# LOMBARD STREET RESEARCH

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# More rows about the exchange rate ahead

## In the long run price level determined by money growth

**Establishment vs. Keynesian/ Kaldorian view of the exchange rate**

Since the UK's first abandonment of the gold standard in 1919 the Treasury, the Bank of England and the policy-making establishment have squabbled about the right value of the pound. Most participants in the debate have regarded the exchange rate as the correct guide to interest rate decisions. But two ideas have been in conflict. The first (which might be termed "the Establishment view") is that - if other countries are on average conducting sensible monetary policies - a passive policy of fixing the exchange rate will keep the British inflation rate respectably low; the second ("the Keynesian/Kaldorian view") is that the exchange rate is an active instrument of policy and should be manipulated in order to secure broader objectives, such as export competitiveness and higher employment.

**and neither view has prevented long-run loss of value for the pound**

The Establishment view has held sway most of the time. It has led to several episodes of monetary deflation imposed from outside, notably during the restored gold standard between 1925 and 1931, and also the UK's membership of the exchange rate mechanism from 1990 to 1992. But it has been far too permissive of excess domestic credit growth when the exchange rate is strong and, over the decades, it has not prevented a substantial fall in the external value of the pound. The Keynesian/Kaldorian view has been espoused by officialdom only occasionally, but it was held by many influential economists and civil servants in the 1970s. Their attitude was part of the explanation for the plunge in sterling's value in 1972 and 1973, and for the resistance to sterling's appreciation in 1977. The net result of Establishment/Keynesian bickering and compromising is that since the 1920s the pound has lost 70% of its value against the US dollar, which has itself lost over 80% of its internal purchasing power.

**Key to price stability is to control rate of money growth**

1997 may see another fierce debate about the exchange rate. Already a number of commentators are urging that the pound's recent appreciation argues against a rise in interest rates, despite 10%-a-year money supply growth and the upturn in domestic demand. In this context the Bank of England's latest *Quarterly Bulletin* and *Inflation Report* are interesting, even revolutionary documents. An article by Astley and Garratt in the *Quarterly Bulletin* on 'Interpreting sterling exchange rate movements' proposes that exchange rate levels are "endogenous variables" which can be interpreted in terms of economic variables, including differences in the rate of monetary growth between countries. Once this step has been accepted, it becomes possible to think about adjusting interest rates in order to control the quantity of money, instead of targetting the exchange rate. None of this guarantees that interest rates will increase over the next few months, in the teeth of industrialists' protests about the "high" exchange rate. But it does at least make a rise in interest rates more likely.

Professor Tim Congdon

3rd December, 1996

# Summary of paper on

## 'The condition of the British financial system, late 1996'

**Purpose of the paper**

The rate of monetary growth has powerful effects on balance-sheet strength throughout the economy and, hence, on the growth of demand and output. The purpose of the current *Monthly Economic Review* is to consider how much effect the acceleration in monetary growth since early 1995 has had on balance-sheet strength.

### Main points

* **Apart from the personal sector, all parts of the British economy have made a complete convalescence from the financial strains of the recession of the early 1990s.**

* **The personal sector still suffers from high indebtedness relative to the value of the housing stock. (See p. 7.) But the annual increase in house prices may be about to exceed the post- tax mortgage rate, for the first time since 1988. (See p. 6.)**

* **Reflecting the burden of mortgage indebtedness, personal bankruptcies continue to run at extremely high levels by pre-1990 standards, while company liquidations are at roughly the same rate as in the early and mid-1980s. (See p. 4.)**

* **Despite the high incidence of personal bankruptcies, both banks and building societies are strongly capitalised. In particular, building societies' reserves are well above historically-normal levels. Unless they can expand their mortgage business more rapidly, it is hardly surprising that they want to deploy their capital elsewhere by de-mutualisation and/or conversion into banks. (See p. 10.)**

* **Company finances are in good shape, providing part of the explanation for the current spate of take-over deals. (See p. 12.)**

This paper was written by Professor Tim Congdon, with help from Stewart Robertson and Brendan Baker.

# The condition of the British financial system, late 1996

## Faster monetary growth helping balance sheets across the economy

**Changes in money growth affect balance-sheet strength, asset prices and investment**

Fluctuations in broad money growth have important effects on balance-sheet strength and balance-sheet strength then influences spending of all kinds, but particularly on capital items (such as houses, cars and consumer durables by the personal sector, and investment and stocks by companies). The volatility of capital expenditure is crucial in understanding the business cycle. (The role of capital expenditure is of course emphasized in Keynes' theory of national income determination. According to that theory, as set out in *The General Theory* of 1936, expenditure is of two main kinds, consumption and investment. Consumption depends on income, whereas investment is determined by other factors, such as the rate of interest, business confidence and the balance-sheet position of key economic agents. Investment is therefore independent of national income and national income is a multiple of investment.)

One argument - associated with Professor Patrick Minford of Liverpool University - is that faster broad money growth has no net effect on the private sector's balance sheet, because banks' extra money liabilities are matched by extra assets. However, this is to overlook that a deposit (which can be spent an indefinitely large number of times) is a very different kind of financial instrument from a loan (such as a mortgage, which has a more or less fixed repayment schedule sometimes lasting 25 years). Simultaneous expansion of both sides of banks' balance sheets makes people and companies feel more "liquid", and they are inclined to spend more out of income than they would have done before.

