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The big policy consequences of small statistical fibs

Important differences between three mesures of GDP

National income accounts are largely "guesstimates"

According to Mark Twain, Disraeli said there were three kinds of lies: lies, damned lies and statistics. A milder version of the same remark might be that there are three kinds of fib: fibs, unfortunate fibs and the national income accounts. The Office for National Statistics has a difficult task estimating how much the United Kingdom produces every quarter and, in the circumstances, does quite a good job. But the practice of quoting gross domestic product down to the nearest £m. is ridiculously precise. In fact, much of the time the ONS is guessing to the nearest £200m. The guesses may be well-informed, but they are "guesstimates" at best.

Three measures of GDP diverged at start of Lawson boom

GDP can be measured in three ways, by adding up all the outputs, all the incomes or all the expenditure. Crucial to the accurate estimation of GDP is the principle that the three methods should give the same answer. If they do not, the ONS knows that something has gone wrong and it conducts a critical re-examination of the information. Occasionally, the three measures of GDP fit together at a first attempt. More often the initial estimates of the three measures are quite a long way apart. In the mid-1980s, at the start of the Lawson boom, the three measures behaved quite differently, with the income- and output-based measures showing much higher growth than the expenditure-based measure. But officialdom and quasi-officialdom (which includes the so-called "leading forecasting groups" like the National Institute and London Business School) focussed on the expenditure-based measure. Some analysts have claimed that this was one reason for the failure to take early action to control the boom.

and are diverging again today, with implications for timing of increase in inflation

A similar divergence between the GDP estimates has now opened up again. In the year to the third quarter of 1996 the income-based measure grew by 2.8%, whereas the output-based measure was up by 2.5% and the expenditure-based measure by only 1.8%. Current monetary trends point to an acceleration in inflation at some point in the next few quarters. The timing will depend on which of the three estimates of GDP growth is correct. If the income-based measure is right, the "negative output gap" (i.e., the excess of trend over actual output) may be small, perhaps only 1/2% of trend output. Above-trend growth in 1997 will quickly put pressure on the economy's resources and inflation will rise in early 1998. Alternatively, if the expenditure-based measure is right, the negative output gap may remain at about 1 1/2% of trend output and the economy can grow at an above-trend rate for a few quarters before inflation becomes a problem. Past experience of the national accounts and a great deal of contemporary data (such as the recent plunge in unemployment) suggest that the income-based measure is closer to "the truth" than the expenditure-based measure. If so, higher interest rates are needed to brake the speed of economic growth, despite the strength of the pound.

Professor Tim Congdon — 6th March, 1997

Summary of paper on

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

Purpose of the paper

Financial markets are not expecting a significant acceleration in inflation over the next few years. The purpose of the paper - which follows roughly the same format as the *Monthly Economic Reviews* of March 1992, June 1993, April 1994, March 1995 and March 1996 - is to review some of the key influences on future inflation.

Main Points

* **The headline rate of inflation dipped to 2.1% last summer but has since risen back to 2.8%, about the same level as a year ago. A 25% increase in oil prices in the second half of last year was responsible for much of the rebound in inflation.**

* **Survey evidence from the CBI suggests that the current exceptionally low rates of producer output inflation will continue in coming months. A major reason for the good short-term outlook for inflation has been the 16% appreciation in sterling's effective exchange rate since last August.**

* **Estimates by Lombard Street Research suggest that output remains around 1 1/4% below trend, although official statistics are ambiguous about recent growth rates. (See p. 1.) Until output is above trend inflationary pressures will remain weak.**

* **The medium-term inflation outlook is worrying. Broad money growth remained above the top of its 3% to 9% monitoring range last year. Output is set to be above trend by early 1998.**

* **At current interest rates, the annual rate of broad money growth is likely to remain at about 10%. This is not consistent with an inflation rate of 2 1/2% or less in the long run.**

This paper was written by Professor Tim Congdon, Brendan Baker and Michael Taylor

Five more years of low inflation?

Monetary threat to low inflation has gained a firm foothold

Present analysis similar to five previous exercises

This is the sixth in a line of research papers which have assessed the outlook for inflation. The March 1996 *Gerrard & National Monthly Economic Review* concluded that inflation remained under control and that the UK's recent good inflation record would be sustained for the time being. This view has been borne out by official data so far. Between 1992 and 1996 the headline rate of inflation was, on average, 2.6%, the lowest figure over a five-year period since 1959-63. In this research paper the question is "will this performance be sustained over the rest of the 1990s?"

Pound's appreciation will help to slow inflation this year

Sterling's appreciation is exerting a significant downward pressure on prices. On a trade-weighted basis the pound is almost 20% stronger than it was a year ago. The impact of this on raw material costs is apparent. For example, in the year to January the cost of imported metals fell by 15%, while that of home-produced materials was unchanged. In response, pressure for higher prices on manufactured goods has eased. The balance of CBI members expecting to increase prices in the coming four months fell from +16% in the three months to February 1996 to +11% in the same three months in 1997. (See p. 6.) Indeed, the beneficial effect of a stronger pound on inflation is so important that the Governor of the Bank of England recently said it may allow the Government to meet its target of 2.5% for "underlying" inflation (i.e., the annual increase in the retail price index, minus mortgage interest payments) by the time of the election.

Above-trend GDP growth is narrowing the negative output gap

However, such benign short-term influences must be set against long-term trends in the economy. A stronger pound or low wage inflation can change the price level over a number of quarters. But in the long term inflation is the result of too much money chasing too few goods and services. If money growth is well above the increase in nominal incomes, people and companies have "excess real money balances", and they take steps to eliminate the excess by increasing their purchases of goods and services. In due course the rise in demand causes national output to move above its trend level (i.e., the economy "overheats") which causes inflation to accelerate. When output is below trend, as it is currently, the inflation rate should be falling or (at worst) stable. (See pp. 7 - 9.) However, this "negative output gap" is closing and calculations carried out at Lombard Street Research suggest that it will be negligible by the end of 1997.

