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Unsustainable growth on both sides of the Atlantic

The relationship between shares prices and economic activity

Consensus that US growth to slow without rises in interest rates and inflation

Lex's remarks in the *Financial Times* (4th March) are representative of much commentary on the American economic situation. While conceding that the impact of the Asian crisis has been less than expected, the columnist says "the betting must still be that Asia will make itself felt this summer, with most analysts expecting economic growth to slow from 3.8% [in 1997] to 2.5% in 1998." The prevailing view is that, with unchanged interest rates, the slowdown will be sufficient to maintain low inflation.

But the American economy has been booming since mid-1996

This sort of view was being expressed about a year ago, after unexpected buoyancy in late 1996. It was completely wrong then and it is completely wrong again now. The mistake a year ago was to under-estimate the importance of the high money supply growth which began in early 1995 on balance sheets and asset prices, and thereafter on demand. Clear symptoms of excess liquidity were the extraordinary levels of corporate acquisition activity and the massive flows into mutual funds. The most conspicuous result of "too much money chasing too few assets" was a surge in share prices to levels far out of line with long-run value. As the market valuation of corporate equity was in excess of its replacement cost (i.e., in jargon, "Tobin's Q" was much above 1), investment boomed. Meanwhile the personal sector tried to convert its stock-market winnings into housing wealth, leading to an exceptionally busy housing market. (Similar processes were under way in the UK, but on this side of the Atlantic forecasters did expect 1997 to be a strong year for the economy.)

and - given current share prices and the positive wealth effects they have on activity - it will not slow down to a sustainable rate

Isn't it obvious that the powerful stimulatory forces on US domestic demand that were at work in early 1997 continue to operate today, except that they are far stronger? There has been another year with the broad measures of money growing by 8% - 10%, another leap in share prices and another jump in mortgage applications, followed by soaring home sales and housing starts, plus a resurgence of speculative activity in commercial real estate. As in early 1997 the consensus on the American economic outlook is rubbish. The truth is that the USA is in the midst of a silly boom of a very familiar type. It will end in the usual way, with rising inflation, a vast balance-of-payments deficit, much higher interest rates "than anyone expected" and asset price collapses. (The inflationary reckoning has been postponed by "the Asian effect" and the fall in oil prices. What would happen in 1999 if Asia recovered and oil prices returned towards $20 a barrel? Again, the UK would face similar inflationary trouble, but at least some anticipatory action has been taken by the Bank of England. Policy-makers here have also publicly acknowledged their concern about high money growth and share prices, and the dangers of excessive domestic demand.)

Professor Tim Congdon 6th March, 1998

Summary of paper on

"How long before inflation rises?"

Purpose of the paper

Consensus forecasts expect little change in underlying inflation from recent levels of 2 1/2% - 2 3/4% over the next two 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, March 1996 and March 1997 - is to consider whether these estimates, or Lombard Street Research's less benign view, will be borne out.

Main points

* **The underlying rate of inflation rose to 3.0% in July, but has since fallen and it was 2.5% in January, with heavy discounting partly responsible. Sterling strength has contributed to the fall from last summer's high.**

* **Survey evidence on the immediate outlook for inflation is encouraging. Producer input prices fell at an annualised rate of 16.5% in the three months to January, the lowest so far in the current cycle.**

* **The medium-term assessment needs a more fundamental view on the determinants of inflation. In the monetarist framework adopted by Lombard Street Research, inflation is the result of too much money chasing too few goods.**

* **Broad money growth has run at above 10% a year for three years, too high to be compatible with 2 1/2% inflation.**

* **According to calculations based on ONS estimates, the level of output may be 1/2% above trend. But in previous upswings growth has been under-recorded. The "positive output gap" (the excess of actual over trend output) may be as high as 1 1/2%.**

* **If strong real money growth persists, domestic demand will tend to grow at an above-trend rate. With the level of output already above trend, this points to rising inflation in late 1998 and 1999. The pound's strength remains an important counterweight, at least for the time being.**

This paper was written by Brendan Baker and Michael Taylor

How long before inflation rises?