**Current acceleration in money growth is having the usual effects, but personal sector still suffers from excessive mortgage debt**

The survey of balance-sheet strength in this *Monthly Economic Review* follows the same structure as similar surveys in October 1992, October 1993, October 1994 and September 1995. There has been an immense change since October 1992, when the plunge in broad-money growth since 1990 had crippled balance sheets, especially in the personal sector, and necessitated a drastic change in macroeconomic policy (i.e., the UK's exit from the exchange rate mechanism and a sharp fall in interest rates). The banking system is again well-capitalised, while building societies have exceptionally strong reserves. (See pp. 8 - 11.) Credit and money growth are therefore reviving, and - as might be expected - there are many signs of a broader economic recovery. But it is striking that lending to companies and financial institutions is more buoyant than lending to persons, reflecting the constraint placed on household borrowing by the overhang of excessive mortgage debt from the late 1980s.

# Bankruptcies and failures

## Better housing market should reduce personal bankruptcies

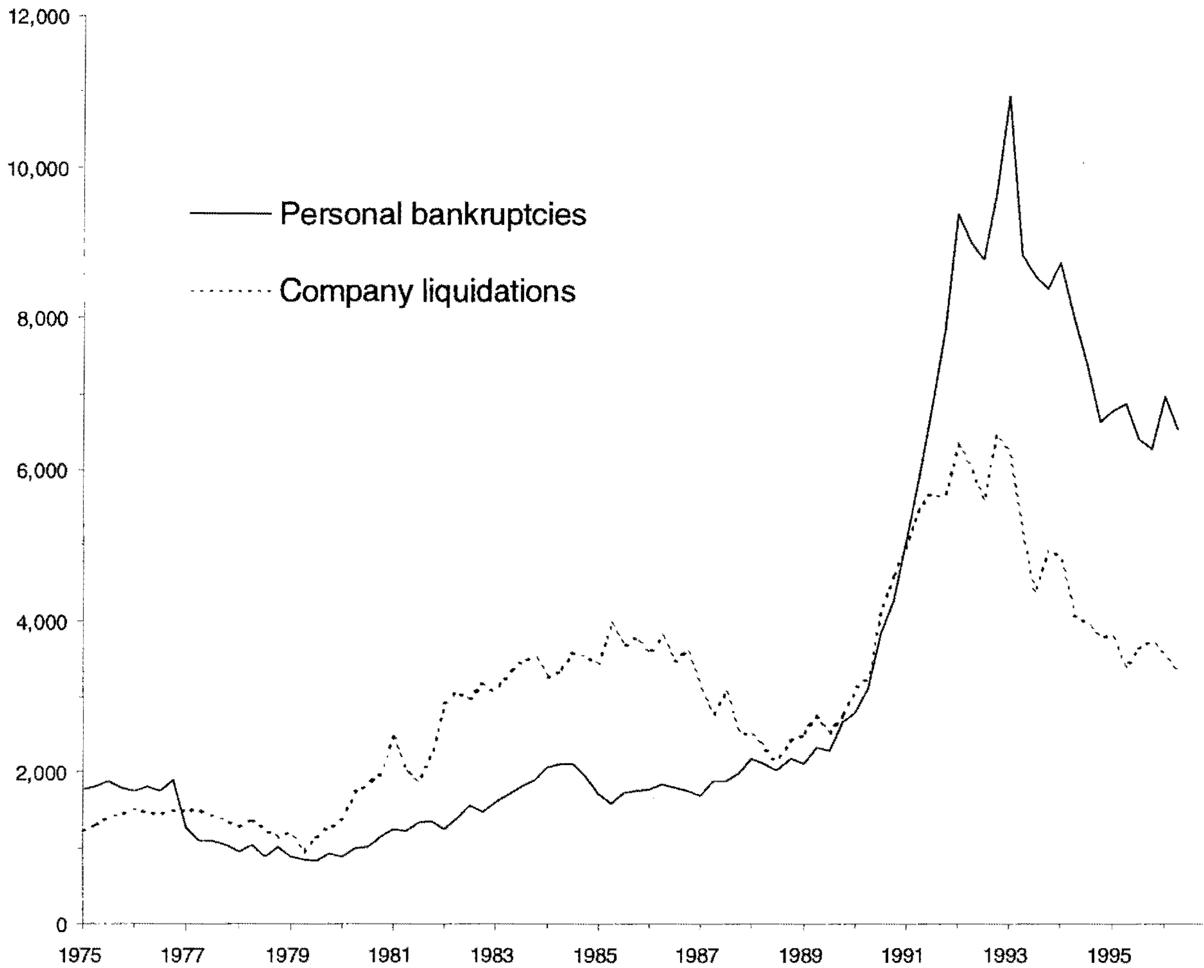



*Chart shows the quarterly number of personal bankruptcies and company liquidations, according to the DTI. (The figures for 1996 are only for the first half of the year.)*

The financial hangover from the credit binge of the late 1980s continues to trouble the British economy. For the first time in the post-war period house prices fell significantly between 1989 and 1993, and the number of personal bankruptcies reached record levels. The incidence of bankruptcies has fallen from the peaks in 1992 and 1993, but it is still remarkably high by pre-1990 standards. However, the macroeconomic damage has been contained because banks' and building societies' strong operating profits have enabled them to absorb high loan losses, and yet to achieve strong increases in their capital by retentions. With house prices now rising quite briskly again, personal bankruptices are likely to be much fewer in the rest of the 1990s. Company liquidations are back to the level of the mid-1980s.

