LOMBARD STREET RESEARCH

Monthly Economic Review

No. 103, January 1998

Contents

Page No.

Commentary on the economic situation 1

Research paper -
Topic: Inflationism vs. deflationism 3

The *Lombard Street Research Monthly Economic Review* is intended to encourage better understanding of economic policy and financial markets. It does not constitute a solicitation for the purchase or sale of any commodities, securities or investments. Although the information compiled herein is considered reliable, its accuracy is not guaranteed. Any person using this *Review* does so solely at his own risk and *Lombard Street Research* shall be under no liability whatsoever in respect thereof.

Gerrard Group PLC

Gerrard & King Limited
Cannon Bridge,
25 Dowgate Hill,
London, EC4R 2GN
Tel: 0171 337 2800
Fax: 0171 337 2801
e-mail: enquiry@gerrard.com

GNI Limited
Cannon Bridge,
25 Dowgate Hill,
London EC4R 2GN
Tel: 0171 337 3500
Tlx: 884862
Fax: 0171 337 3501
e-mail: www.gni.co.uk

Lombard Street Research Ltd.
Cannon Bridge,
25 Dowgate Hill,
London, EC4R 2GN
Tel: 0171 337 2975
Fax: 0171 337 2999
e-mail: lsr@lombard-st.co.uk
www.lombard-st.co.uk

Greig Middleton & Co. Limited
30 Lombard Street,
London, EC3V 9EN
Tel: 0171 655 4000
Fax: 0171 655 4321

Greig Middleton, Inc.
20 Custom House Street,
Boston, MA 02110, USA
Tel: 00 1 617 292 4000
Fax: 00 1 617 292 4321

High money growth argues against UK recession

Domestic demand growth will slow, but not to a beneath-trend rate

Forecasters warn of recession,

The main story on the front page of the *Financial Times* of 5th January was headlined "Growth set to fall sharply, say top forecasters". The final paragraph said that, while the forecasters acknowledged the margins of error, "a recession could not be ruled out". In particular, the National Institute put the risk of recession in 1998 at 20%. The gilt market celebrated this news, and new worries about the Asian financial scene, with a rise of over a point at the long end.

but ignore the effect of excess money holdings on the economy

But, following their usual practices, the so-called "top forecasters" have ignored the implications of high money supply growth for economic activity and inflation. Over the year to December 1997 M4 increased by 11.2%, following an increase of 9.8% in the year to December 1995 and 9.6% in the year to December 1996. Not surprisingly, company balance sheets are strong and a number of businesses have proposed large share buy-backs in the last few months. Money holdings in the hands of the financial sector, which were £92.7b. at the end of 1994, had probably climbed - on a comparable basis - to over £175b. by the end of last year. The excess liquidity in financial institutions is part of the reason for the resilience of UK share prices, and for healthy gains in the value of commercial property and unquoted companies. Domestic demand therefore continues to benefit from positive wealth effects. Interest rate rises since the general election have dampened the housing market a little and the strong pound continues to hurt exports. Early 1998 will see a slowdown compared with 1997. Nevertheless, while companies and financial institutions have excess money holdings, it is unlikely that this slowdown will be to a beneath-trend rate of growth. Unemployment will keep on falling, reinforcing the upward pressure on pay rises. The National Institute's worries about a recession are misplaced.

Excess money could be mopped up by "over funding", but no official interest in this

What can be done? Assume - controversially - that inflation of 2 1/2% or less can be restored only if money supply growth is reduced to an annual rate of 5% or so. One answer would be for the pound to tumble on the foreign exchanges, enabling the Bank of England to raise interest rates until they are consistent with a sharp moderation in new bank lending. Something like this may happen in 1998, although it is not certain and no one can forecast the timing. Alternatively, the authorities could try to remove the excess institutional liquidity by more direct means, actively selling long-dated gilt-edged securities to the financial institutions to mop up some of their £175b. cash pile. Unhappily, the Bank and the Treasury have foresworn the use of debt management for the purposes of monetary control. So short- term interest rates - and the exchange rate - will have to be higher for longer than would otherwise have been necessary.

Professor Tim Congdon 22nd January 1998

Summary of paper on

"Inflationism vs. deflationism"

Purpose of the paper

Early 1998 has see a growing divergence of view between forecasts of rising inflation, particularly in the USA and the UK, and concern about potential "global deflation" (i.e., outright falls in the price level). This paper analyses money supply developments in the main industrial economies, to assess which side of the "inflationism vs. deflationism" debate is right.

Main points

* **Nominal money growth in the G7 has been higher since early 1995 than in the first half of the 1990s. With inflation still low, real money growth has also accelerated (see p. 4), with a positive message for world economic activity in 1998.**

* **Measures of "global broad money" which convert national-currency-denominated money stocks into common currency terms (see p. 5), are misleading. Claims of a "decline in the world's money supply" based on such measures are wrong.**

* **The acceleration in money growth has been most pronounced in the USA, the UK and some European countries (such as Spain), and these have also seen most strength in economic activity over the last 18 months. They will also suffer from more inflation than other countries in 1998 and 1999.**

* **In continental Europe money supply growth is generally stable at moderate rates, but note that Italian money growth accelerated in late 1997. (See pp. 8 - 9 and p. 11.) These trends are consistent with a mild upturn in the growth of European domestic demand.**

* **Japan's financial situation remains difficult, with the public authorities now reluctantly injecting capital into the banking system. But broad money growth is stable at a low level (see p. 7); it is not collapsing.**

* **The inflationists have the better of the argument.**

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

Inflationism vs. deflationism

Does money supply growth throw any light on conflicting views about the world prices outlook in 1998?