Good inflation record in jeopardy, higher interest rates needed

The current high rate of monetary expansion is being driven by strong demand for credit from the corporate and personal sectors. (See pp. 10 and 12.) The correct policy prescription to avoid the danger of the economy "overheating" is higher interest rates now. But in the run-up to a general election restrictive action is unlikely. Without a tightening in monetary policy, broad money growth is set to remain close to or possibly even above 10%. (See p. 11.) There is a danger of inflation rising to 4% and above in 1998 and 1999.

Inflation performance over the last decade

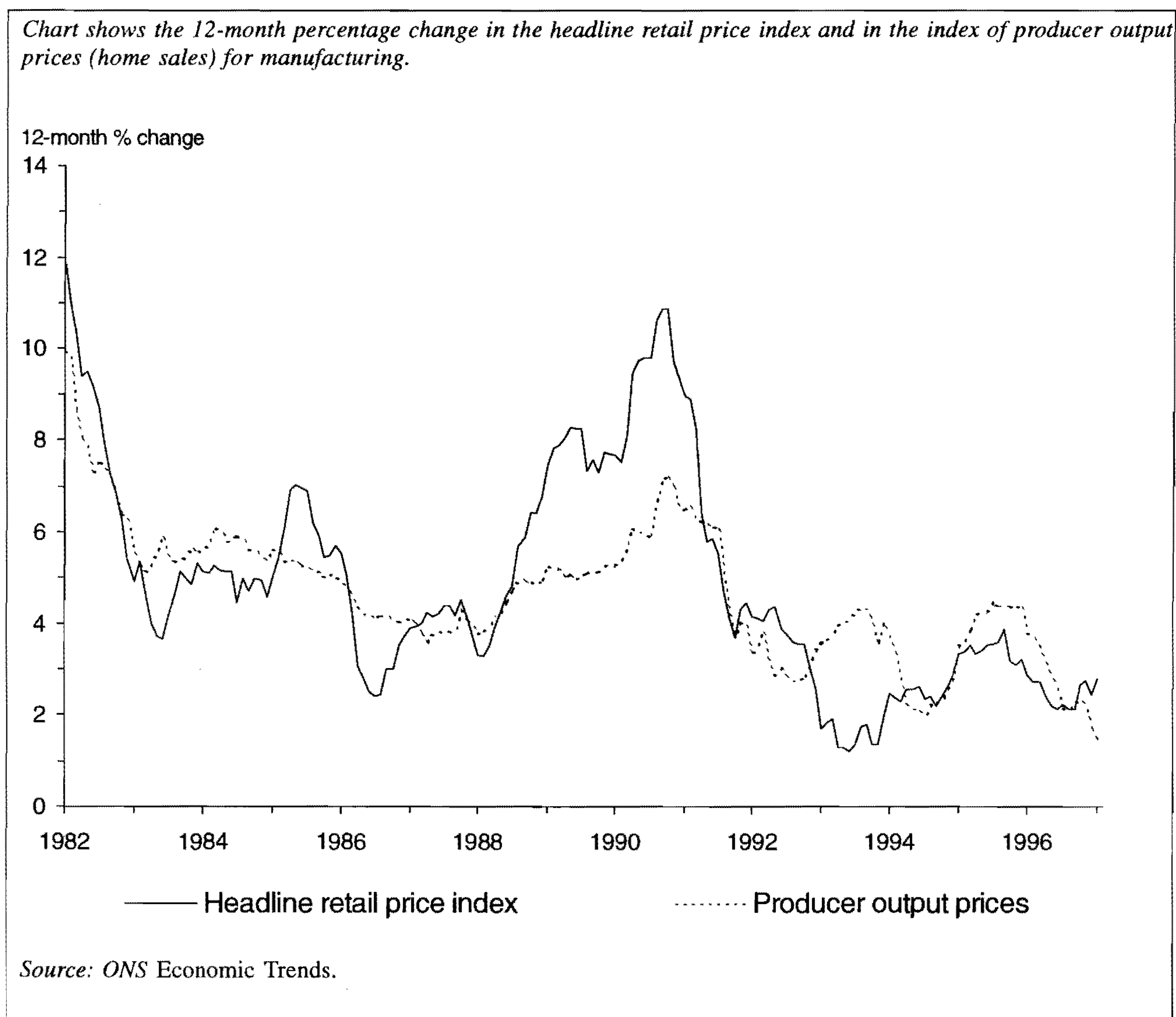


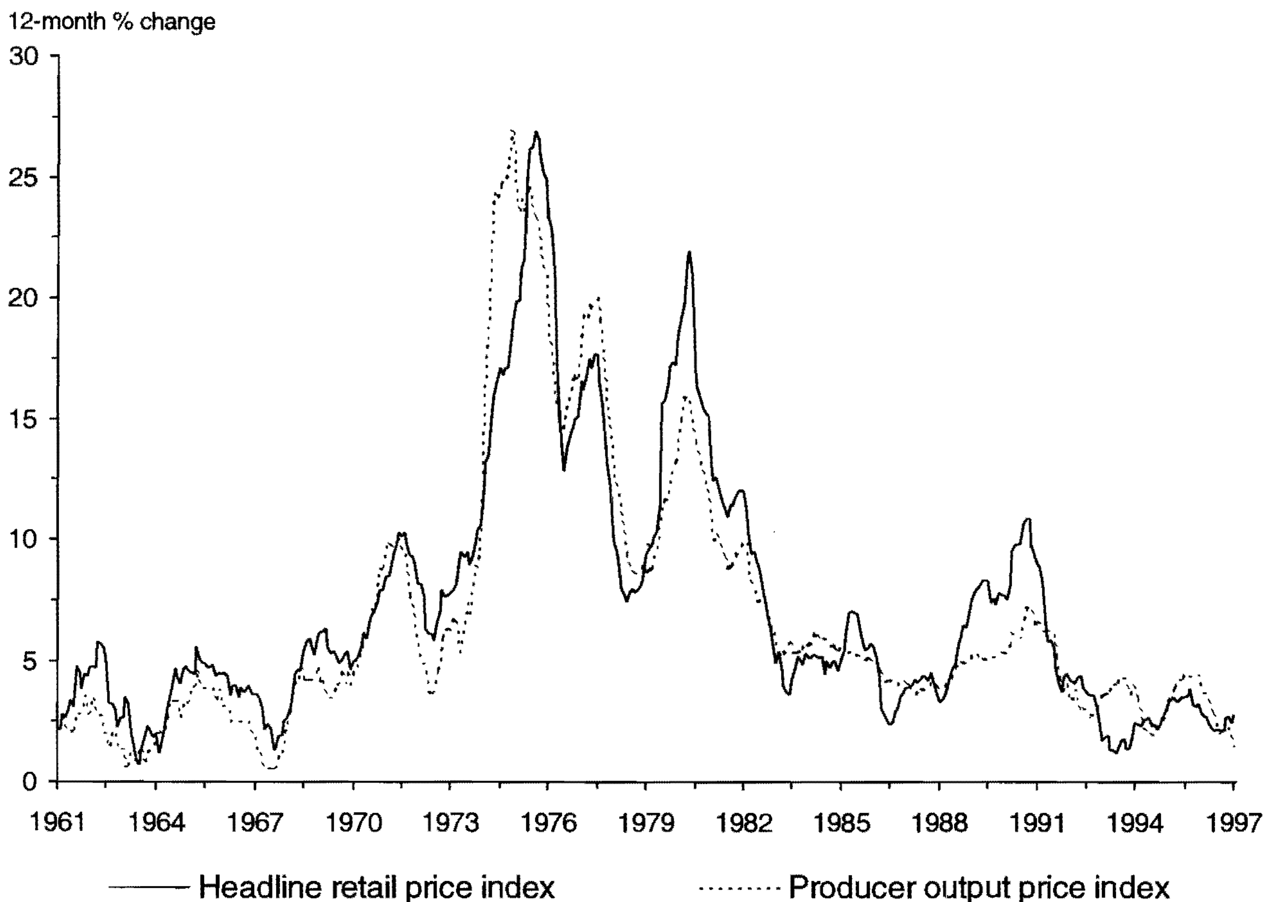
Chart shows the 12-month percentage change in the headline retail price index and in the index of producer output prices (home sales) for manufacturing.

Source: ONS Economic Trends.

Headline inflation in January 1997 (2.8%) was about the same as a year earlier. (2.9%). It fell during the first half of 1996 to 2.1%, but rebounded in the second half. Much of this was due to higher oil prices, which increased by 26% in the second half of last year. Producer output price inflation declined throughout the year, from 3.8% in January 1996 to just 1.5% a year later. Excluding volatile components (especially petroleum products) the annual rate is just 0.6%. These are the lowest rates for almost 30 years and suggest that retail price inflation may stay low in the early months of 1997. But calculations by Lombard Street Research show that the output gap (i.e. the excess of potential over actual output), while still negative, is narrowing rapidly, due to above-trend GDP growth. Once the output gap is eliminated, inflationary pressures will emerge.

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.