# The state of the commercial property market

## Recovery in rental growth offers prospect of better returns


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

With a large proportion of commercial property purchases financed by borrowing, interest rates are important in any discussion of total returns. Property returns edged above short-term interest rates in 1995 and, on current trends, this gap should widen for 1996 as a whole. In 1994 returns surged principally because of increased capital values. However, these gains were not sustained and falling valuations depressed returns in 1995. In 1996 capital values have stabilised. Market reports suggest that shortages of prime office and retail space are contributing to higher rental growth, especially in central London. Indeed, according to data from Hillier Parker, all-property rental growth is currently running at 5%, the best performance since the early 1990s. This revival seems likely to contribute to total returns from property of close to 10% in 1996.

# The state of the housing market

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

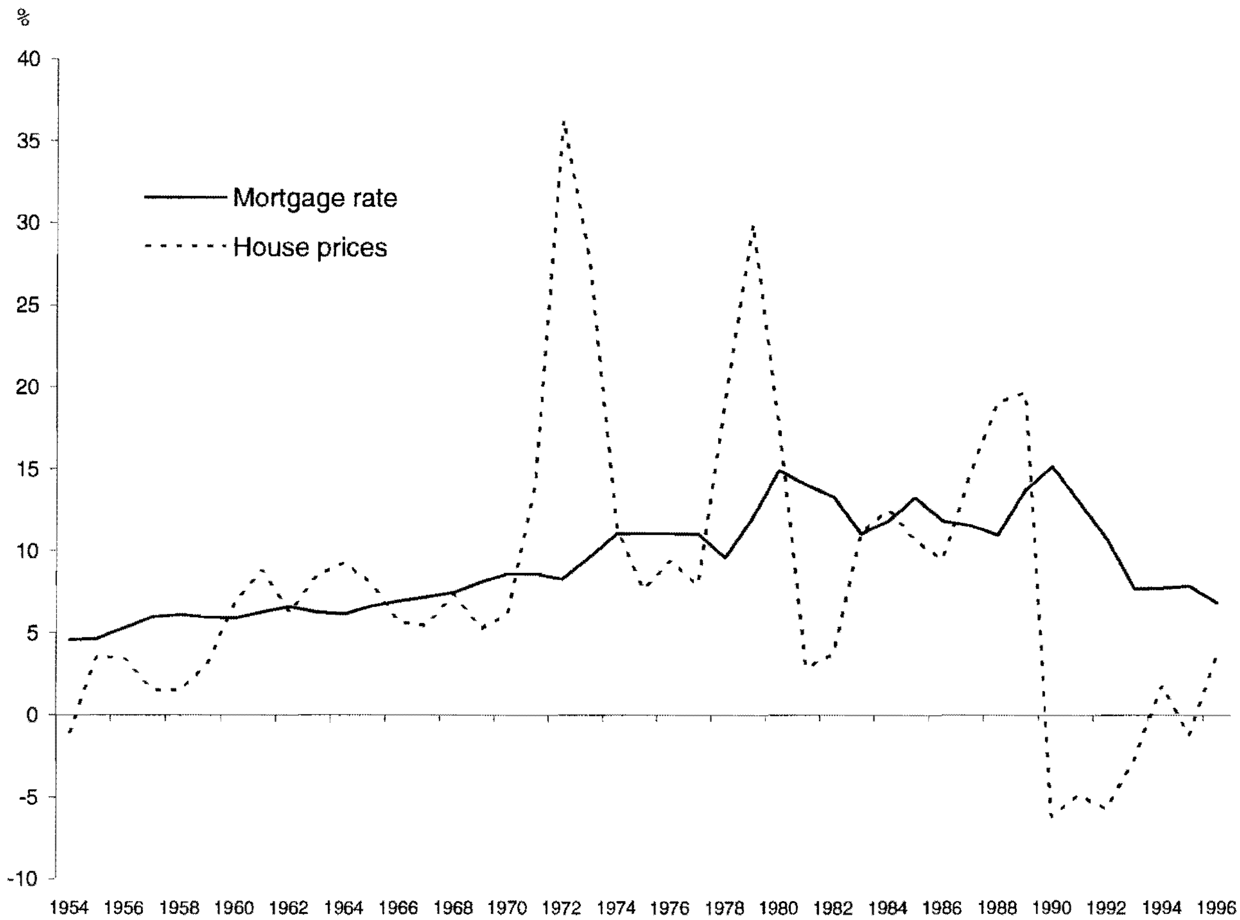
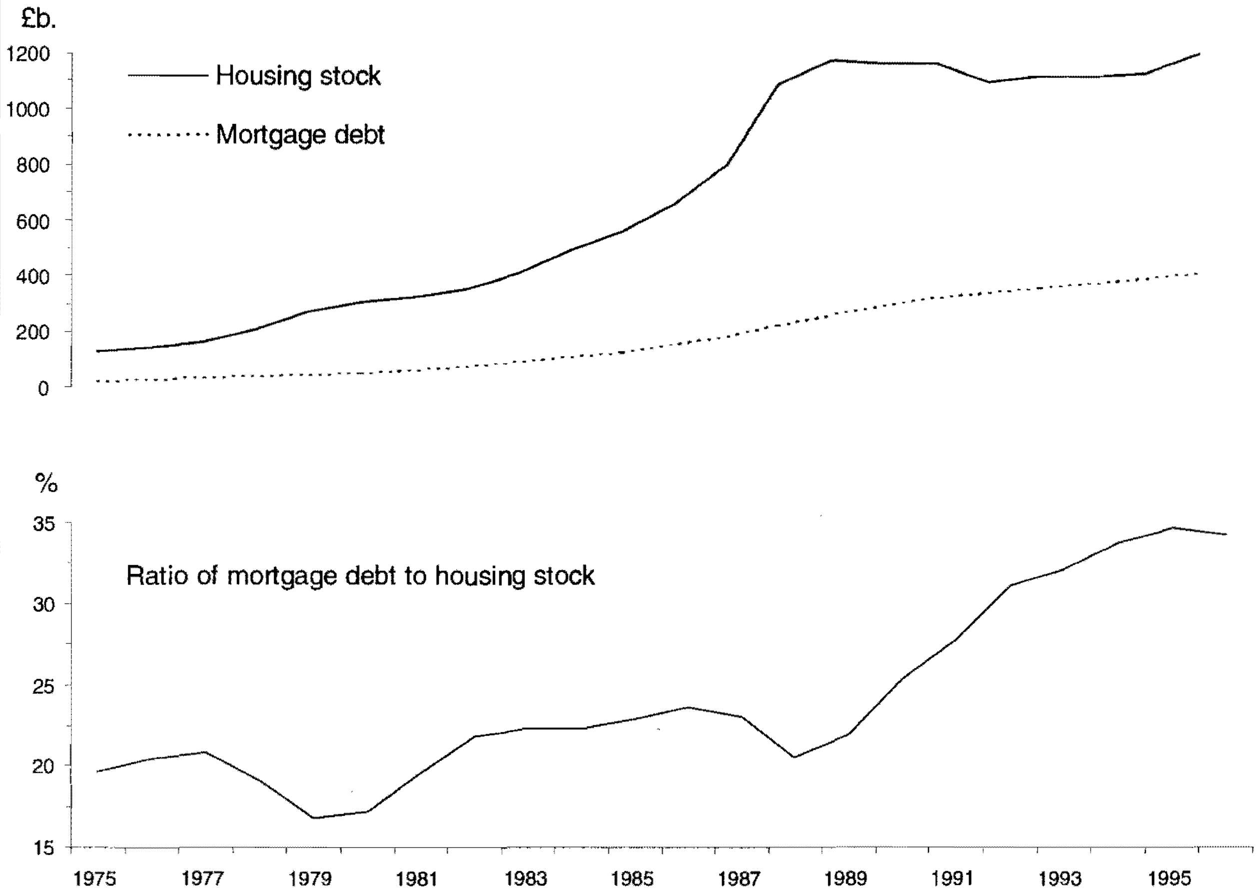



