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Contents | Page No.

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Why must the Budget be so cautious?

Worries about long-run sustainability of UK's public finances

Tax cuts ahead,

Of course the Budget will include tax cuts. Mr. Clarke has - perhaps rather surprisingly - listened to the voices of monetary restraint and agreed to a small base rate increase of 1/4% to 6%. But, with the general election only six months away, he will not pay similar attention to the advocates of action to reduce the budget deficit. 1p. off the standard rate of income tax seems likely and even 2p. off, financed by tax increases elsewhere (such as a drastic overhaul of profit-related pay), is possible.

but less than hoped because of renewed concerns about sustainability of public finances,

Many of the Government's supporters will nevertheless be disappointed. They will correctly point out that the tax cuts in the two Budgets of 1995 and 1996 are far less than the mammoth tax increases announced in the two Budgets of 1993, which amounted altogether to over £15b. Why has the Government had to be so cautious? The essence of the answer is that the UK, like virtually all the leading industrial countries, is finding it difficult to prevent public debt rising faster than national output. A happy phase of budget surpluses in the late 1980s was followed by a lurch into heavy deficit in the early 1990s. As the deficits have increased the debt, interest on the debt has itself become part of the threat to long-run fiscal sustainability. In 1992 general government debt interest was 2.9% of gross domestic product; this year it will probably be 3.8% of GDP.

The mathematics of debt control are well-known. If the real interest rate on public debt is above the trend growth rate of the economy, the Government must run a so-called "primary surplus" to prevent the ratio of debt to GDP increasing explosively. (A primary surplus is an excess of tax receipts over non-interest government expenditure.) Since the inflationary binge of the 1970s, investors in conventional gilt-edged securities have required a real return of about 5%, well above the 2 1/2% trend growth rate. So a primary surplus is necessary. Instead the 1990s have seen massive primary deficits and the ratio of net debt to GDP has climbed from 19% in 1992 to over 40% today. This jump has occurred despite tight restrictions over public sector investment. General government gross domestic fixed capital formation in the first quarter of 1996 was 24% (yes, 24%!) less than a year earlier. The Government's deficit on its current account (i.e., excluding the severely-squeezed capital expenditure) is much higher today than on average in the 40 years to 1990. An interesting analysis in the latest *National Institute Economic Review* suggests that "the current primary deficit" is still "about 2% of GDP above its sustainable level". This is a good sample of the kind of thinking which will influence fiscal policy over the next few years, particularly under a Labour government.

which would continue under a Labour government

Professor Tim Congdon 1st November, 1996

Summary of the paper on

The Clarke boomlet?

Purpose of the paper

The Treasury Panel of Independent Forecasters presents the Chancellor of the Exchequer with forecasts of the British economy, so that these can be compared with the Treasury's own forecasts. Professor Congdon's latest *Submission* to the Panel expressed increasing concern about the high rate of money supply growth now being recorded and warned about the medium-term inflation risks from a "Clarke boomlet".

Main points

* **1996 should again be a good year for the economy, with output growth of 2 1/2% acompanied by end-year retail inflation of under 3% - and possibly even beneath the 2 1/2% figure which has been the Government's target.**

* **In the first half of 1996 domestic final sales (i.e., domestic demand minus stockbuilding) grew at an annualised rate of 4.0%. If - as seems likely - i. this continues in late 1996 and early 1997, and ii. the change in stockbuilding becomes positive, the annualised growth rate of domestic demand could approach 5%, which would represent a boom.**

* **The most fundamental cause of the upturn in demand growth has been an acceleration in the annual rate of (broad) money growth. This was 5% in the three-and-a-half years to end-1994, but has been almost 10% subsequently.**

* **The growth rates of credit and money cannot be halved without a significant rise in interest rates. But money growth needs to be lowered to, say, 5% a year if it is again to be consistent over the medium term with inflation of 2 1/2% or less.**

* **The cyclically-adjusted budget deficit is still too high, arguing against large tax cuts in the coming Budget.**

This paper - which differs slightly from the actual *Submission* to the Panel - was written by Professor Tim Congdon. Much of the work was done at Lombard Street Research, the Gerrard Group's research subsidiary. It was completed before the 1/4% rise in base rates to 6%.