Greenspan mentions "deflation" risk

As noted by Mr. Alan Greenspan, chairman of the US Federal Reserve, in a speech to the American Economic Association in Chicago on 3rd January, optimism about low inflation in the USA has become entrenched and "indeed some observers have begun to question whether deflation is now a possibility". By "deflation" Greenspan meant actual declines in the price level. Greenspan's comment followed an article in the *Financial Times* of 31st December by Mr. George Soros which also warned about the dangers of "global deflation". By contrast, the IMF's chief economist, Professor Michael Mussa, had a very different message on 4th January in a speech to the same Chicago conference as that addressed by Greenspan. Mussa noted that, "there is a concern that, with the very tight labour market conditions, if the US economy does not slow to a more sustainable pace, inflation pressures could begin to build".

Or is inflation still the problem?

Which view is right? The "inflationism vs. deflationism" debate is plainly crucial to the prospects for both the world economy and international capital markets in 1998. In this research paper - which follows the same format as research papers in the January 1995, February 1996 and February 1997 issues of the *Monthly Economic Review* - money supply trends in the main industrial countries are analysed, to see whether they can help to answer the question. In the long run inflation is strongly influenced by the excess of money supply growth over output growth.

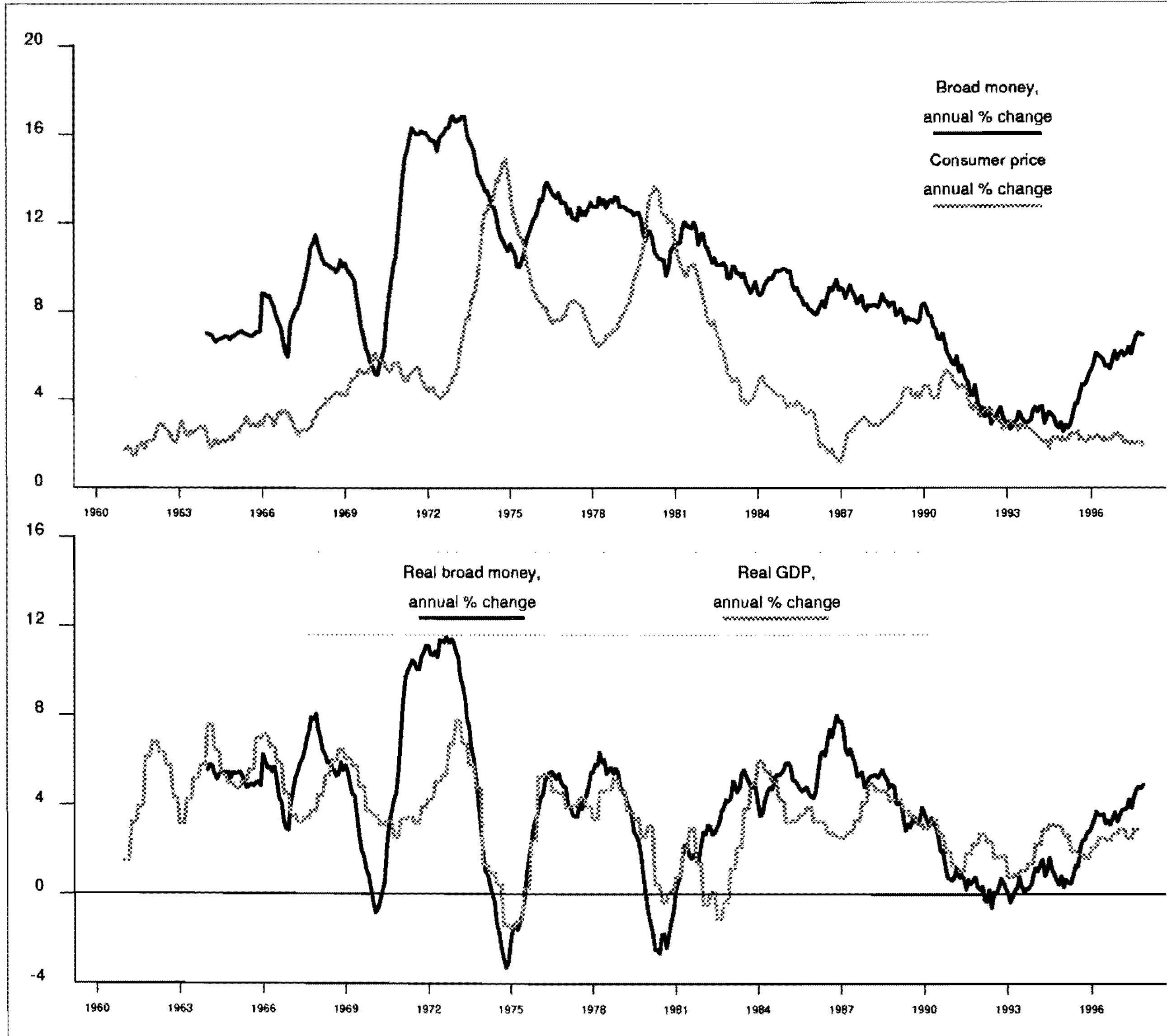
Faster money growth in the G7 argues that rising inflation more likely than deflation

The central conclusion is straightforward. Across the G7 group of large industrial nations money supply growth has been higher since early 1995 than in the previous four years. Further, in late 1997 the growth of the G7 money stock seems to have accelerated, partly because banks were able to finance a record volume of corporate finance deals, particularly large international take-overs. (See p. 6.) On this basis, the medium-term prognosis must be for rising inflation, not deflation. It is very striking that the growth of M3 in the USA ran at an annualised rate of 10% in the final quarter of 1997. The resulting excess liquidity has been one reason for the continued buoyancy of US share prices, while the buoyancy of US shares prices is in turn an argument for expecting further above-trend growth in American domestic demand and national output.

