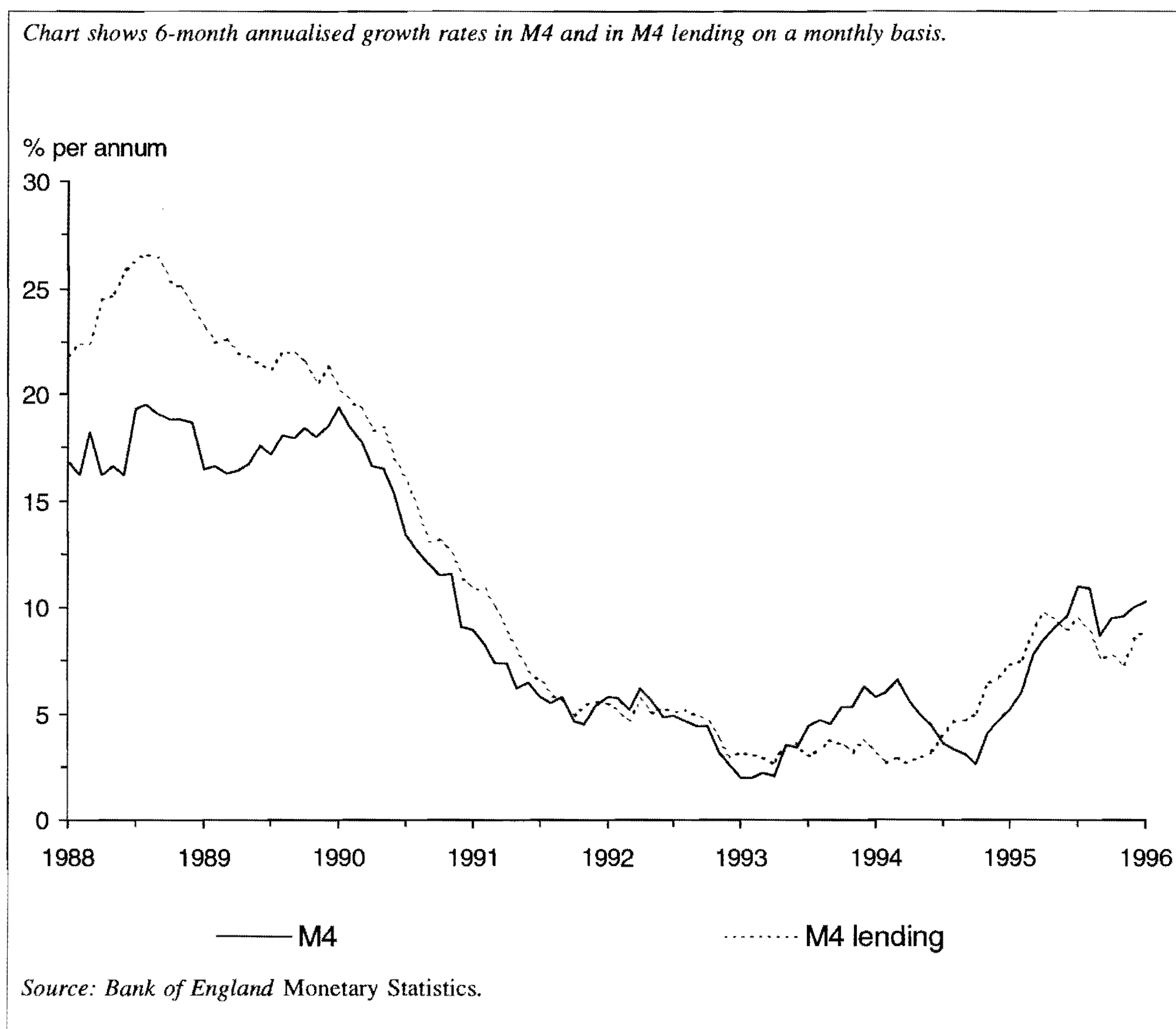


Chart shows 6-month annualised growth rates in M4 and in M4 lending on a monthly basis.

Source: Bank of England Monetary Statistics.

The money supply is dominated by the deposit liabilities of banks and building societies. Its growth therefore depends on banks' and building societies' keenness to expand their assets, which are principally loans to the private sector. So it is no surprise that the main credit counterpart to the current acceleration in monetary growth is increased lending to the private sector. As the chart shows, the typical growth rate of M4 lending between mid-1991 and mid-1994 was under 5% a year, but since then it has moved up to almost 10% a year. The most abrupt change in credit trends has been in the corporate area, with 1995 seeing the highest-ever level of take-over activity. This has continued into early 1996, while there are also signs of strong demand for consumer credit and even possibly of more mortgage lending. The annual rate of credit growth seems unlikely to return to under 5%, at present interest rates.