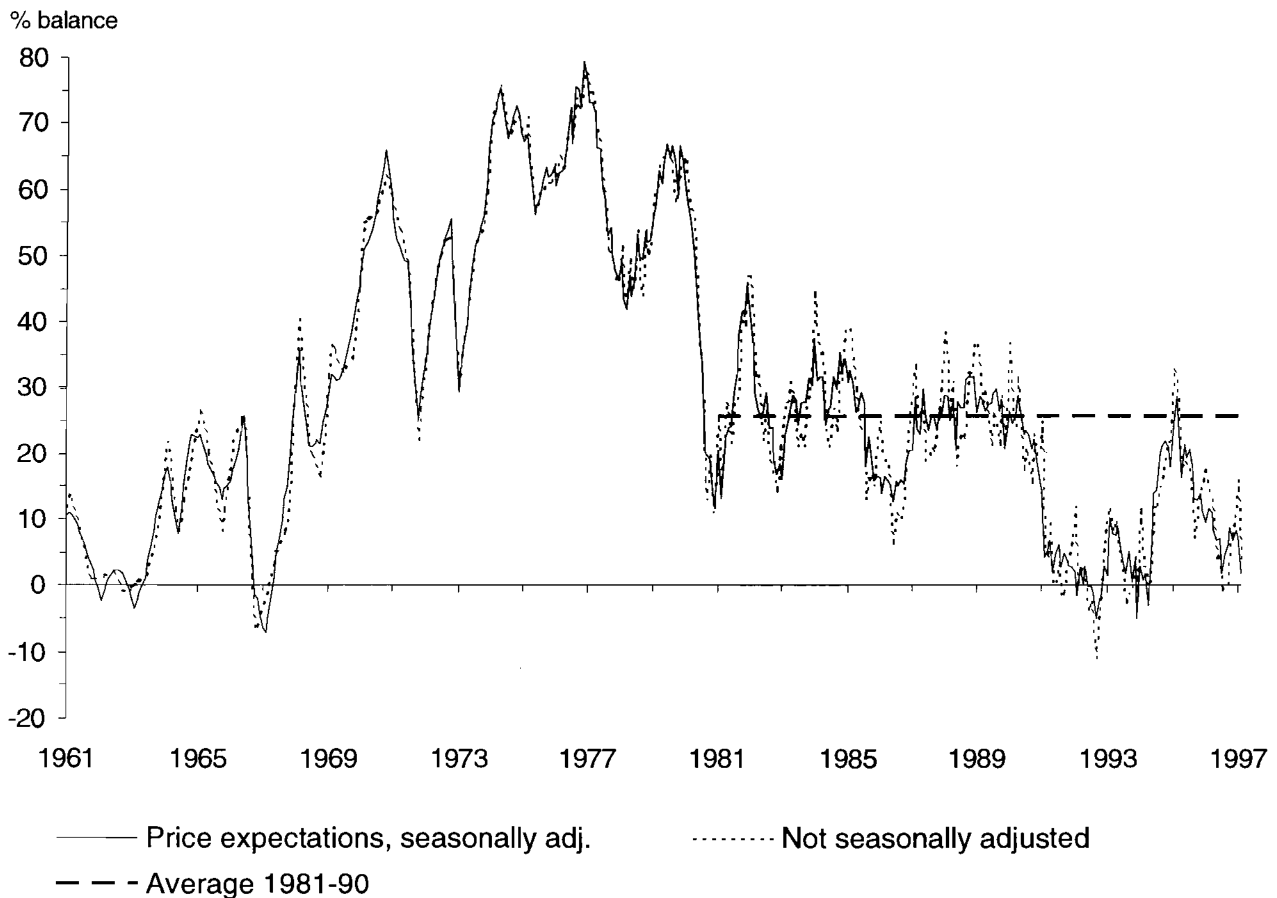


Source: ONS Economic Trends.

While a negative output gap persists, underlying pressure on inflation will be subdued. The beneficial effect of sterling's recent appreciation may push headline inflation lower. Indeed, the annual rate of "underlying" inflation (i.e. excluding mortgage interest costs) may fall to the Government's 2.5% target, from 3.1% in January. But the medium-term inflation outlook is deteriorating as above-trend growth eliminates the remaining output gap. There may be similarities between the situation now and in 1986. A fall in the oil price reduced headline inflation to 2.4% in July 1986. But at the same time inflationary pressures were developing, as the Lawson boom gathered pace. Less than three years later inflation was over 8%. The rise in inflation in the late 1990s may be more modest, but the pattern will be similar.

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.

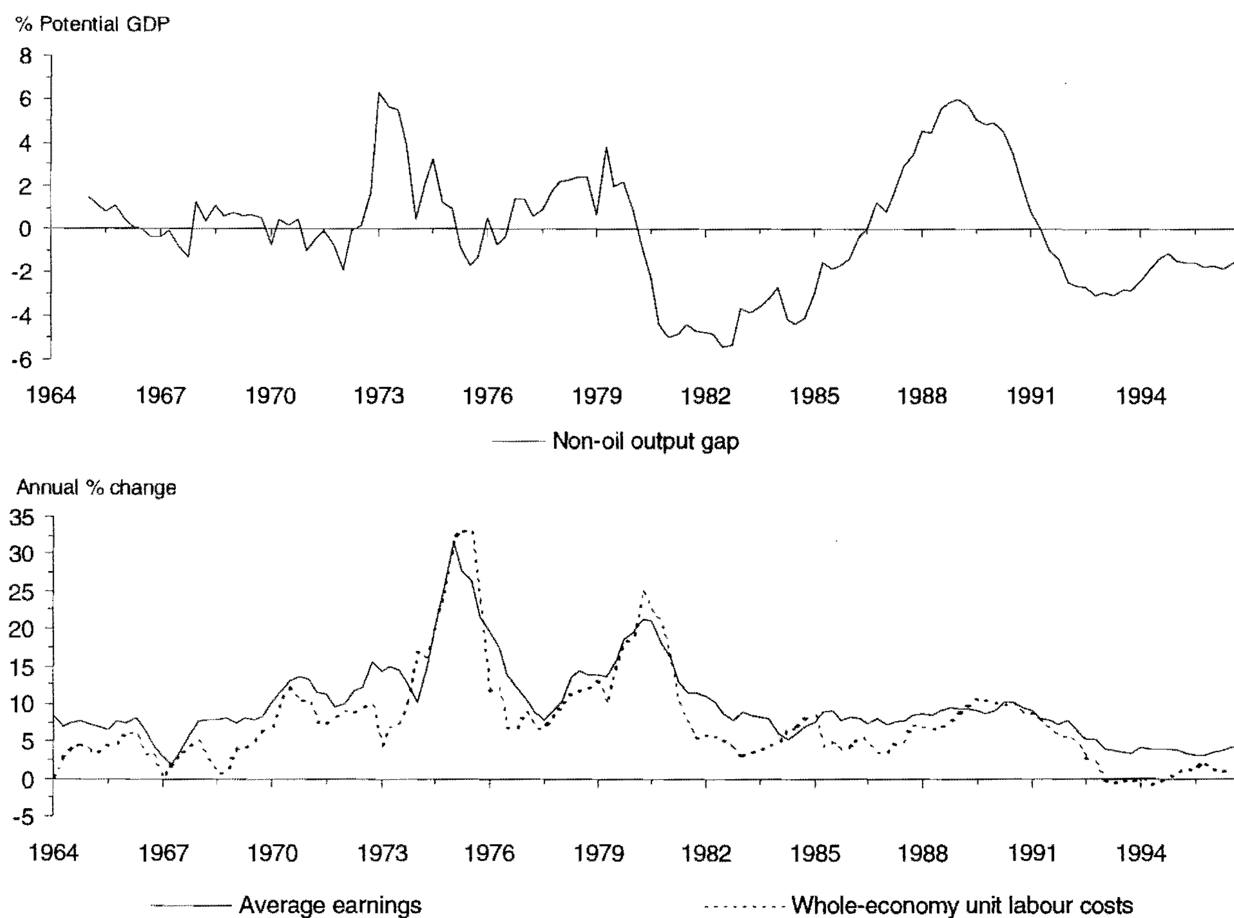


Source: CBI Monthly Trends Enquiry.

Manufacturers' expectations of future price increases, as measured by the CBI *Monthly Trends Enquiry*, remained modest throughout 1996. The seasonally adjusted balance was on a downward trend, falling from +12 in February 1996 to +2 a year later. These balances have been consistent with the exceptionally low producer output inflation rates recorded by the ONS since the middle of last year. The 16% appreciation of sterling since last August has added downward pressure to output prices by reducing import prices. Domestic demand is likely to sustain rising manufacturing activity this year and allow higher costs to be passed on. As always, increased wages are likely to be a major element of this, since labour accounts for around two-thirds of total costs. In the meantime, the CBI prices balance highlights the benign short-term outlook for inflation.