The Clarke boomlet?

Professor Congdon's *Submission* to the Treasury Panel of Independent Forecasters, October/November 1996

Overview and discussion of the current situation

Last few years have been a stable period for UK economy

Since the recovery began in early 1993 the UK economy has enjoyed trend or above-trend growth and low inflation. Arguably, the macroeconomic performance of the three years, 1993, 1994 and 1995, has been the most satisfactory since the 1960s. The central reason for this happy outcome is that the *level* of national output in early 1993 was substantially beneath trend (perhaps by as much as 4% of trend output) and this large "negative output gap" continued to dampen inflation pressures even as the *change* in output ran at an above-trend rate. (Here and elsewhere the trend growth rate of non-oil output is taken to be between 2% and 2 1/2% a year, so that - roughly speaking - a quarterly increase of less than 0.5% is beneath-trend, while a quarterly increase of 0.7% or more is above-trend.)

Inflation news has remained good

Growth slowed in 1995 and for a few quarters even ran a touch beneath trend. Gross domestic product in the fourth quarter of 1995 was only 1.7% higher than a year earlier. The brief phase of slower growth preserved a significant negative output gap, probably more than 2% of trend output, in early 1996. As a result, inflation fell once more. Progress on inflation has nevertheless varied between the various official measures. The headline annual rate of retail price inflation dropped from 3.9% in September 1995 to 2.1% in August 1996 but the underlying rate (i.e., RPIX, excluding mortgage costs) was still 2.8% in August. By contrast, in August the annual increase in the producer price index (output series) was 2.0% and in the last four months the PPI has actually fallen by 0.5%. As factory-gate prices tend to lead retail prices, the better news on factory-gate prices (i.e., PPI measure) gives some encouragement that the the RPIX measure of inflation will be down to under 2 1/2% by the end of the current Parliament, in line with the Government's target.

Recent acceleration in growth, especially in consumer spending

Early 1996 was a difficult period for many companies, particularly manufacturing companies exposed to the weak European market. The growth of demand and output has accelerated in the last few months. The acceleration has been particularly marked in consumer spending, with the volume of retail sales in August 1.8% higher than in May (i.e., implying an annualised growth rate of 7.4%). The three-month comparison may overstate the underlying trend, but there is little doubt that consumer spending is now growing strongly. Indeed, some recent developments - such as the boom in eating-out and the practice of telephone ordering for multi-media products - suggest that the growth rate of retail sales is less than the growth rate of consumer spending. After allowing for retail sales growth in the three months to August being atypically high, a reasonable conclusion is that consumer spending is now growing at about 1% to 1 1/4% a quarter (i.e., at an annualised rate of 4% to 5%). With current interest rates this growth rate is unlikely to change in the next few quarters, except in an upward direction.

Manufacturing and construction also improving

What about those parts of the economy, such as manufacturing and construction, which are at some distance from retail demand? It is clear from business surveys - notably the Confederation of British Industry's industrial trends survey and the more recently-established survey from the Chartered Institute of Purchasing and Supply - that the last few months have seen an improvement in demand for manufactured products. By contrast, the construction sector is still operating at well below capacity levels. But the housing market is reviving, helped by an annual rate of house price inflation reported to be above 5%, while several large office and hotel developments (such as the proposed Baltic Exchange tower and the £300m. new Docklands hotel) are also being proposed. The economic upturn is evidently not confined to consumer spending.

Unemployment falling and now only slightly above "natural rate"

It is therefore logical that unemployment continues to fall by about 15,000 a month. The level of unemployment, at 7.5% of the workforce, is only 1% to 1 1/2% above most estimates of the "natural rate" (i.e., the rate at which pay settlements and inflation ought to be stable). The fall in unemployment is under way, despite a transfer of claimants (running at a few thousand people a month) from the invalidity register to the unemployment register following the replacement of invalidity benefit by incapacity benefit.

1996 another "golden year"?