*Chart shows the percentage mortgage rate (annual average from the* Compendium of Building Society Statistics *and other building society sources) compared with the annual percentage change in the Nationwide "all houses" index. (1996 is partly estimated.)*

After falling in four out of the five years to 1995, house prices now seem established on a rising trend. Higher valuations are releasing an increasing number of households from a position of negative equity. The Nationwide estimated that there were 1.2m. such households at end-June 1996, down from 1.7m. at the end of 1995. But the recovery in the property market is not evenly spread across the country. Away from the South East only Northern Ireland has shown solid growth over the last year or so. With data available for three-quarters of the year it appears that, for the UK as whole, 1996 will be the seventh year in succession that the annual change in house prices is below the mortgage rate. The outlook for 1997 is clouded by the likelihood of higher rates. A number of lenders have stopped giving discounts on mortgages and/or put up rates in line with the ¼% increase in base rates.

## 2. Mortgage debt and the housing stock

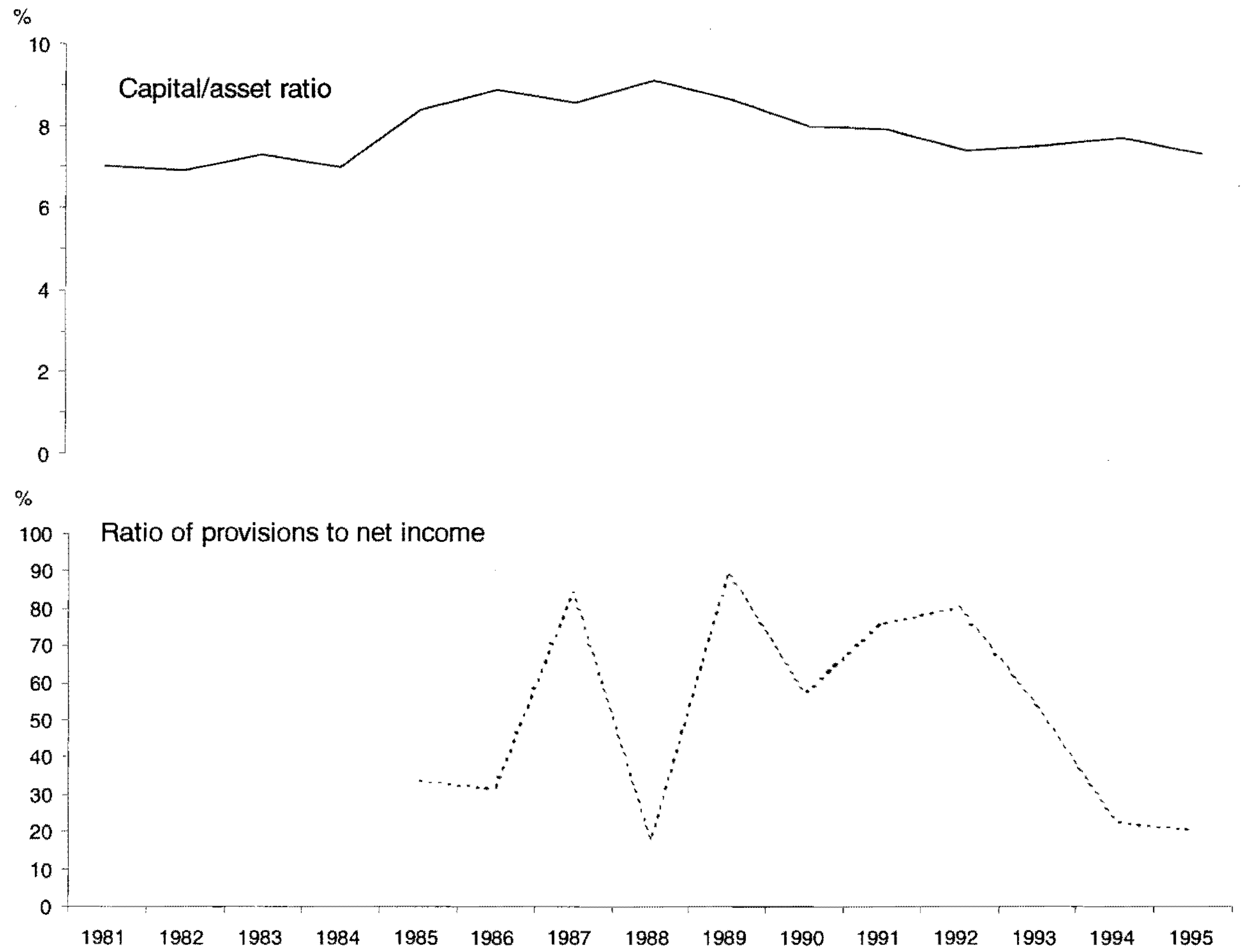



*Top chart shows the end-year value of mortgage debt and the housing stock, in £b.; bottom chart shows the ratio of the value of mortgage debt to the housing stock, in %. The value for 1996 relates to mid-year and is partly estimated. The main source is* Financial Statistics.

*Between 1988 and 1995 the ratio of mortgage debt to the value of housing* stock rose from 20.5% to 34.6%. The extent of this rise in personal sector indebtedness has been unprecedented in post-war experience. Previously, this series has tended to fluctuate around its long-term average of just over 22%. But research carried out by Lombard Street Research suggests that by end-1996 the ratio will have edged down to 34.2%. However, the reduced tax efficiency of mortgage lending (as well as a weakening in the public's confidence in housing as a sound investment) suggests that the property market recovery will not see a return of 1980s-like boom conditions, when house price inflation was running at 15%-20% a year. Without the benefits of such strong inflation, further progress in the rebuilding of the personal sector's balance sheet will be slow.

# The condition of the banking system

## 1. Banks' capital position is healthy




*The top chart shows the ratio of the capital base of the nine largest UK banks to their total assets; the bottom chart shows all provisions (specific and general) charged to their profit and loss accounts as a percentage of net income.*

The capital/asset ratio of the major British banks was lower at the end of 1995 than a year earlier. This may seem a surprising outcome, given the strong profitability that the banks currently enjoy. Part of the explanation is that Lloyds' acquisition ofTSB and the Cheltenham & Gloucester was accompanied by large goodwill write-offs. If it had not been for these write-offs, British banks' combined capital/asset ratio would have fallen, but only slightly. (Also relevant have been Barclays' share buy-backs.) The improvement in capital adequacy since the recession has stimulated greater eagerness to lend, with margins in syndicated corporate lending and the personal mortgage market still under downward pressure. With base rates today (at 6%) half of their average level in the 1980s, borrowers can more easily service their debt and the ratio of provisions to net income is back to a historically normal 20%.