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.

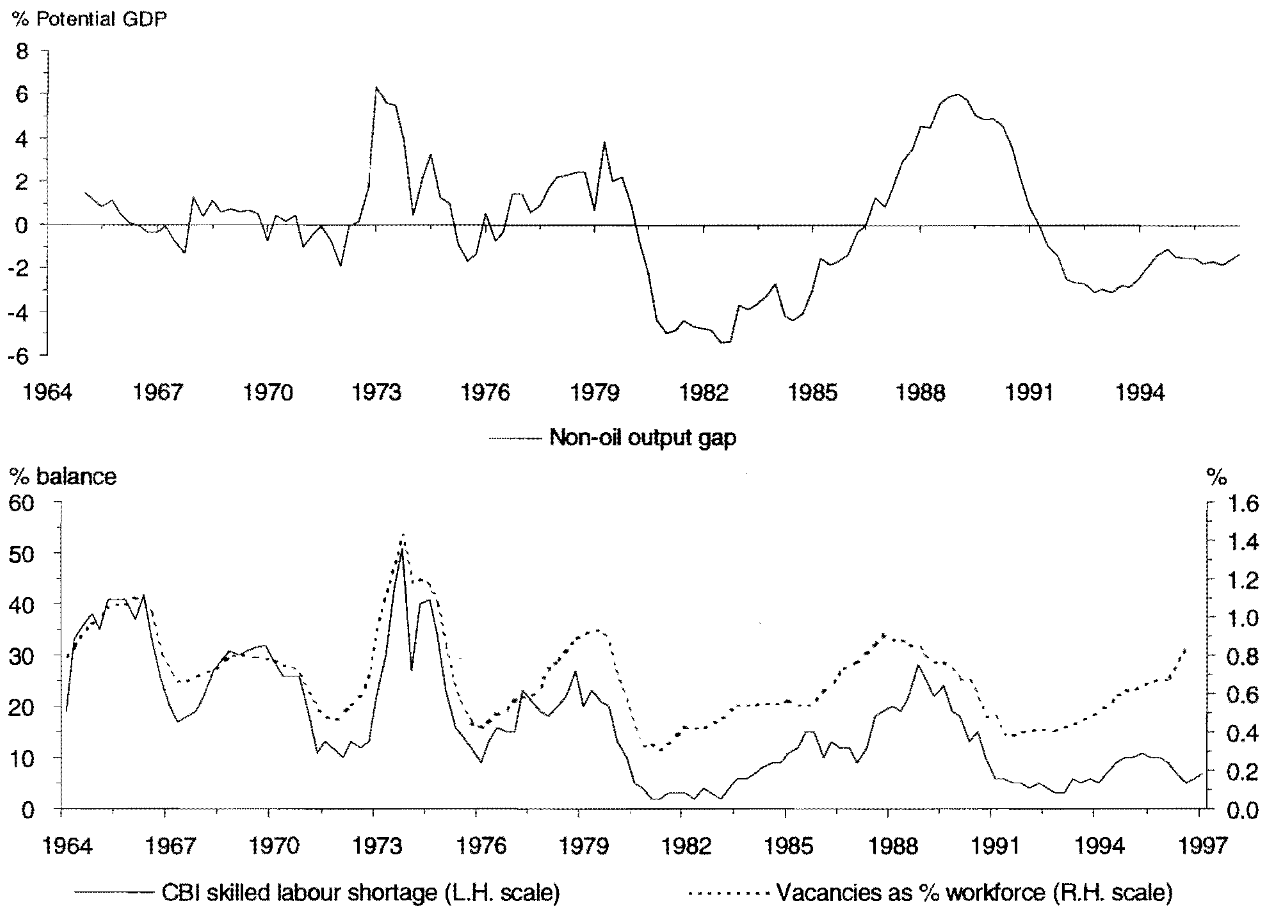


Source: ONS Economic Trends *and Lombard Street Research calculations.*

Unemployment fell by the equivalent of 1.4% of the workforce in the year to January 1997. Half of the fall occurred in the final three months of the period, representing a significant acceleration in the rate of decline. Increased employment, rather than a contraction in the workforce, is now reducing the unemployment rate. The latest quarterly increase in employment (200,000 in Q3 1996) was the biggest since Q1 1989. At 6 1/2% the unemployment rate is now close to many estimates of its natural rate (i.e. the rate at which wage increases are stable). Growth in average earnings reached 4 1/4% in November and December last year, the first time the rate has been above 4% since February 1993. As the labour market tightens a more significant acceleration is likely. Unit wage cost increases for the whole economy remained moderate in 1996.