Pound keeping inflation down, but medium-term prospects are unsatisfactory

Present analysis similar to previous exercises

Last March's Lombard Street Research *Monthly Economic Review* included a research paper with the title "Five more years of low inflation?" Its main conclusions were twofold. First, without tighter monetary policy, broad money growth would remain close to 10%. Secondly, the "negative output gap" (the excess of trend over actual output) would close in 1997 and inflation would rise thereafter. Interest rates are now 1 1/4 percentage points higher than a year ago, but the annual increase in M4 has doggedly remained above 10%. Most commentators would accept that the negative output gap closed by mid 1997. However, underlying inflation (the 12-month percentage increase in the RPI excluding mortgage interest payments) fell from a high in July 1997 of 3.0% to 2.5% in January. This paper looks at why it declined and asks whether it will remain at current levels in the late 1990s.

Sterling strength masks rising domestically-generated inflationary pressures

An important influence on the recent favourable inflation outturn was sterling strength. The pound appreciated by 16.5% in 1997, on a trade-weighted basis. Along with falling prices for internationally traded commodities, this reduced producer's costs. Evidence suggests that savings have been passed on to the retail sector. For example, using seasonally-adjusted data, the balance of CBI members expecting to increase prices in the coming four months was -5% on average in December, January and February, the lowest in over two decades. But the exchange rate is out of line with the pound's "fair" value. According to Lombard Street Research's estimates of purchasing power parity (PPP) exchange rates, based on producer prices, sterling is 20% overpriced relative to the three major world currencies. A widening current account deficit argues that, at some stage, the pound will weaken and return to its PPP rate, reversing the favourable effect on prices of the earlier appreciation.

But in the medium term domestic forces the dominant influence on prices

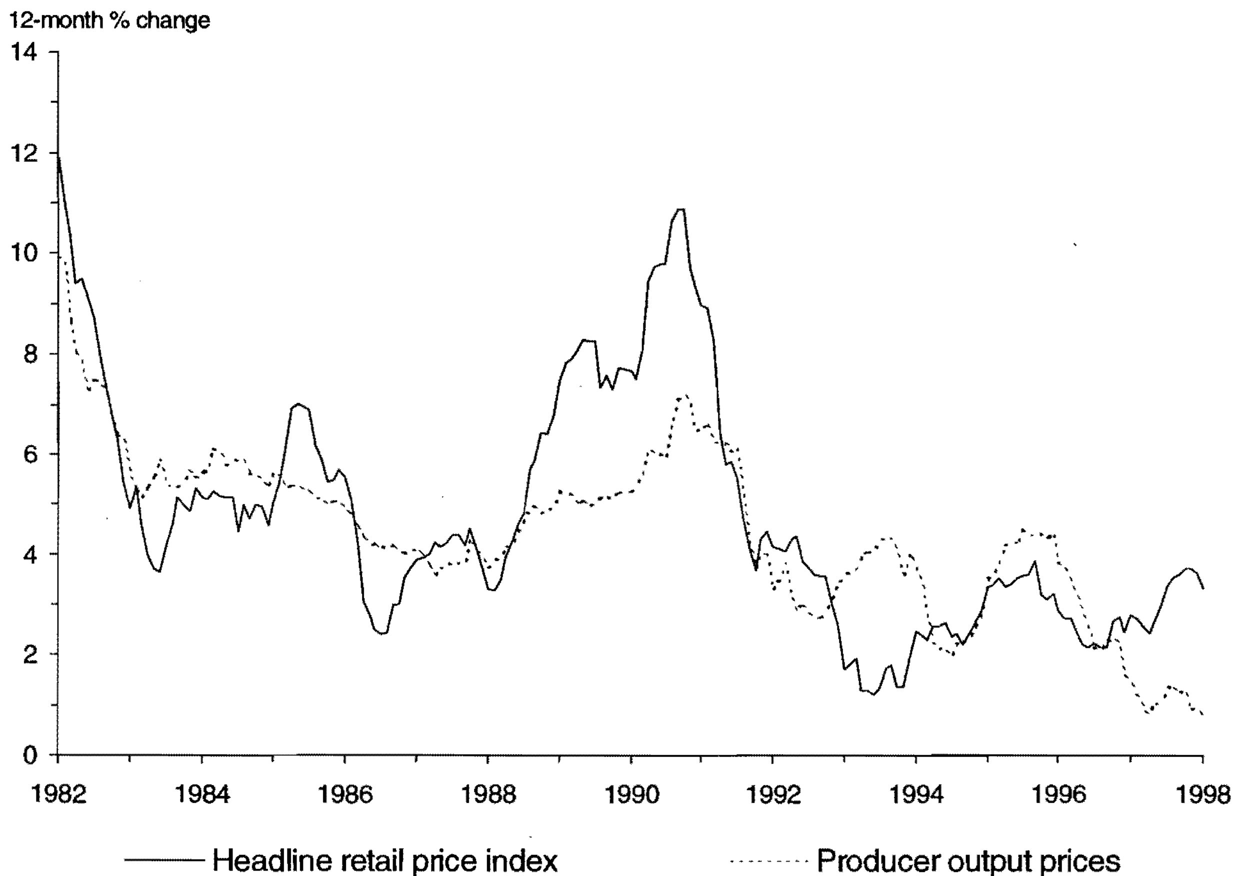
Moreover, in the medium term, domestic events will dictate the path of inflation. Within the monetarist framework adopted here, inflation is ultimately the result of faster increases in the money supply than in the value of national output. If real money growth is well above the increase in real incomes, people and companies have "excess real money balances". To eliminate these, they buy more goods and services. Currently, output is almost certainly above its trend level and a further stimulus to demand will lead to higher inflation. This process is not mechanistic, but past experience suggests that it will take hold in time.