## 2. Credit growth to be sustained by higher personal borrowing

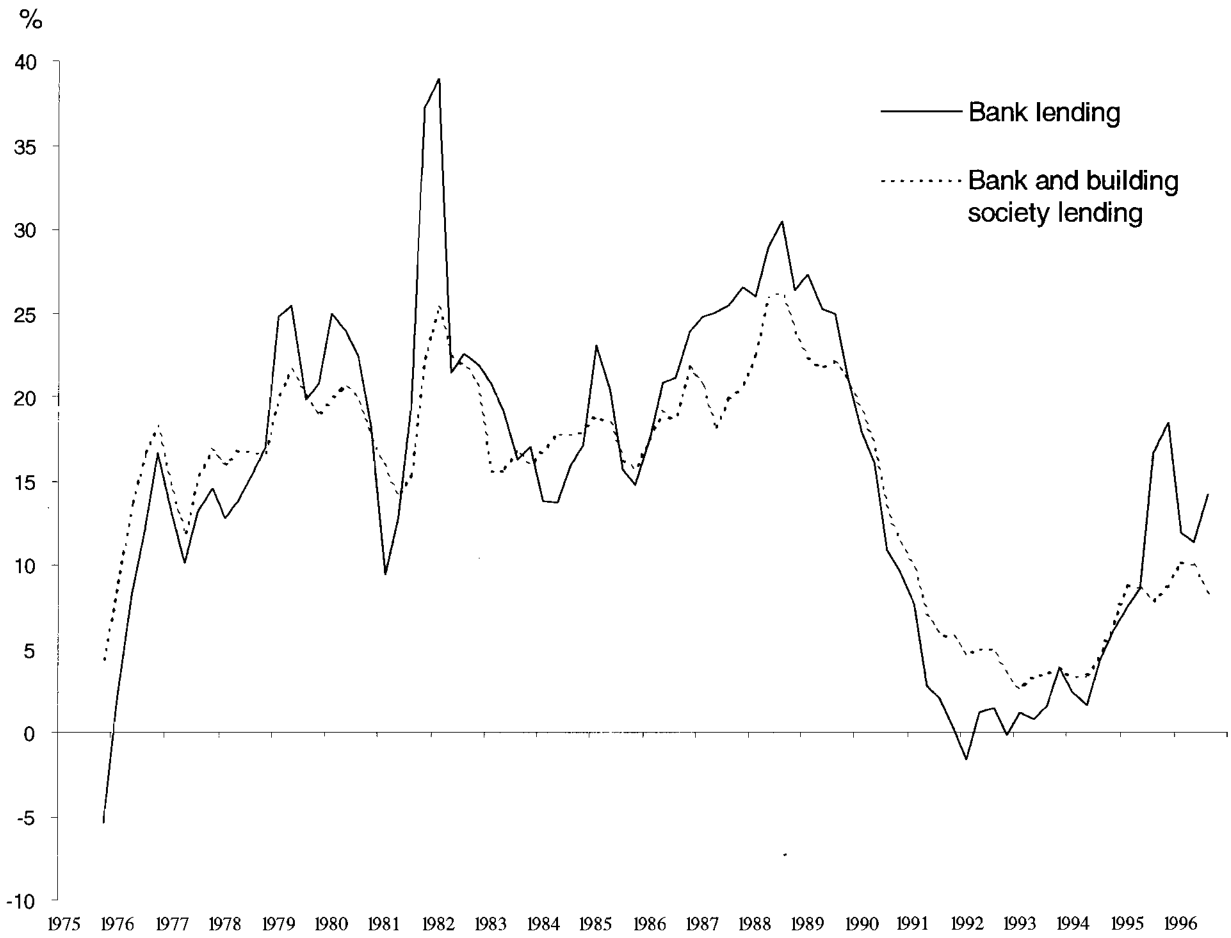
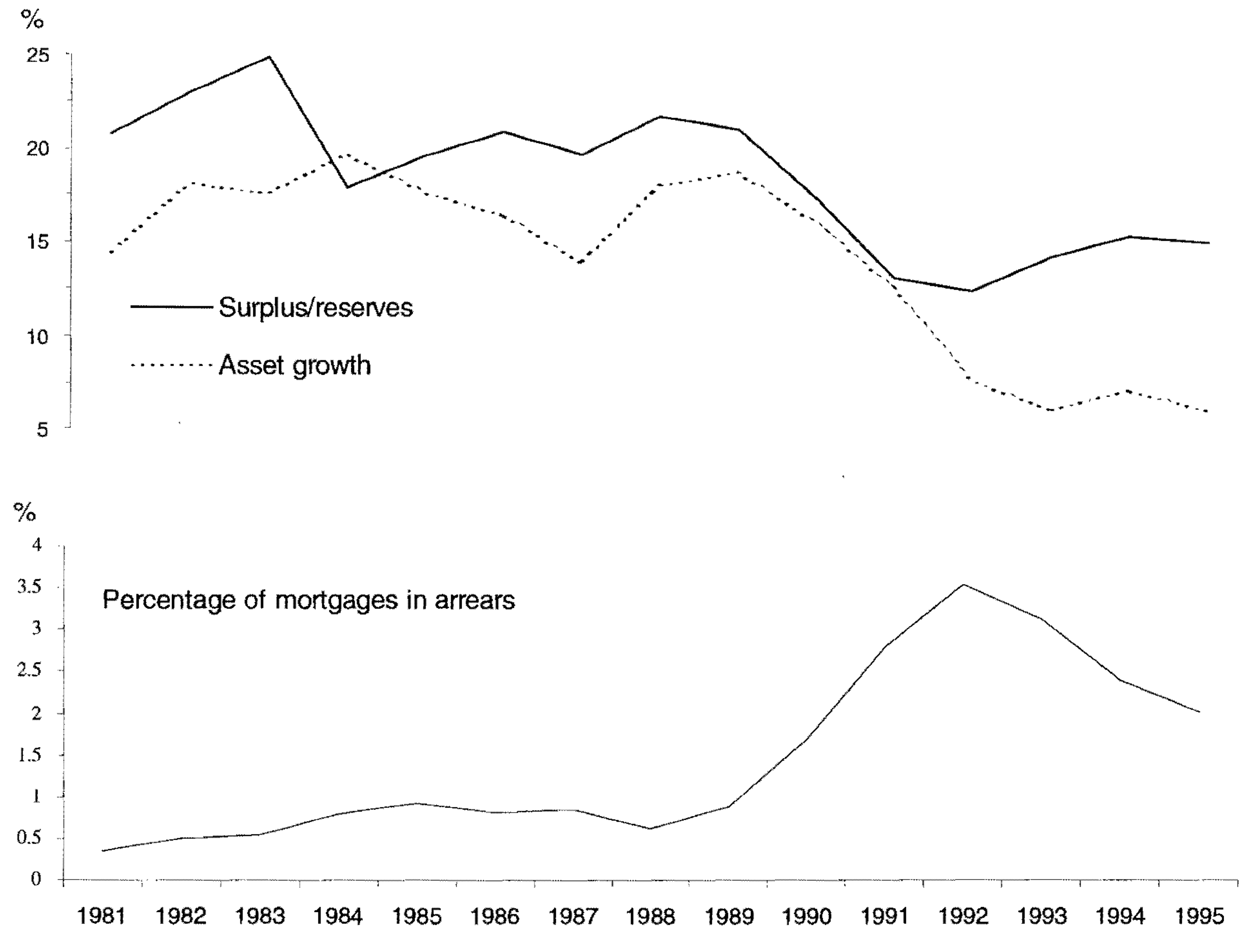



*Chart shows the percentage change in six months, at annualised rate, in bank lending alone, and in bank and building society lending combined.*

In the analysis on this page in the October 1995 *Monthly Economic Review*, it was suggested that there were "good reasons to doubt whether the [recent] acceleration in lending growth will be maintained". That comment has been wrong. Credit growth has remained at the high level seen in early 1995, with the stock of M4 lending increasing in the six months to September 1996 at an annualised rate of 8.1%. In retrospect, the Glaxo/Wellcome deal in March 1995 was a watershed between a three-year period of sluggish credit demand and the current phase of resurgent credit growth. The lull in take-over activity in the summer dampened corporate bank borrowing, but personal credit demand is reviving. In the three months to September the annualised growth rate of all M4 lending to individuals was 6.7%, the highest figure since 1990, and the pace of growth is still rising.