Two measures of labour market slack

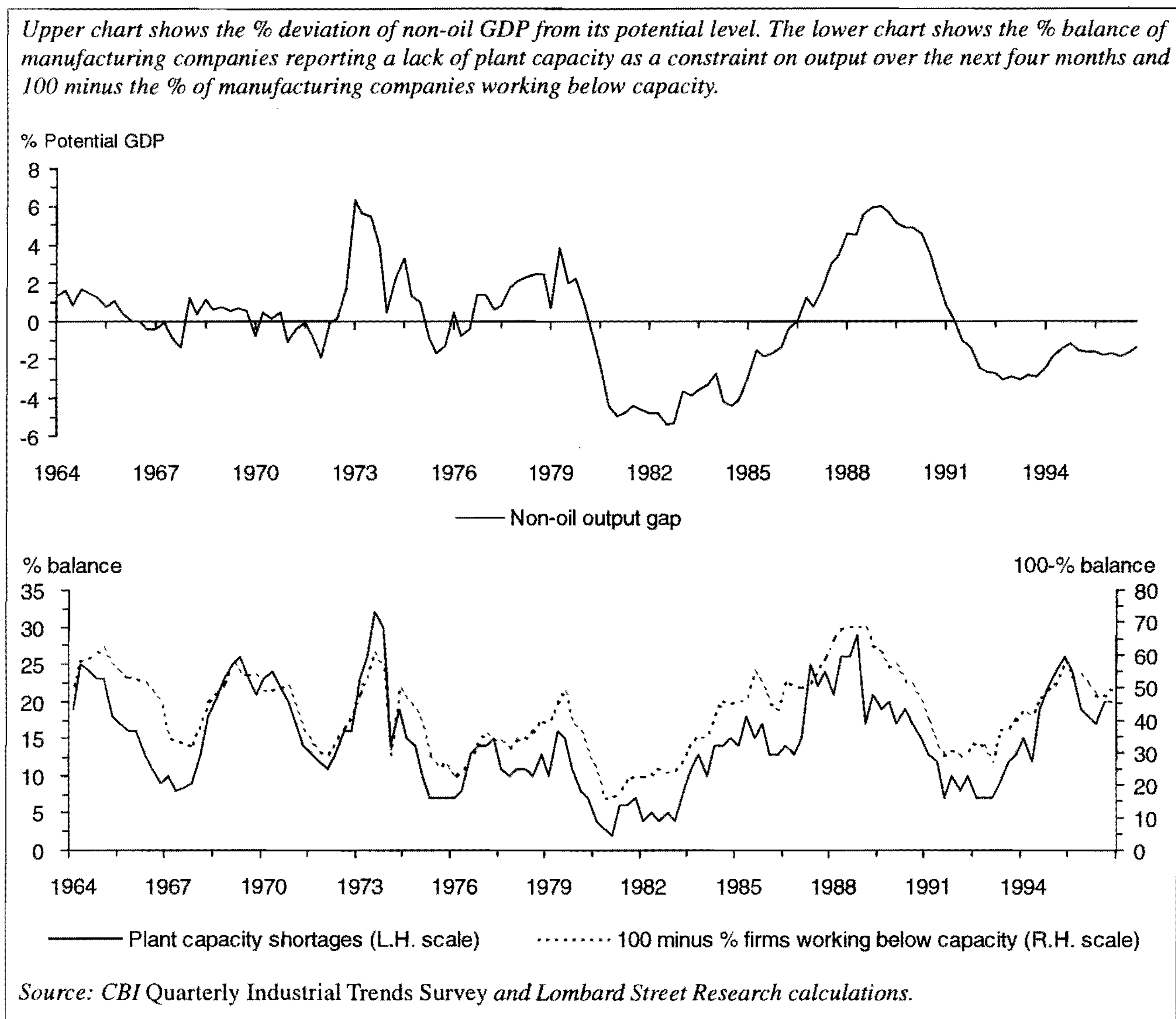
Upper chart shows the % deviation of non-oil GDP from its potential. The lower chart shows the balance of manufacturing companies reporting shortages of skilled labour to be a constraint on output over the next four months and unfilled vacancies at job centres as a % of the workforce.



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

Growth in GDP was around trend rate in the first half of 1996, but accelerated above this in the second half. As a result, the negative output gap (estimated by Lombard Street Research) narrowed from around 1 3/4% at the end of 1995 to 1 1/4% by Q4 1996. On this basis strong growth can continue for a while before inflation begins to rise. But it is possible that growth is faster (and the output gap smaller) than current ONS estimates suggest. According to the CBI *Quarterly Survey*, there is no sign of serious skill shortages in manufacturing. But there has been other survey evidence from employers reporting skill shortages in the Midlands, North East and Scotland. Further, vacancies at Jobcentres as a proportion of the workforce increased significantly last year to reach levels last seen in the late 1980s.

Two measures of capacity utilisation



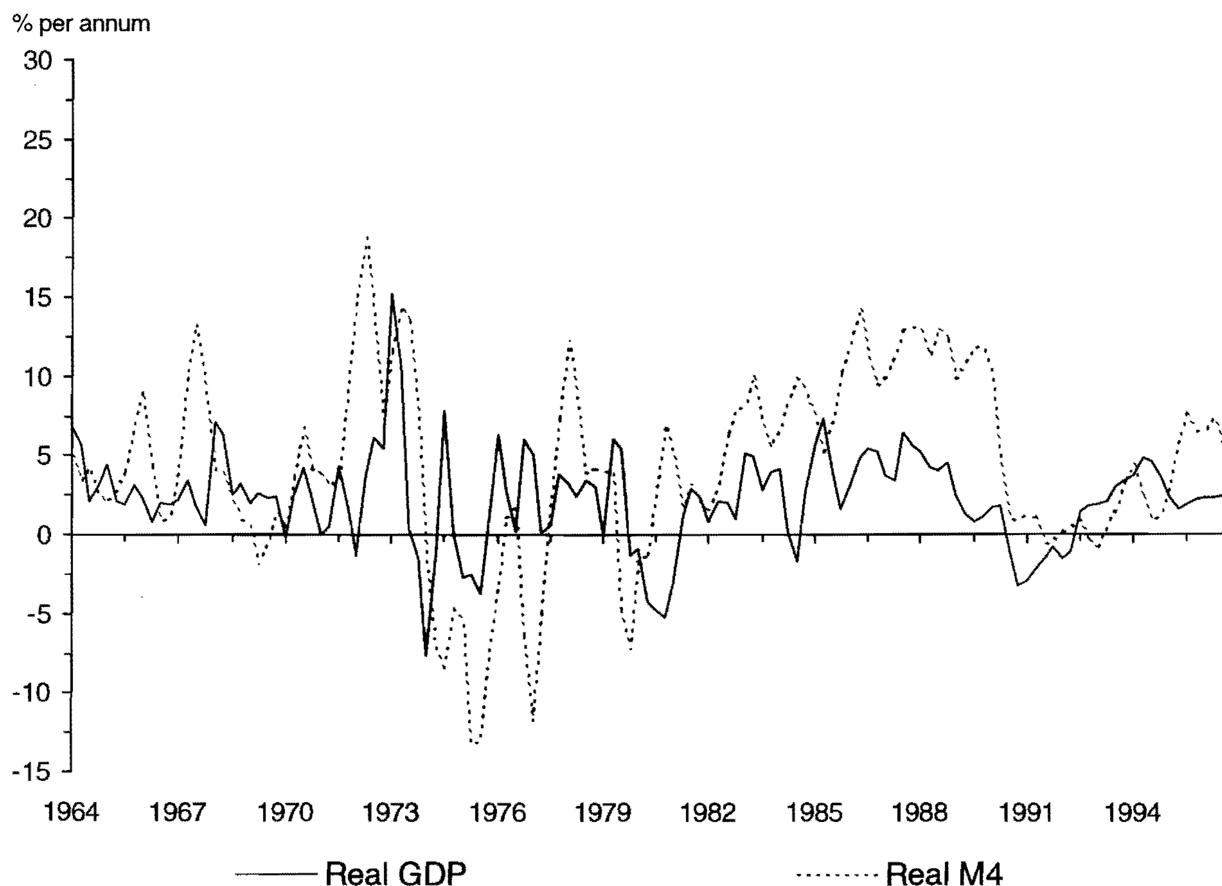
Upper chart shows the % deviation of non-oil GDP from its potential level. The lower chart shows the % balance of manufacturing companies reporting a lack of plant capacity as a constraint on output over the next four months and 100 minus the % of manufacturing companies working below capacity.