Higher inflation in 1999 now unavoidable

Interest rate rises have not curbed sufficiently the high rate of growth of the money supply. Given the buoyancy of personal sector credit demand, it is difficult to envisage a significant slowdown in money growth without further monetary tightening. However, unless policy moves are draconian, a rise in inflation seems unavoidable in late 1998 and a move to underlying inflation of above 4% in 1999 is likely.

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.

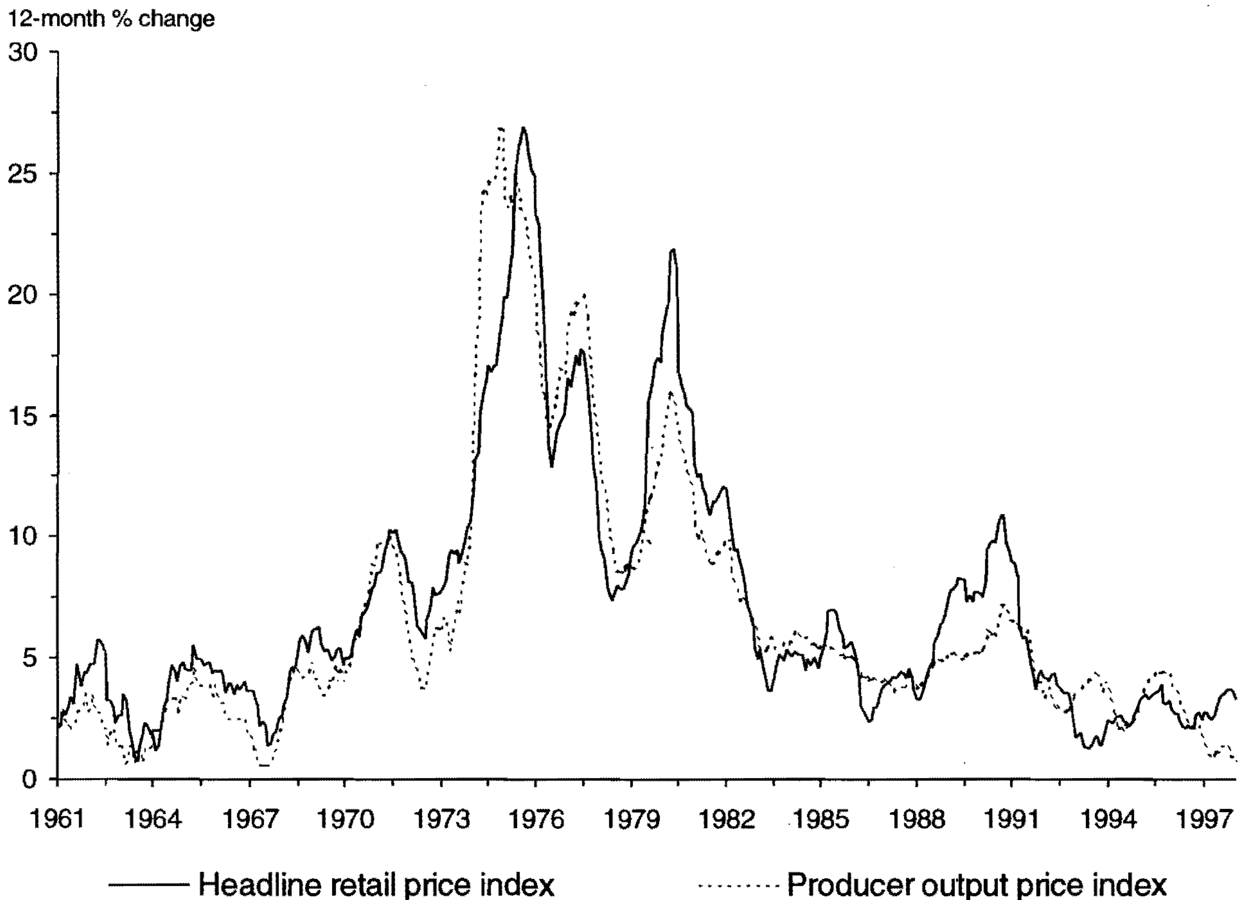


Source: ONS Economic Trends.

The annual rate of all-items inflation in January 1998, at 3.3%, is higher than a year ago (2.8%). But the underlying rate (excluding mortgage interest payments) has fallen over the period, from 3.1% to 2.5%. Exceptionally large discounts in New Year sales helped reduce annual inflation rates in January. Despite the unwinding of this effect, inflation may stay low in coming months. Producer output price inflation in the year to January was 0.7%, around the lowest rate for 30 years. This reflects both the continued strength of sterling and a recent fall in commodity prices. But sterling's average effective exchange rate has been little changed since November. If this stability persists, then the downward effect on producer prices from sterling's appreciation will weaken. A 10% fall in sterling could push producer output inflation over 4% next year.

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.