On balance, it seems likely that GDP is currently growing at an above-trend rate of about 1% a quarter. If this is the figure recorded in the third and fourth quarters, GDP growth in the year as a whole would be about 2 1/2%. So there is a good chance that output growth will be above end-year inflation, which would qualify 1996 as another of Mr. George's "golden years". (When he was appointed Governor of the Bank of England, Mr. George said that his hope would be to have a sequence of golden years in which output growth exceeded the inflation rate.)

Demand components other than consumption:

Finally, in this survey of the economic situation, what about the components of aggregate demand other than consumption? In most business cycles three of these demand components - namely, investment, stockbuilding and net exports - are more volatile than consumption. (Government expenditure on current goods and services is relatively stable.) Moreover, their current behaviour usually has a predictable implication for their behaviour over the next year or two, and so carries a vital message for the broader economic prognosis.

1. Stockbuilding

An important feature of the first half of 1996 was that the economy was held back by persisting weak demand in the the rest of Europe and destocking (or, at any rate, reduced stockbuilding). So net exports and fluctuations in stocks restrained growth. The pattern is demonstrated in Table 1, which covers the period since the end of 1992 (i.e., the recovery). The top half of Table 1 shows that, whereas from the start of 1994 to mid-1995, net exports made a powerful contribution to extra demand, since mid-1995 their influence has been mostly negative. The bottom half of Table 1 splits the increase in domestic expenditure between the increase in stockbuilding and the increase in domestic final sales (i.e., domestic expenditure minus stockbuilding). It also gives the annualised rate of increase in the last two quarters for total domestic demand and domestic

Table 1 Influences on GDP Growth

i. Domestic demand and net exports as influences on GDP

Table shows change (in £m., 1990 prices) compared with two quarters earlier.

		In domestic expenditure	In net exports	In GDP at market prices
1991	Q3	-2611	1502	-1109
		701	-814	-113
1992	Q1	372	-1106	-734
		-70	-740	-810
		1583	-830	753
		727	-30	697
1993	Q1	1054	317	1205
		1432	236	1900
		1689	27	2173
		2276	-21	2308
1994	Q1	2046	268	2023
		1694	1465	2874
		1380	1791	3171
		3068	-470	2598
1995	Q1	346	1249	1654
		135	808	1042
		2254	-952	1356
		918	363	1320
1996	Q1	1819	-487	1390
		1773	-62	1677

ii. Recent acceleration in the growth of domestic final sales

Annualised % growth rate in previous two quarters in

		Domestic expenditure	Domestic final sales (i.e., domestic exp. - stockbuilding)
1991	Q3	-3.7	-2.0
		1.0	-0.5
1992	Q1	0.5	-0.3
		-0.1	-0.3
		2.3	0.1
		1.1	0.8
1993	Q1	1.5	2.5
		2.1	1.4
		2.4	1.3
		3.3	3.3
1994	Q1	2.9	3.3
		2.4	1.7
		1.9	1.1
		4.3	3.3
1995	Q1	0.5	2.3
		0.2	1.0
		3.1	0.1
		1.3	0.4
1996	Q1	2.5	2.7
		2.4	4.0

Source: Office of National Statistics, press release (96) 154, "Quarterly national accounts".

final sales. (Note that the figures for stockbuilding in Table 1 are those which appear in the GDP table in the national accounts and include the alignment adjustment. The impact of the stocks fluctuation in dampening growth from early 1995 to early 1996 is greater, if the alignment adjustment is excluded.)

2. Net exports

The weakness of net exports from mid-1995 can be largely attributed to a short-lived European recession in late 1995 and the rather hesitant nature of the return to growth in most European countries in early 1996. Domestic demand in Italy and Spain has been notably sluggish, as these countries struggle to meet the Maastricht criteria for participation in European economic and monetary union. With Europe likely to see better growth in the next few quarters, and the world economy also expanding well, the growth of the UK's exports may not be much behind the growth in the UK's imports over the next few quarters. A deterioration in the trade balance normally provides the economy with an escape-hatch from rapid growth in domestic demand. But - with external demand rising - that escape-hatch may not open in 1997 and 1998.