Money growth has to fall in order to avert rising inflation

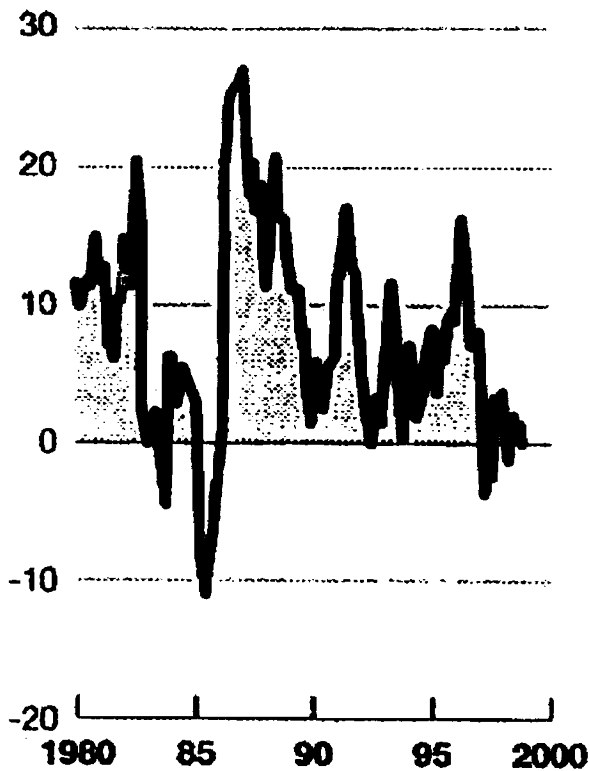
A similar pattern is evident in the UK (see p. 10), while money growth in some European countries (such as Italy, see p. 11) is increasing, and in other European countries and Japan it is roughly stable. The "Asian effect" is certainly dampening down inflation pressures for the time being, but - over the medium term (i.e., the next two or three years) - policy-makers in the leading economies will have to restrain money supply growth if they are to keep inflation under control.

Group of Seven



Real broad money growth is a useful leading indicator of economic activity, typically moving six months to a year before the corresponding change in demand and output. Thus, the slump in G7 real money in 1979 and 1980 came ahead of the recessions of 1980 and 1981, and the marked fall in G7 real money in late 1990 and 1991 was a precursor of the difficult years for the world economy in the early 1990s. (G7 real output grew by only 1.1% in 1980 and 1981, and fell by 0.3% in 1982; it rose by only 0.7% in 1991, 1.8% in 1992 and 1.0% in 1993.) On this basis, a key message from the chart is that the world economic outlook for 1998 remains positive, despite all the deflationary talk. A negative view on global economic activity depends on the falls in demand in the Asian economies (ex-Japan), which are relatively small, outweighing macroeconomic trends in the dominant economies; it depends - in other words - on the tail wagging the dog.

A different view on global liquidity



The *Investors Chronicle* of 21st November 1997 said:

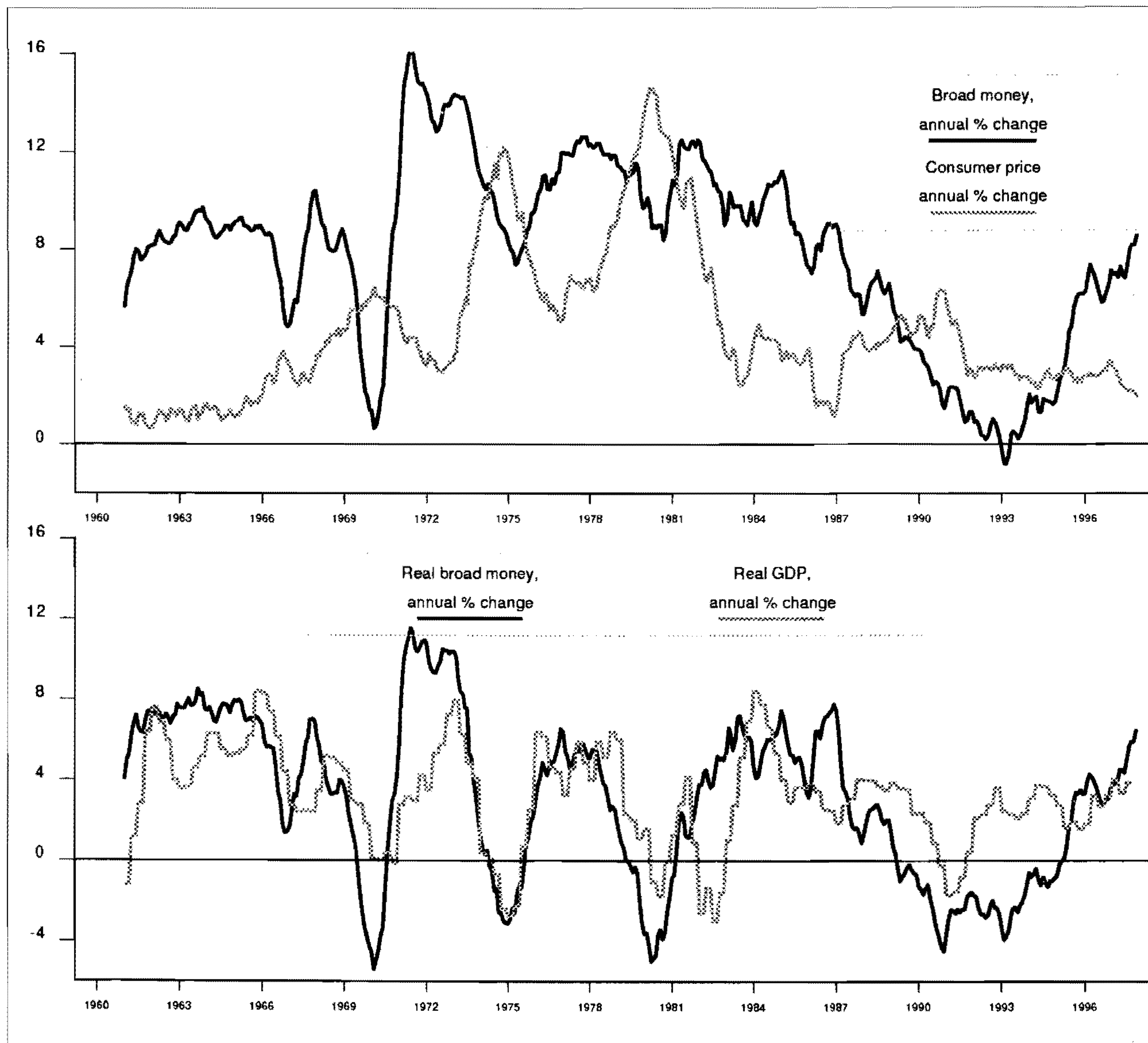
"... curbs on lending by Japanese banks would merely intensify the decline in the world's money supply likely to result from the bad-loan crisis across all Asia", and

"Those who seek comfort in the fact that the trade links between the West and Asia are small are, then, missing a point. A falling global money supply could add to the knock-on effects on the West of Asian deflation. It's [sic] impact may be larger than thought."