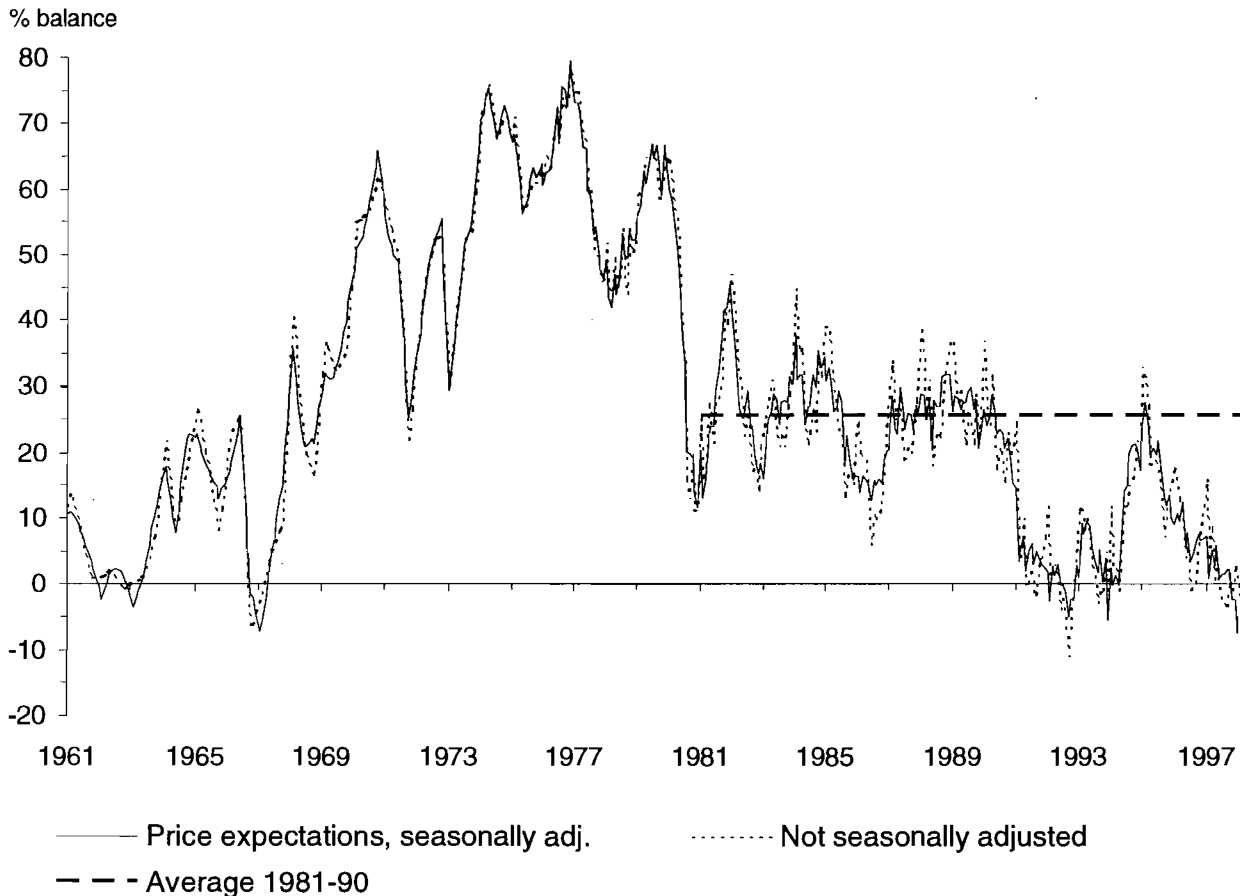


Source: ONS Economic Trends.

Fears that inflation may rise towards 4% next year must be viewed from a historical perspective. Headline inflation was above 4% continuously between April 1968 and May 1983. The peaks in inflation over the past 25 years have all been associated with sharp increases in oil prices. At present oil prices are at a four-year low, reflecting increased OPEC production, reduced Asian demand and a warm winter in the northern hemisphere. (There may be an emergency OPEC meeting later this month in an attempt to restrict output and support prices.) But leading indicators point to robust expansion in the world economy this year, despite the slowdown in Asia. This will underpin commodity prices generally. The negative influence of commodity prices on inflation is unlikely to persist throughout 1998.

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.