So domestic final sales are already growing quickly

The key message from Table 1 is given by the last number in the final column, showing a 4.0% annualised growth rate in domestic final sales in the first half of 1996. This was the highest figure for the growth of domestic final sales since the recovery began. In fact, if it had not been for the negative impact of lower stockbuilding, total domestic demand would have been increasing at above its trend rate even in the first half of 1996. As emphasized earlier, the pace of growth has undoubtedly strengthened in the last few months.

3. Gross domestic fixed capital formation

One or two remarks about investment are the last pieces of the jigsaw. An interesting article on "Testing for bias in initial estimates of the components of GDP" in the August issue of *Economic Trends* conceded that bias was found in the first official estimates of gross domestic fixed capital formation. These estimates tended to be significantly lower than actual GDFCF. Moreover, the under-estimate carried through to total GDP on an expenditure basis. It seems possible that the GDFCF numbers for early 1996 have again been affected by these problems. According to the national accounts, GDFCF in nominal terms was 5.0% higher in the first half of 1996 than a year earlier, but it was up only 0.9% in terms of 1990 prices, implying a price deflator of 4.1%. An inflation rate in capital goods of almost 5% seems impausible, in view of the excess capacity in the construction sector and the falling prices of computers and other items of office equipment. The GDFCF numbers will probably be revised upwards. This reinforces the message that, if it had not been for the temporarily restrictive effect of stocks and net exports, the economy would have returned to trend (or even above- trend growth) in early 1996.

Official figures may understate recent growth

The outlook over the next two years

If growth in early 1996 was at trend despite an adverse movement in stocks, and if growth in domestic final sales in late 1996 is running at an above-trend rate which will eliminate any remaining over-hang of excess stocks, what can be said about growth prospects in early 1997?

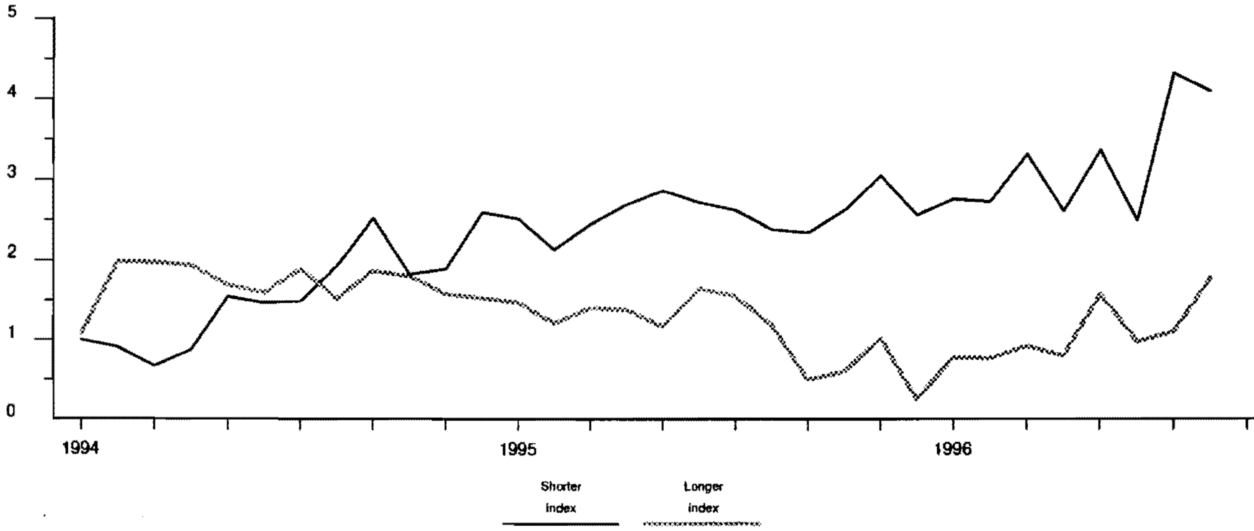
Change in stockbuilding likely to be a *positive, not negative,* influence on GDP growth in 1997

They depend - in terms of arithmetic - on the relative contributions of domestic final sales, stockbuilding and net exports. Leading indicators of economic activity, such as data for orders already placed (like car registrations) or of definite spending intention (mortgage commitments, for example), argue that the growth in domestic final sales is likely to remain high in the next few quarters and may even accelerate. (See Chart 1.) It also seems likely that movements in stocks, instead of holding the growth in domestic demand beneath that of domestic final sales, will cause the growth in domestic demand to be above that of domestic final sales. The conclusion is that demand growth could reach quarterly rates of 1% to 1 1/4% in early 1997 (i.e., annualised rates of 4% to 5%). The growth of GDP would be significantly lower than these figures only if net exports were heavily negative.