Note: The chart to the left is reproduced from the *Financial Times.*

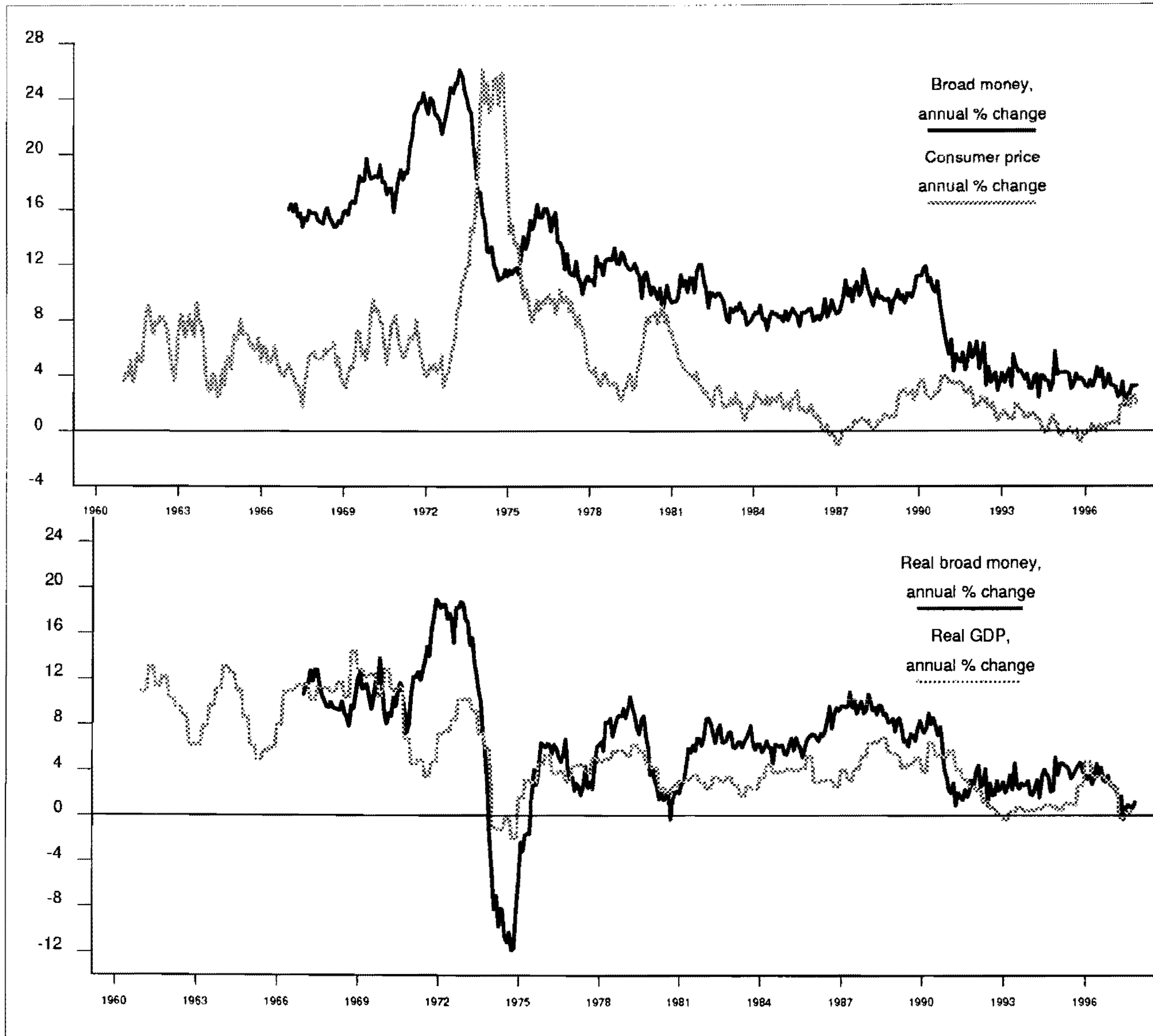
Recent newspaper stories have referred to a "global liquidity crunch", alleging that "world money growth" has stopped. An example is the statement from the *Investors Chronicle* of 21st November quoted above. However, recognised measures of "world money" give a different message. For example, the November 1997 OECD's *Main Economic Indicators* publication has a series for broad money in growth in the OECD area, minus high-inflation Turkey, which shows 6.5% growth in the year to September. The "global broad money" series attributed to CrossBorder Capital may have been calculated by converting to a common currency, such as the dollar. This is misleading, because it would be affected by currency fluctuations. If the dollar were used, the dollar values of yen and DM deposits would have fallen sharply in 1997, giving a spurious impression of "crunch", "squeeze" or whatever.