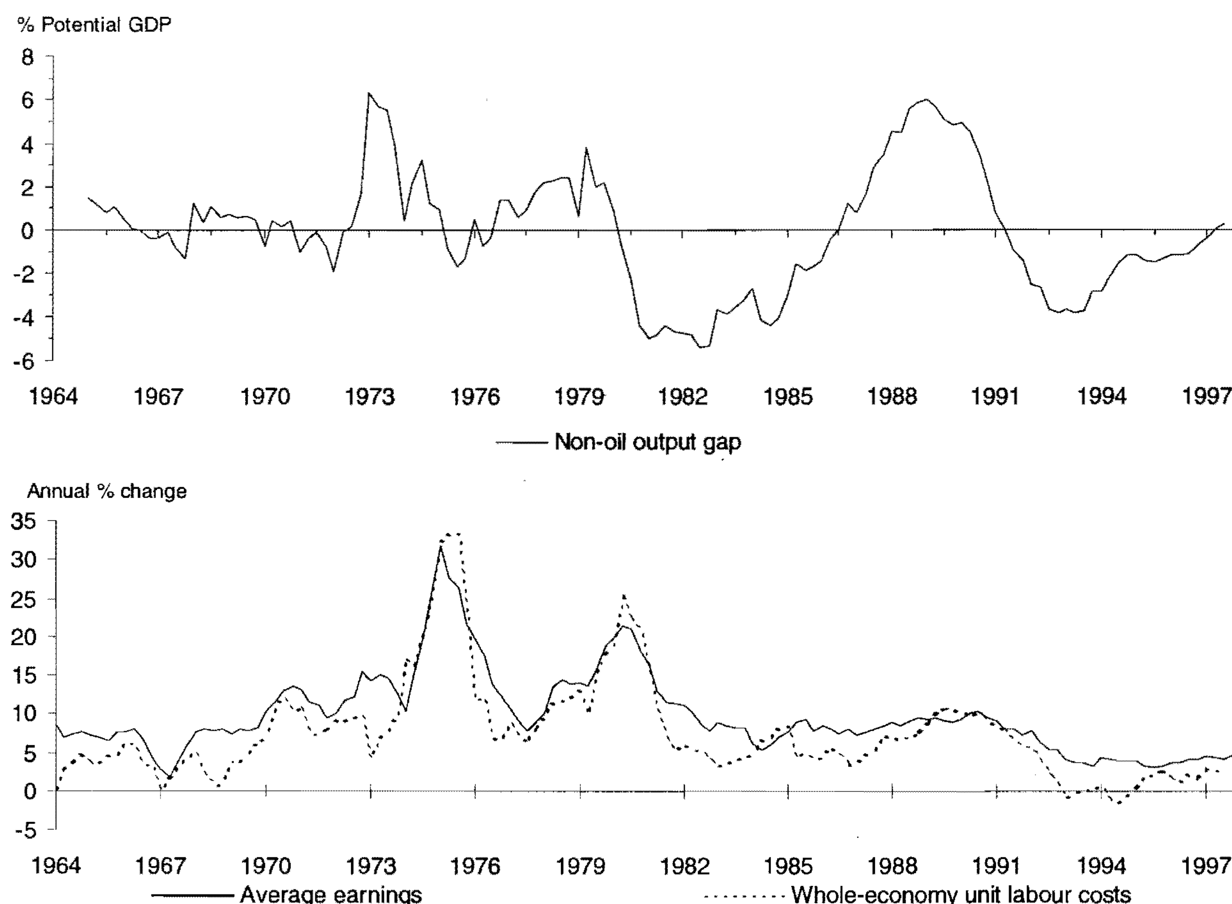


Source: CBI Monthly Trends Enquiry.

The prices balance in the CBI survey emphasises the very weak inflationary pressures in manufacturing. Much of this is due to the strength of sterling, which has reduced the price of imported raw materials. (Input prices fell by almost 10% in the year to January.) The prices balance has now fallen to levels similar to those immediately before sterling's exit from the ERM in September 1992. If sterling now depreciates, these beneficial effects will unwind. Moreover, unlike in 1992 there is now a positive output gap, indicating that price pressures may revive quickly. Rising wages will put upward pressure on costs this year, as labour accounts for two-thirds of total manufacturing costs. Manufacturing earnings are already rising by 4 ¾%a year. Cost pressures in manufacturing are likely to deteriorate from now on.