Negative output gap could be eliminated by end of 1997

The kind of growth rates indicated here (i.e., 1/2% a quarter, or 2% a year, more than the trend rate of 2 1/2%) would eliminate the negative output gap by late 1997. If output growth continued to run at 1% or more a quarter, the negative output gap of the early and mid-1990s would be replaced by a positive output gap. The positive output gap (i.e., an excess of actual over trend output) might persist throughout the late 1990s, just as it did in the late 1980s after the Lawson boom. Inflation would keep on rising until the level of output were again curbed to its trend figure. The precise quarterly and annual profile of demand and output in 1998, 1999 and 2000, and the nature of policy-makers' response to the re-emergence of an inflation problem, cannot be predicted in October 1996. But the sad tale of the late 1980s - when forecasters constantly under-predicted both output and inflation - might be repeated. If so, it would not be foolish to envisage, even at this early stage in the game, an increase in inflation to well over 5% a year.

Chart 1 Lombard Street Research's leading indicator indices



The indices, like national output, fluctuate around a trend level represented by the origin in the chart.
Shorter leading index leads the economy by around six months; longer leading index leads the economy by about a year.

Source: Lombard Street Research calculations

Underlying cause of new inflation risks is acceleration in monetary growth

The gloomy assessment of the UK's medium-term inflation prospects of course raises the question of the underlying cause of both the current upturn in economic activity and the return of inflation. The essence of the answer is simple. The UK is on the threshold of another inflationary episode because of the acceleration in (broad) money growth since early 1995. While a miscellany of other factors can be cited, a key cause of the increase in demand growth in late 1996 has been the upturn in real money growth since early 1995. While excess real money growth stimulates above-trend growth of demand and output in the short run, in the long run rapid money growth cannot deliver any extra real output. So - sooner or later - the rate of real money growth has to be brought down to the trend rate of real output growth, plus or minus an adjustment for changes in the equilibrium ratio of real money balances to output.

Real money growth cannot indefinitely run at a higher rate than trend growth of real output

The key question for the UK macro-economic outlook over the next few quarters is whether the reduction in real money growth happens soon because of sensible and timely policy action or late as a result of an upturn in inflation. Ideally, the Government and the Bank of England ought to be considering measures now - in terms of raising interest rates and pursuing actively restrictive debt management (i.e., selling government debt outside the banking system) - to limit monetary growth. In that case the reduction in real money growth to a sustainable annual rate of 2% to 4% might be accomplished by a fall in the rate of nominal money growth to, say, 4% to 6% a year. If action is postponed and broad money growth stays at about 8%, 9% or 10% a year, the reduction in real money growth to 3% or 4% a year will occur because of nature's remedy, a rise in inflation to over 5% a year.

Uncertainties about monetary analysis should not be exaggerated, particularly given the stability of the personal sector's demand to hold money

Critics of the monetary approach to macro-economic analysis might object that the relationship between monetary growth and national income is too imprecise to justify the strong conclusions drawn here. In particular, they might object that the phrase "plus or minus an adjustment for changes in the equilibrium ratio of money balances to output" is an evasion, because no one can be certain in the real world when the equilibrium ratio of money balances to output has changed. This is certainly an area of considerable debate among economists. However, Lombard Street Research has identified a stable demand function for the personal sector's money balances for a period extending over 30 years. The Bank of England also appears to be using a similar relationship in its analysis of the economy. The deputy governor, Mr. Howard Davies, referred to it in a speech given recently to the Money Study Group, noting that the personal sector's money balances are running about £10b. above the expected level. This agrees with the view that the economy at present has excess money balances.