# Trends in the building society movement

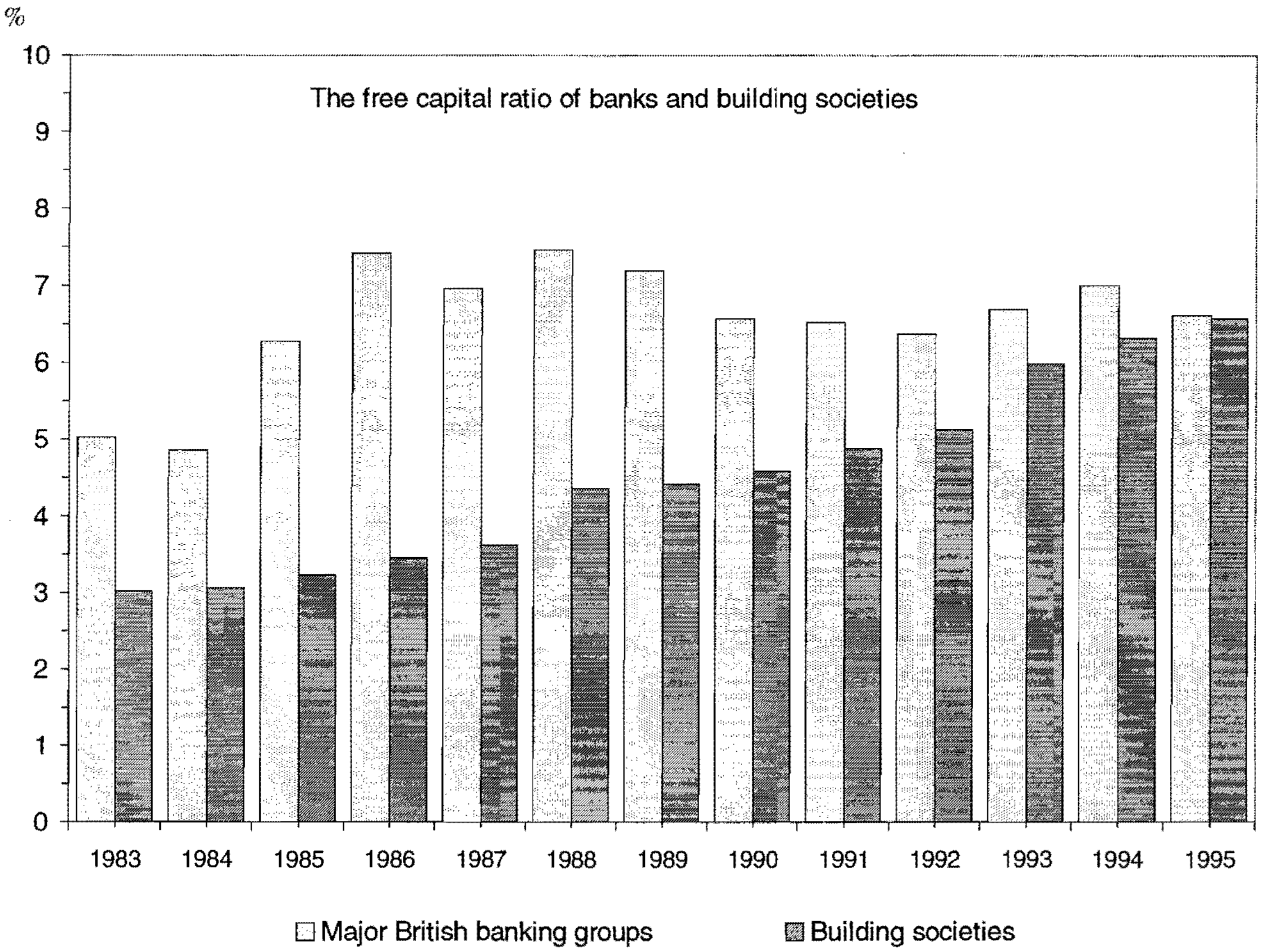
## 1. Building societies' balance sheet growth set to accelerate




*Top chart shows building societies' surplus added to reserves (as % of reserves) and percentage growth rate of building societies' assets; bottom chart shows percentage of building societies' mortgages six months or more in arrears. The figures take account of conversion of some societies to plc status.*

Building societies' surplus as a percentage of reserves (essentially a measure of profits as a proportion of capital) fell slightly in 1995 to 14.9% from 15¼% in 1994. The decline may be attributed to the fact that the housing market remained weak in 1995, in terms of both prices and turnover. However, the surplus which building societies were able to add to their reserves rose to above ¾% of assets for the first time since 1989. The main reason for the better result has been the fall in bad debt provisions. Having reached over ¾% of assets in 1992, the ratio dropped to 0.31% in 1994 and to 0.22% last year. The now-healthy reserves position (almost 6% of assets in 1995 and closer to 7% if other capital is included) argues for faster growth of their balance sheets in 1996 and 1997. The strengthening housing market and renewed demand for mortgage credit should allow them to expand more rapidly.