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

Manufacturing output rose by 4.4% in 1994, but by less than 1 1/2% a year in 1995 and 1996. Before this slowdown CBI surveys had indicated increased capacity utilisation in the manufacturing sector. For example, the balance of firms operating below capacity in the CBI *Quarterly Trends Survey* was +59% in spring 1995, as compared with a long-term average of +57%. But the series weakened over the second half of 1995 and was at or above +50% for most of 1996. However, as the last recession becomes a more distant memory, further progress is being made in the erosion of the property supply over-hang. Indeed, recently, King Sturge recently reported that the amount of available industrial floorspace is at its lowest level since the end of 1991.

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.

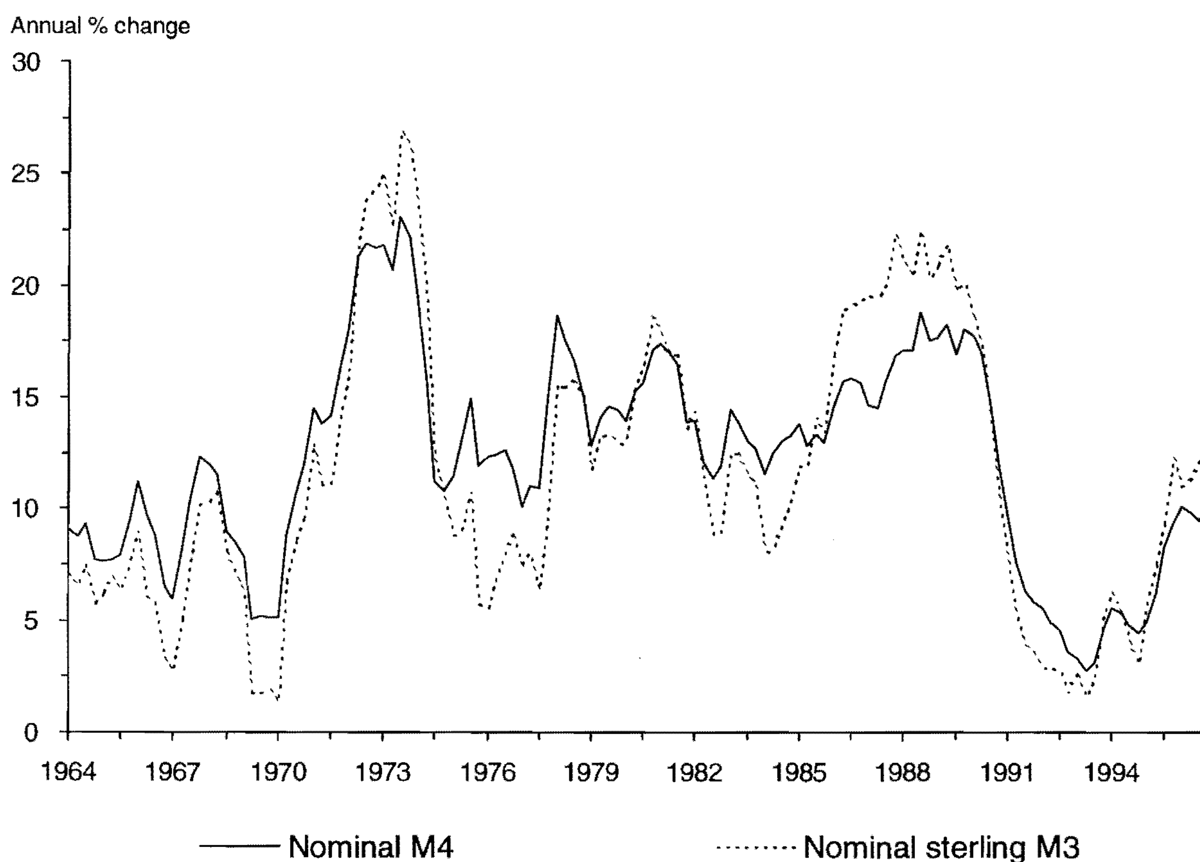


Source: CSO Economic Trends *and Bank of England* Monetary Statistics.

Over the period 1991 to 1994 the stock of broad money, M4, expanded in real terms at between -1/2% to 3 1/2% a year. However, growth accelerated in the second half of 1995 to 6%-plus and has remained close to this rate since. In previous cycles, stronger real money growth was followed after a few quarters by higher GDP growth. GDP increased by 0.5% in the fourth quarter of 1995. But in the final quarter of 1996 growth was recorded at 0.8%, which gives an above-trend annualised rate of 3.2%. Recently, industrial and commercial companies have benefited from strong monetary inflows. Thus, although ICC debt with banks increased by 13% in 1996, their liquidity ratio (deposits divided by borrowings) was broadly unchanged between end-1995 and end-1996 at 59%, comfortably above a long-term norm of 52%.