Excess liquidity most obvious in the financial sector

Another salient feature of the monetary environment since early 1995 has been the remarkably fast growth of financial institutions' money holdings. In broad terms, whereas the annual growth rate of the money supply has increased from 5% a year to 10% a year, the annual growth rate of the financial sector's money holdings has soared from under 10% to 20% or more. The importance of this development was discussed at some length in Lombard Street Research's April 1996 *Submission* to the Panel, which warned that it was "a naive misunderstanding to think that financial markets are segregated from the rest of the economy". A key sentence in that *Submission* was that "[t]he behaviour of asset prices and the economy at present - with rising share prices, high prices of agricultural land, a rather under-valued exchange rate and recent large revaluations of hotel property, accompanied by incipient signs of recovery in spending on big- ticket items of personal spending - is entirely consistent" with an analysis carried out in 1993 of the expected consequences of a well-defined upturn in monetary growth. It is now six months later and not one word of that comment needs to be retracted. Share prices are even higher, hotel prices have increased again and the commercial property market is stirring, while housing market turnover and car registrations are more buoyant than at any time since the late 1980s.

Is spontaneous slowdown in money growth possible at current interest rates?

Is there a fundamental flaw in the analysis here? Specifically, could inflation remain under control without a rise in interest rates? There is a possible way out. If the growth of bank and building society credit eased spontaneously at current interest rates, monetary growth might return to 5% a year or less without an interest rate upheaval. (Money is dominated by deposits on the liabilities side of banks' balance sheets. Banks' liabilities expand if they can increase their assets by extending new credit.)

It seems unlikely, in view of the buoyancy of mortgage credit

The stock of bank and building society lending was £753.1b. in the middle of 1996, of which £371.4b. was lending to persons for house purchase and a further £53.4b. was other forms of lending to the personal sector, including consumer credit. So prospects for total credit growth are strongly influenced by the outlook for mortgages and consumer credit. The latest data are clear-cut. Far from being about to weaken spontaneously, the demand for personal credit is

Table 2 Mortgage lending in the 1990s

	Refinancing*	Net advances	Gross advances
1993 Q1	9,562	3,329	12,891
	9,693	4,033	13,726
	8,905	4,419	13,324
	9,178	4,915	14,093
1994 Q1	9,221	4,954	14,175
	9,527	4,759	14,286
	9,741	4,881	14,623
	9,980	4,665	14,645
1995 Q1	9,704	4,504	14,207
	10,168	3,762	13,930
	10,369	3,440	13,809
	11,459	3,627	15,086
1996 Q1	11,902	4,084	15,986
	12,568	4,412	16,980

Refinancing refers mostly to repayments followed by replacement borrowing when people move. Gross advances are the sum of refinancing and net advances.

Source: Bank of England

strong and rising. The value of mortgage loans approved (i.e., a gross figure for mortgages approved, including those where a repayment was followed by a replacement borrowing) in 1995 averaged £13.7b. a quarter. In the first quarter this year it was £15.2b., in the second quarter it was £17.0b. and in the third quarter it could exceed £18b. (See Table 2.) Net mortgage lending (i.e., the increase in banks' and building societies' mortgage portfolios) was £15.3b. in 1995, but ran at an annual rate of £16.4b. in the first quarter, £17.6b. in the second and almost £20b. in the third. If these trends continue, a forecast of £25b. in 1997 would not be silly. Meanwhile consumer credit, which was static in the early 1990s, is booming. The annual growth was still under 10% in 1994, but exceeded 15% in early 1996. In the three months to August the annualised growth rate was 17.1%.

Admittedly, corporate loan demand may have weakened because of less take-over activity

A decline in credit growth is therefore conceivable only if lending to other sectors (i.e., companies, financial institutions and overseas) moderates in the next few quarters. The take-over boom of 1995 and early 1996 has died down recently, and there have also been reports of less management buy-out activity. But this seems a slender reed on which to rely. Several large property deals are in the offing and these will involve a significant element of bank finance. Further, the swing from low stockbuilding in early 1996 to somewhat higher stockbuilding in early 1997 will - on past form - translate into a higher corporate demand for bank credit.