## 2. Building societies' capital adequacy now matches that of the major banks




*Free capital is defined as the total capital base, which comprises shareholder's funds, minority interests, loan capital and general provisions, less infrastructure. Free capital as a proportion of public liabilities (the free capital ratio) takes into account an 'amortisation' factor applied to loan stocks with less than five years to maturity.*

The Basle rules on capital adequacy (agreed in 1988) obliged building societies to adjust their capital position to bring them in line with banks. The process now appears complete as data for 1995 shows almost identical "free capital" ratios for banks and building societies. The small fall in banks' capital ratio last year was primarily attributable to the various ways in which banks handed money back to shareholders (buy-backs, special dividends etc.). Building societies now appear over-capitalised and, although the renewed growth of mortgage lending will allow them to expand their balance sheets, capital ratios are likely to remain strong. Building societies have also been able to exploit the fact that, unlike banks, they do not have to pay dividends. In practice they have under-cut banks in the mortgage market. Thus, despite the de-mutualisation of the Cheltenham & Gloucester and National Provincial, building societies' share of the mortgage market has actually risen in the last year.

# Company finances

## Companies may now invest in new assets rather than existing ones

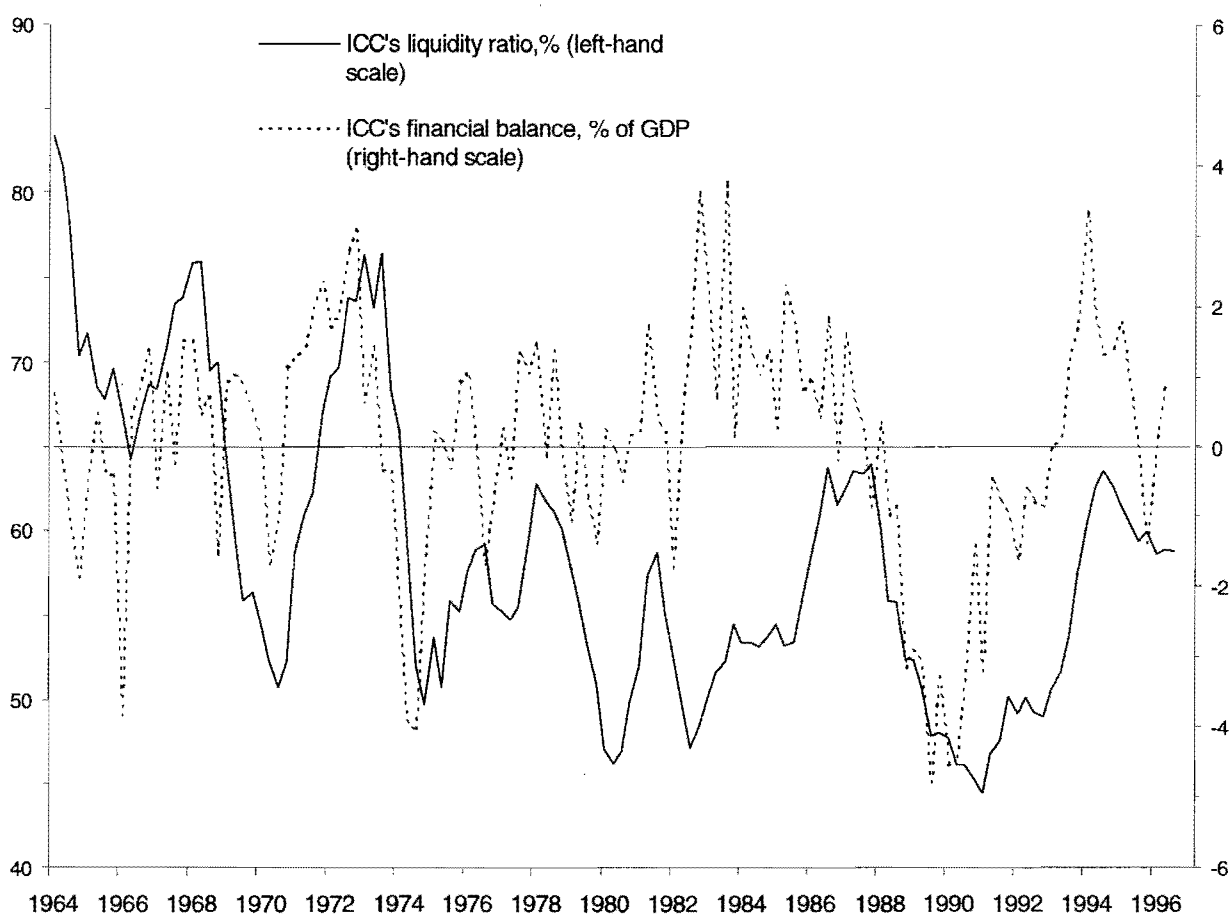



*Chart show liquidity ratio (i.e., ratio of M4 deposits to M4 borrowings) of industrial and commercial companies, and their financial deficit/surplus. The liquidity ratio is expressed as a percentage and the financial deficit/surplus as a percentage of gross domestic product.*

The key corporate liquidity ratio has fallen a little over the last two years as companies have renewed their borrowing, much of it related to take-overs. But the ratio remains healthy by historical standards, having averaged around 55% over the past twenty years. The reason that it has not declined more is that company deposits have begun to benefit from the current high rate of monetary growth. The financial surplus of the corporate sector fell sharply in 1995 as GDP growth slowed. But it is now rising and will be assisted over the next 18 months by reviving corporate profits. The conditions are now in place for a revival of investment spending, which has been sluggish so far during this recovery. Companies may wish to fund investment (and renewed stockbuilding) by borrowing, thereby boosting returns to equity.