United States



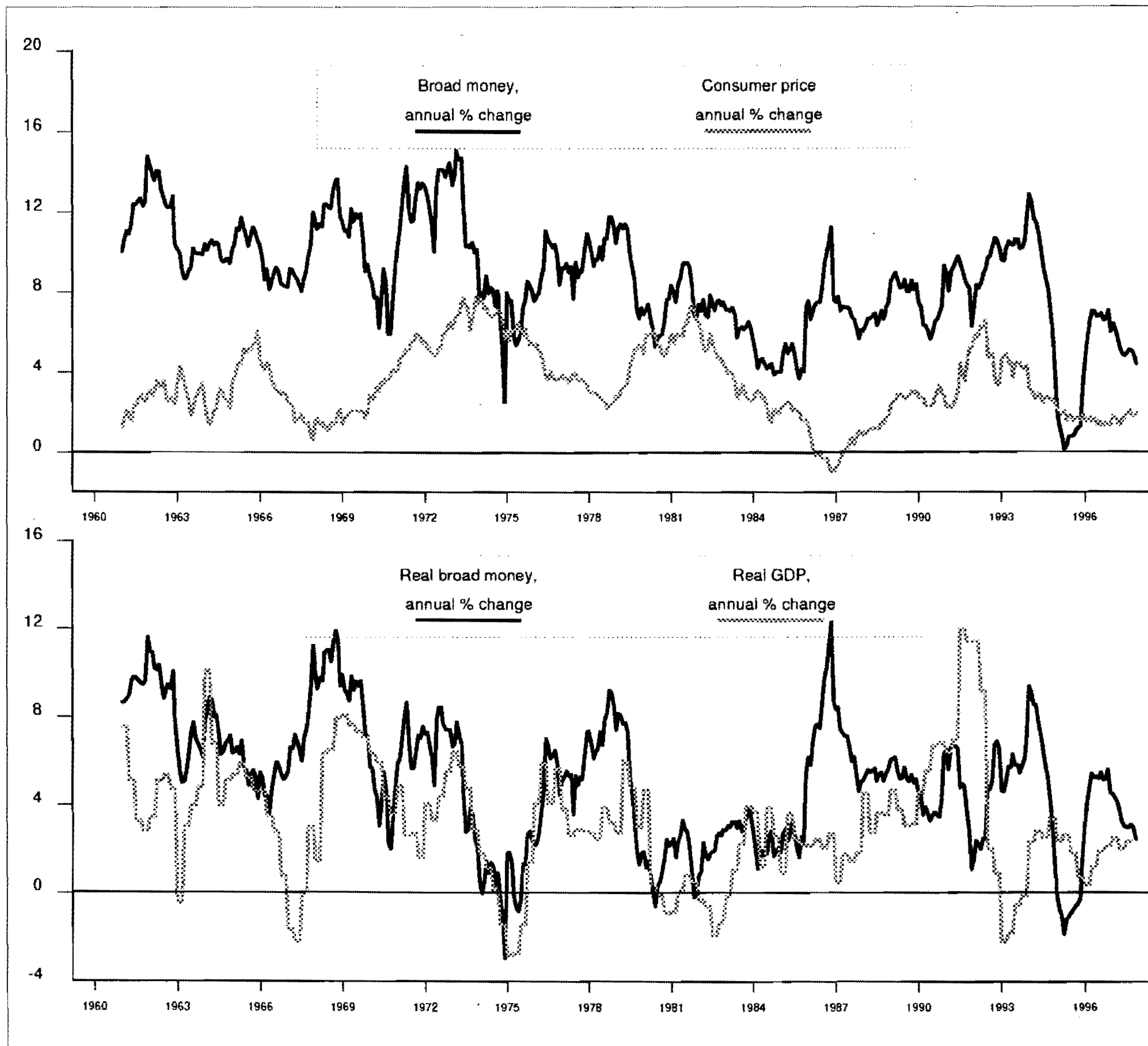
For most of the post-war period US real broad money has been an excellent leading indicator for the real economy. However, in the early 1990s the relationship appeared to break down, with the recovery of 1992 - 4 proceeding while real broad money growth was negative. The Federal Reserve concluded that the money supply was not a reliable basis for policy-making. However, the apparent inconsistency between money and the economy in the early 1990s can be attributed partly to low interest rates, which made interest-bearing money balances an unattractive asset to hold. Last year Lombard Street Research argued - correctly - that the upturn in US real money growth since early 1995 implied a boom in domestic demand. The main message from the chart is that this boom still has a long way to go. Indeed, with the American banking system financing record levels of acquisition activity, money growth accelerated late last year.