M4 credit and money growth are not about to decline

So - at current interest rates - new M4 lending is not about to decline. On the contrary, it will probably increase. Since mid- 1995 it has been running at about £14b. - £16b. a quarter, i.e., at an annual rate of £56b. - £64b. This may well move up towards £17b. or £18b. a quarter, implying an annual growth rate of almost 10% in the stock of M4 credit. In the absence of a dramatic change in other credit counterparts (for example, because of a re-assessment of debt management strategy or a marked widening in the current account deficit on the balance of payments), broad money will also continue to increase at about 8%, 9% or 10% a year, at the top of the Government's monitoring range.

Policy recommendations

Period of stability in jeopardy

Over the last few years the British economy has come closer to securing medium-term financial stability than at any time since the 1960s. The argument of this *Submission* is that the achievement of the early and mid-1990s is in jeopardy. The economy is once again on the threshold of a business cycle which will lead to higher inflation in the late 1990s. It is impossible to say at this point whether it will be a mild stop-go cycle or a severe boom-bust cycle, or to be precise about how high inflation may go. But the period of stability is coming to an end.

Higher interest rates and restrictive debt management appropriate

In terms of policy instruments, the right answer on the monetary front is to raise interest rates and to sell government debt exclusively at the long end (i.e., away from the banking system). On the fiscal side the PSBR should be reduced by tax increases and/or expenditure cuts. The monetary measures are far more important than the fiscal, as fiscal action probably has little effect on national

on monetary side, and action to curb PSBR on the fiscal side

income except in the short run. As the budgetary position is unsatisfactory anyway because of the high level of the general government current account deficit, the case for fiscal restriction can also be based on concern about the unsustainability of current medium- and long-term trends in public debt.

To avoid over-heating money growth should be consistent with low inflation when output is just about to return to trend

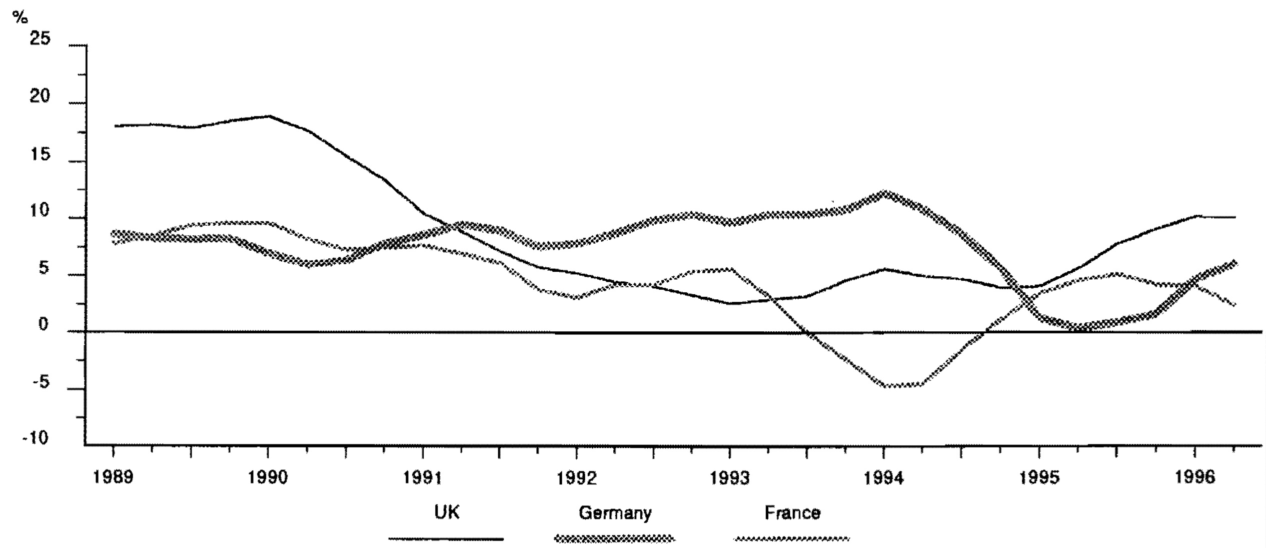
In terms of intermediate target variables, the analysis can be framed in terms of the desirable rate of monetary growth. If output returns to its trend level when broad money growth is excessive compared with the Government's inflation target, a period of over-heating is inevitable. The over-heating will persist until a rising inflation rate erodes the nominal value of money balances to such a degree that the real growth rate of money is equal to the real growth rate of output (plus or minus the adjustment for changes in the equilibrium ratio of money to income). If this view of inflation determination is accepted, the correct rule for monetary management is easily stated. When output is just on the verge of coming back to its trend level, monetary growth should be consistent with the Government's long-run inflation objective.