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.

The old-fashioned measure of broad money, "sterling M3", included nearly all bank deposits, but excluded building society deposits. As the chart shows, the growth rates of sterling M3 and M4 have been highly correlated over the last 30 years, and on the whole they have given similar messages for monetary policy. However, a fair comment is that M3 has been more volatile than M4, as the balance sheet growth of the banks (strongly influenced by the volatile corporate sector) has fluctuated more sharply from year to year than that of the building societies' (almost exclusively serving the personal sector). This pattern has continued in the 1990s, but - as the building society movement contracts - the distinction between M3 and M4 will become increasingly obsolete. (In estimating the M3 growth rate, £13.4b. has been deducted from the change in M3 in August 1995 because of the take-over of Cheltenham & Gloucester and £9.8b. in August 1996 because of National & Provincial.)

Recent monetary trends

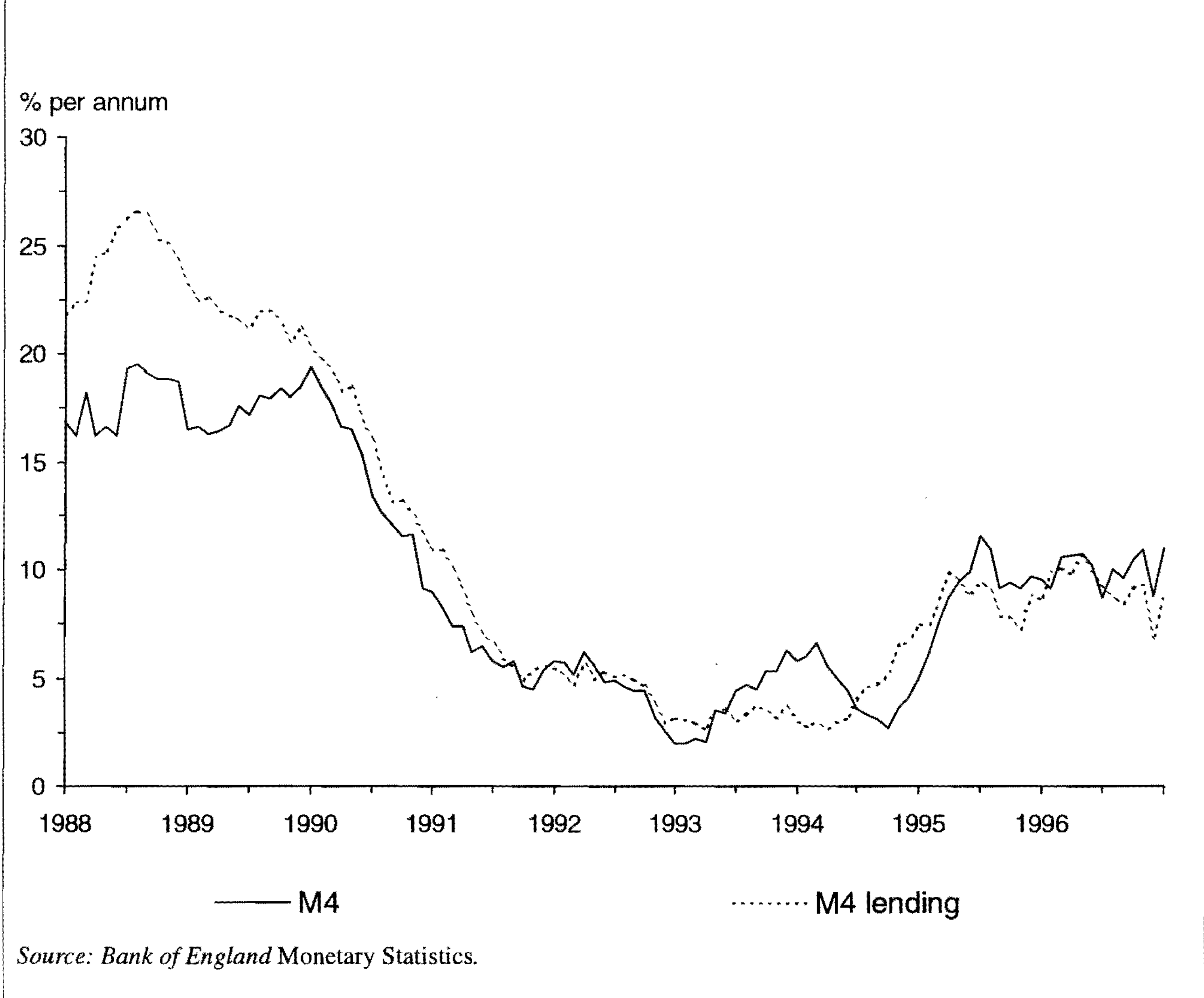


Chart shows 6-month annualised growth rates in M4 and in M4 lending on a monthly basis.

Source: Bank of England Monetary Statistics.

Banks' and building societies' deposit liabilities are the dominant constituents of the money supply. Growth in the money supply is largely determined by lending to the private sector, which boosts the asset side of lending institutions' balance sheets. Demand for new credit was so weak as to limit growth in M4 lending to 5% or less earlier in the 1990s. But in the mid-1990s this changed. After accelerating in early 1995, annual growth in lending has been close to or above 9% for over 18 months. Although bid activity has eased following the near-record level of take-overs recorded in 1995, corporate loan demand will be sustained by higher investment and stockbuilding. The appreciation of sterling, which has made UK-made goods more expensive abroad, will slow manufacturing activity. But half of all lending to the private sector is to individuals for house purchase. Stronger personal sector balance sheets argue that demand for mortgages is set to remain on a rising trend at current interest rates.