Japan



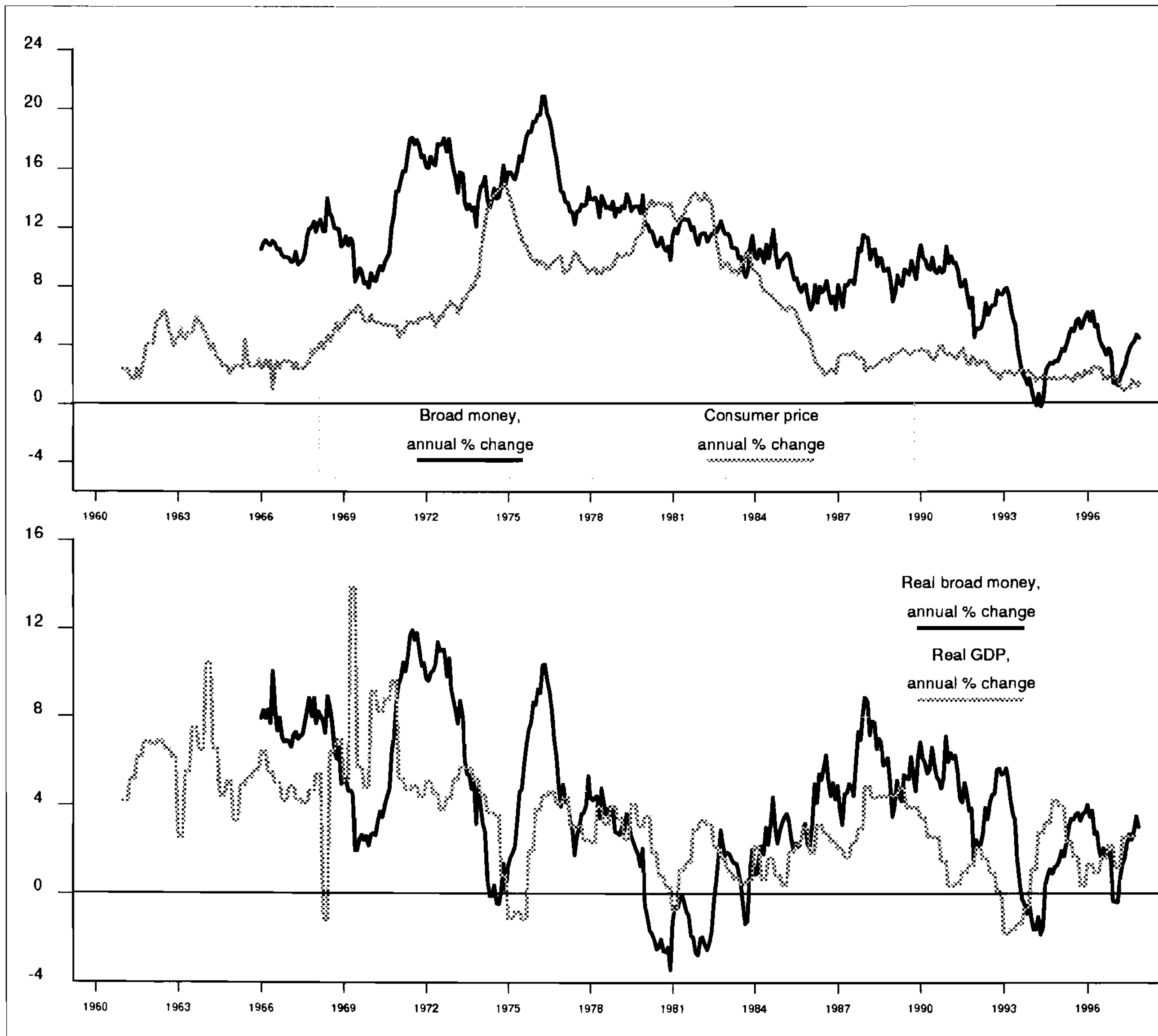
The Japanese financial situation remains difficult. As discussed by Brian Reading in recent issues of Lombard Street Research's *Monthly International Review* publication, the "big bang" reforms to the financial system have aggravated the bad debt problem. Japanese banks had to review loans and threaten not to renew them, whereas previously they would have rolled them over without hesitation. (This has been a contributory element in the South Korean crisis.) Japanese real broad money growth slowed in 1997, as the yen's depreciation boosted the inflation rate. Asset prices stayed depressed and domestic demand weakened. But broad money growth is more or less stable at an annual rate of 3% or 4%, helped by monetary financing of the budget deficit. The Japanese authorities seem to be well-aware that they must keep the banking system adequately capitalized and prevent the money stock from contracting.

Germany



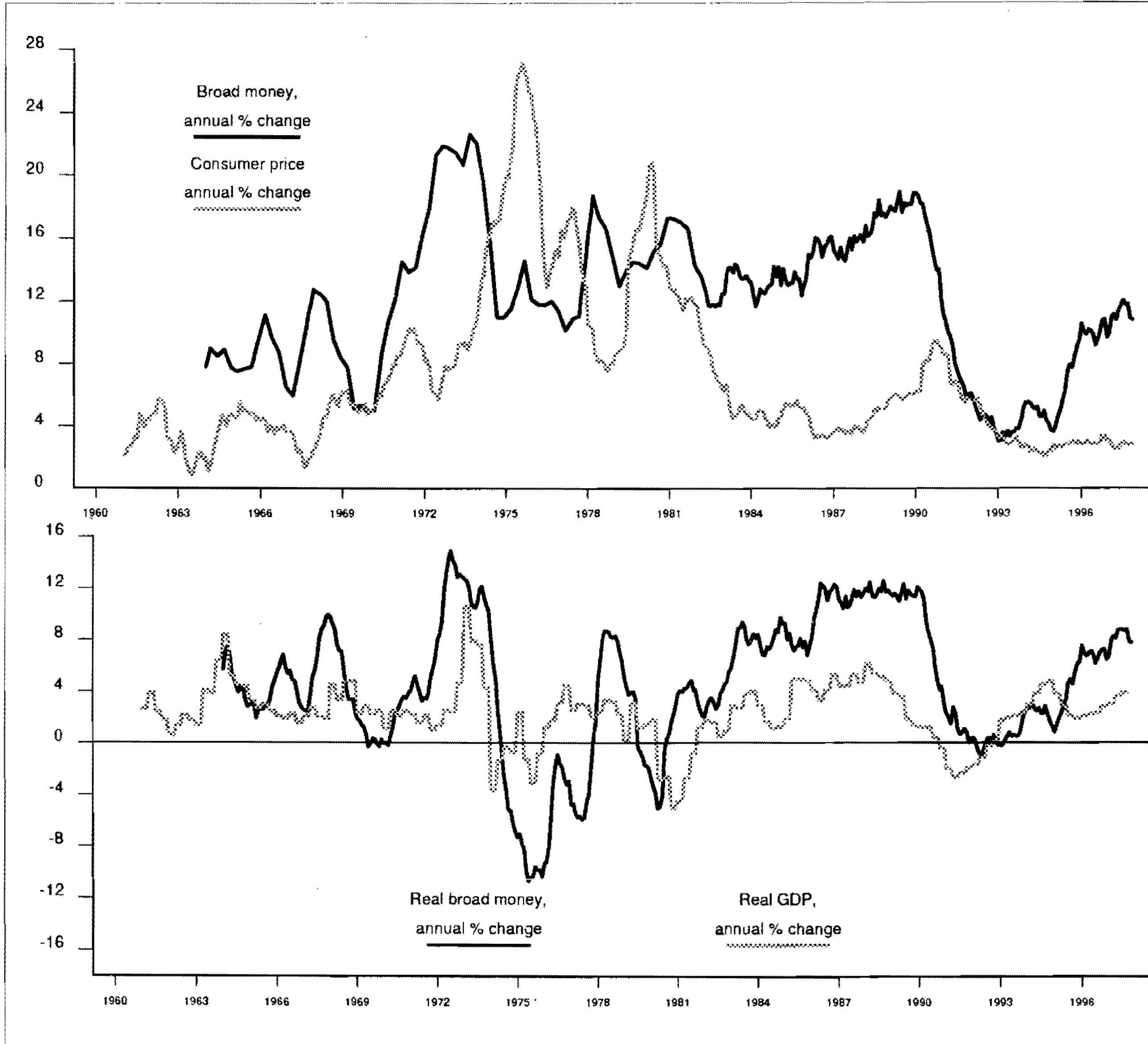
German money growth - relatively high in 1996 - decelerated last year. In terms of the credit counterparts, the explanation for the slowdown lay in the external influences, not domestic credit. The deutschemark's weakness was associated with a fall in the German banking system's net external assets. At the end of last year lending commitments were slightly up on levels a year earlier, implying continued moderate growth of domestic credit and the money stock. Growth in 1998 seems likely to be close to its trend rate, but to be slower than in its European neighbours and to rely more heavily on net exports. (Note that the sharp swing from money growth of over 10% in late 1993 to a negative rate in early 1995 had only limited economic meaning. It reflected a very flat yield curve in 1993, which encouraged people to hold liquidity in the form of term deposits - which are money - instead of *pfandbriefen* [i.e., bank bonds] - which are not.)