Money growth needs to be reduced to annual rate of 5%

The message of the last paragraph may be spelt out with specific figures. The essence of the forecast presented here is that national output, currently perhaps 1 1/2 or 2% beneath trend, will return to trend in late 1997 (or maybe early 1998) when broad money growth is virtually 10% a year and so is too high relative to the 2 1/2% inflation target. Inflation in the late 1990s will therefore be well above 2 1/2%. It would be better if output returned to trend when broad money growth were about 5% a year. Of course, if deliberate action were now taken to dampen monetary growth, national output would return to trend some quarters, perhaps even one or two years, further into the future than late 1997/early 1998. In that sense there would be a short-run cost (in terms of lost

Chart 2 Broad money growth in the UK, Germany and France

Chart shows annual increase %, quarterly data, since the start of 1989. The re-unification blip in 1990 has been taken out of the German series.



Source: OECD

national output and less employment in 1997 and 1998) from adopting a monetary policy geared towards medium-term stability instead of allowing monetary policy to stay on its present inflationary course. But the long-term benefit - with the UK at last having a stable unit of account and store of value - would be enormous.

Meetings - and - minutes policy framework is unsatisfactory

In terms of the institutions for taking macro-economic decisions, the key point is the unsatisfactory nature of the current arrangements. Superficially, the monthly meetings between the Chancellor of the Exchequer and the Governor of the Bank of England, combined with the publication of the minutes, represent a transparent policy-making framework. As debates and disagreements are on the record, responsibility for mistakes lies clearly with either the Chancellor or the Governor, while there is ample room for outside commentators to make their views known.

because decisions on interest rates remain highly political

But in fact all the power to determine interest rates still rests with the Chancellor. The Chancellor is - first and foremost - a politician, and his priority in the months leading up to a general election is to secure his own Government's re-election. There is a long and well-known lag between an upturn in money supply growth and the increase in inflation. He has every temptation to exploit this lag, particularly as the initial effects of faster monetary growth on output and employment are favourable. If another political party is in fact successful at the general election, the unpopular task of restoring anti-inflationary monetary policy rests with this party who are his opponents; if the Government wins the election, the electorate has been deceived, but the Chancellor - who may in any case soon move to another job - is one of "the men of the moment". The larger implication of the present episode of monetary mismanagement is that the meetings-and-minutes framework of British monetary policy has not achieved a sufficient shift of power towards the Bank of England. It has not taken politics out of the determination of interest rates.

UK will have higher inflation than other European countries in the late 1990s, because of divergence in money growth

One final aspect needs to be highlighted. A wide gap has now opened up between money supply growth in the UK and most other members of the European Union. (See Chart 2 on p.11.) On past form the consequence will be a marked divergence between inflation in the UK and its neighbours, particularly in 1998 and 1999. This divergence will almost certainly receive unflattering comments from the quality newspapers and the chattering classes, who will regard it as another demonstration of the UK's need to participate in the exchange rate mechanism and the single currency project. It needs to be emphasized - before the event - that no such demonstration follows. The fundamental reason for the prospective gap between UK inflation and inflation in other European countries is the huge difference in money supply growth rates. If the UK were able over the long run to maintain slower money growth than elsewhere in Europe, the pound would be a strong currency. Further, the UK does not have to participate in European economic and monetary union (EMU) in order to have a stable currency.