France



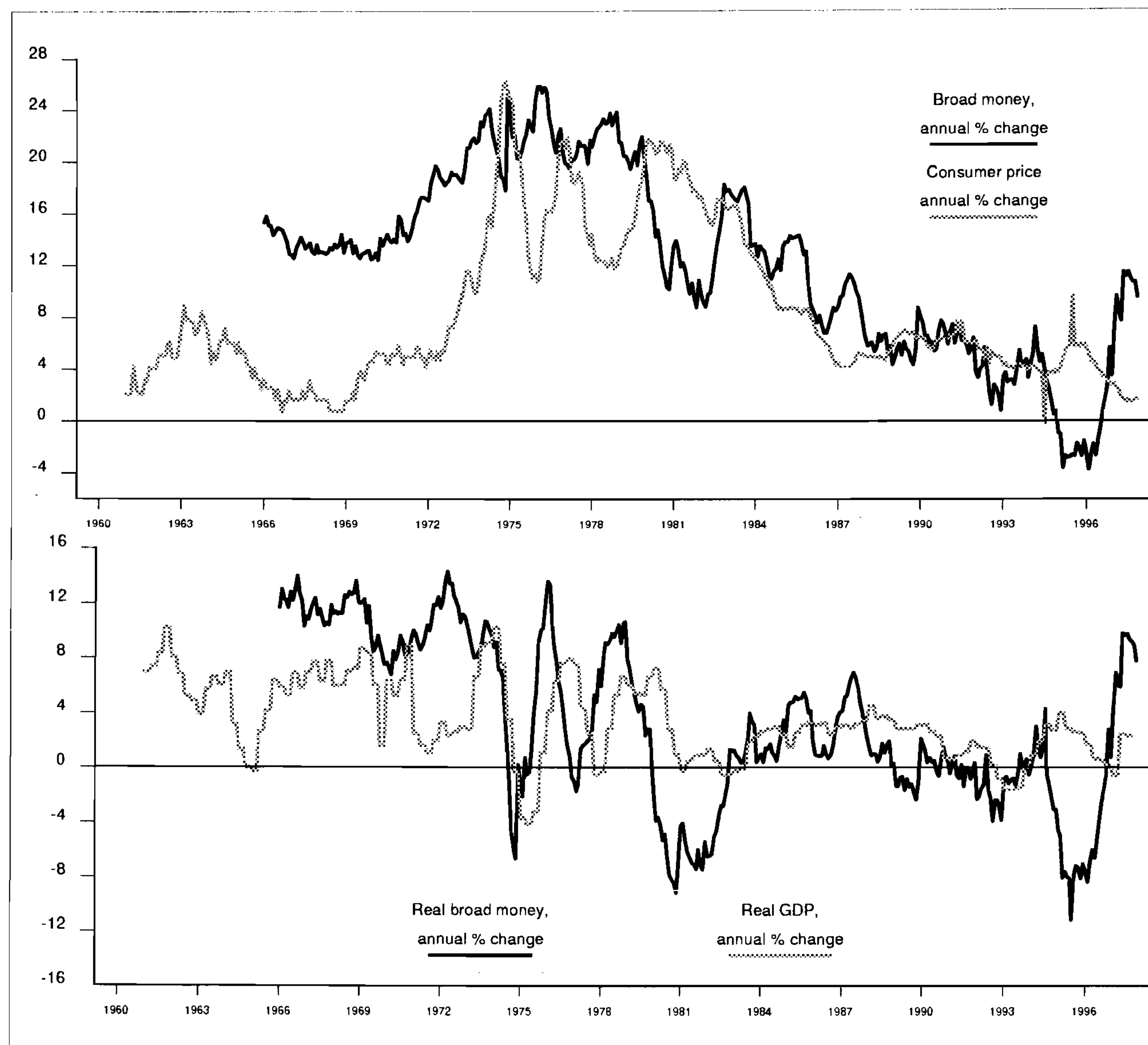
Analysis of French monetary data has been complicated by institutional changes. In 1993 and 1994 the introduction of money market mutual funds led to a large switch into them from bank deposits, which caused a dip in the growth of the narrow money measures; in 1996 people switched out of money market mutual funds, which are part of M3, into Housing Savings Plans (*les plans d'épargne- logement*), which are the bulk of a separate aggregate called P1. M3 + P1 may give the best guide to underlying trends. Its growth dipped in late 1996, but began to accelerate early last year. The M3 + P1 aggregate is now about 5% up on a year ago, consistent with moderate growth in demand and output. This healthier trend seems likely to be durable, as the growth of bank credit - which was negligible in 1995 and 1996 - has picked up. Despite the (supposed) imminence of a single European currency, the French and Germany banking systems are behaving in quite different ways.

United Kingdom



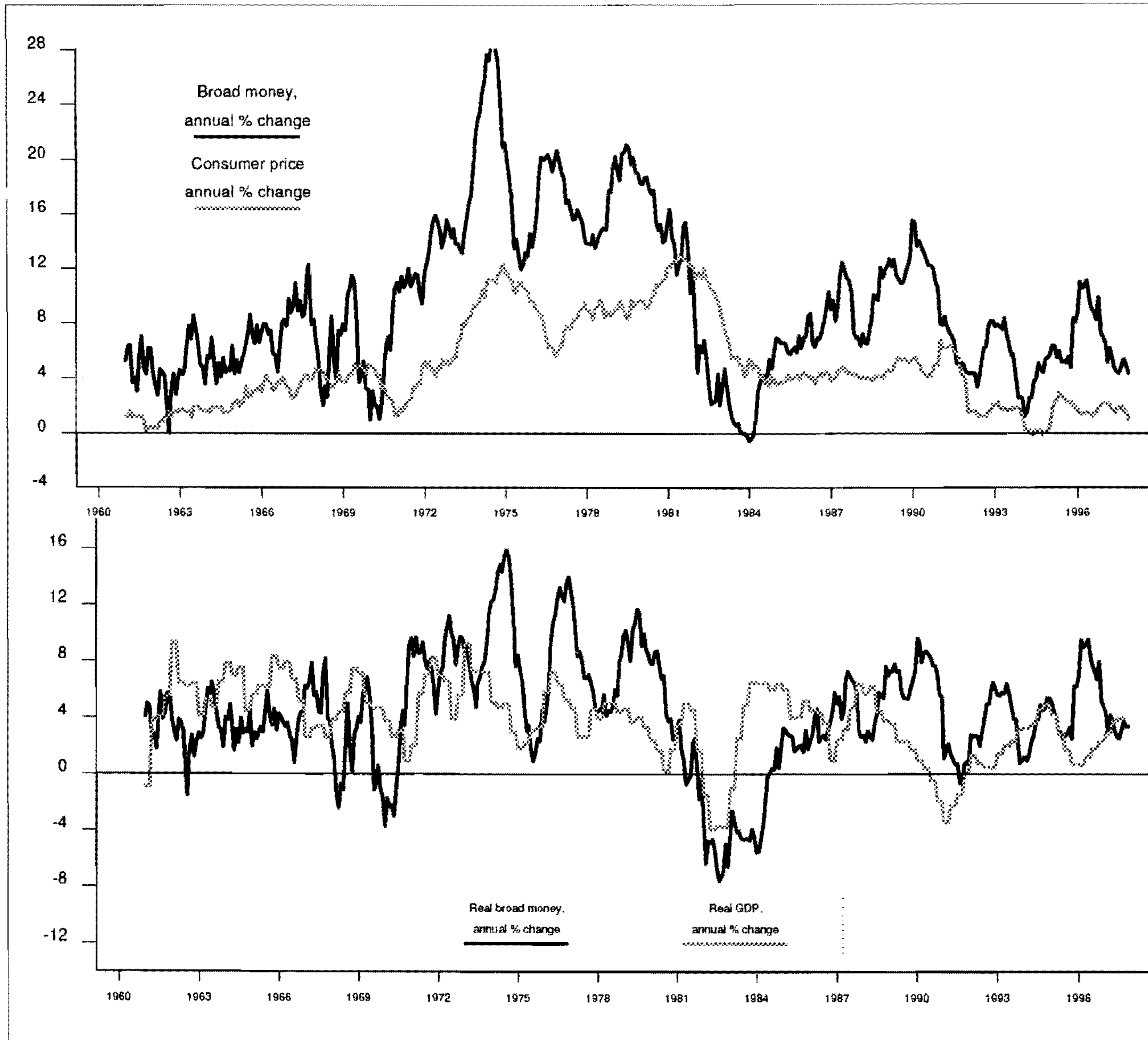
In the 1990s the UK banking system has had a cyclical experience similar to the American banking system, not to that of its European neighbours. It was hit in the early 1990s by a heavy incidence of loan write-offs, but then recovered in 1993 and 1994 after sterling's exit from the European exchange rate mechanism and a sharp drop in interest rates. Since early 1995 banks' capital has been strong and they have been keen to expand. Broad money growth - under 5% a year in the early 1990s - moved up to over 10% a year. It continues to run at double-digit rates. One feature of late 1997 was that sterling lending to foreigners (often American companies) was buoyant, mostly to finance the acquisition of UK companies. Despite a rise in base rates from 6% last May to 7 1/4% now, UK money growth remains high. Real broad money growth of well over 5% at an annual rate is one reason for expecting above-trend growth in domestic demand in early 1998.

Italy



Italian monetary trends in the 1990s have been remarkable. A high budget deficit persisted until 1994 and justified expectations of rapid money growth. Instead money growth plunged in late 1994 and 1995 to the lowest rates in the post-war period, partly on hopes that Italian membership of the European single currency area would lead to windfall gains on government bonds. (The bonds were therefore bought by non-bank investors, including foreigners, and the government did not need to borrow from the banking system.) However, money growth began to accelerate in late 1996 and the 12-month increase has now reached 10%. This has been based on both increased bank credit to the private sector and more financing of the budget deficit from the banks. Italian money trends are not consistent with membership of the single currency zone and imply quite buoyant domestic demand in 1998.

Canada



Canada's economic outlook is dominated by the USA's. Nevertheless, the Bank of Canada has some autonomy in its interest-rate decisions, while the Canadian economy is more dependent on commodity prices than its southern neighbour. 1997 was an interesting year, because the weakness of the Canadian dollar against the US dollar created a quite different monetary environment. The Bank of Canada was obliged to raise its bank rate on a number of occasions from 3 1/4% to 4 1/2%, unlike the Federal Reserve which increased Fed funds rate only once. Money growth slowed down, apparently in contrast to the pattern in the USA. The reason was not sluggish credit demand, but negative influences from the external counterparts to the money stock. As credit growth was in fact rather strong (as in the USA), one way of interpreting these trends is to say that excess Canadian credit growth boosted money holdings in the USA rather than in Canada.