Labour cost developments

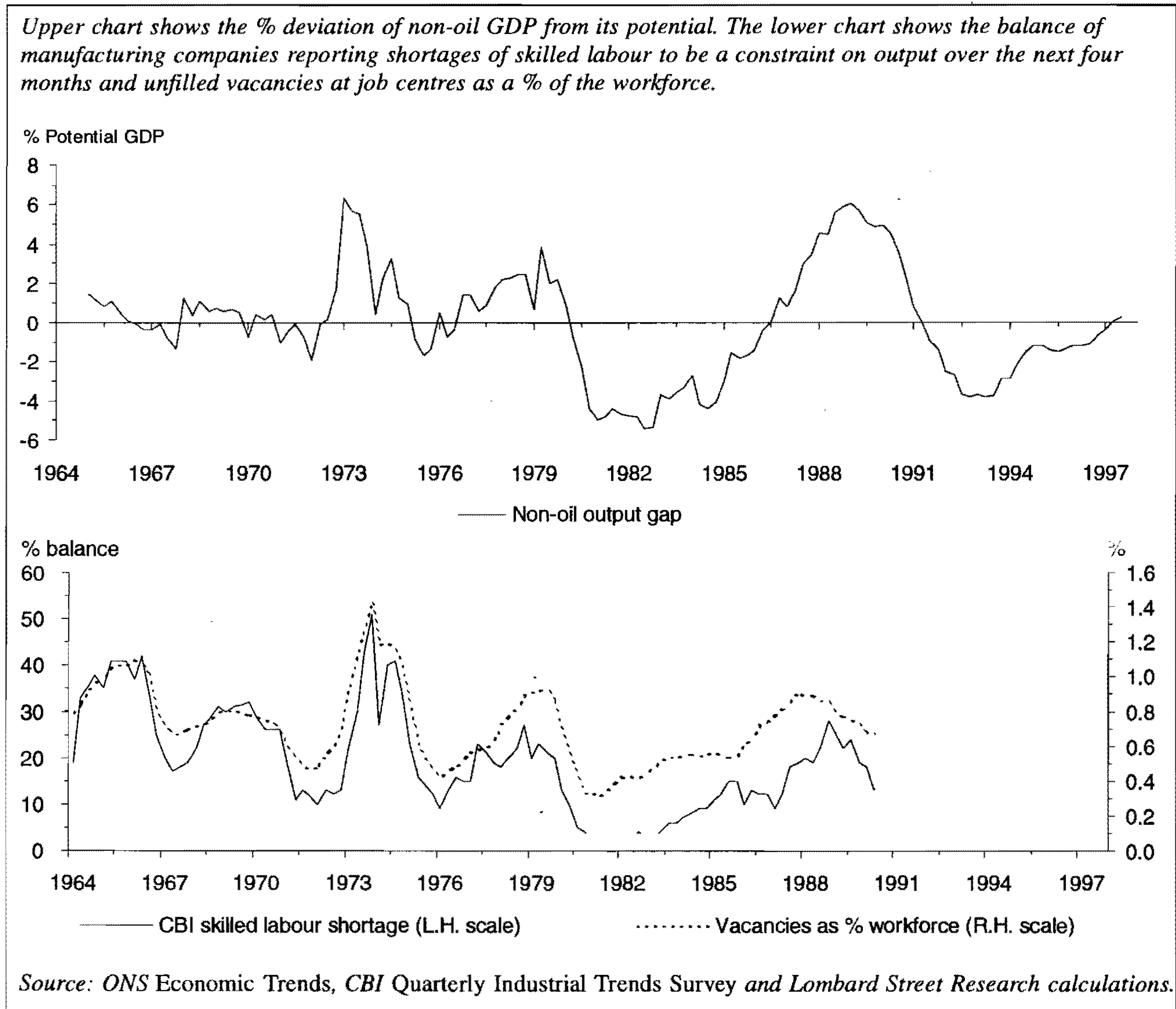
Upper chart shows the % deviation of non-oil GDP from its potential level. The lower chart shows 12-month percentage changes in average earnings and in unit labour costs for the whole economy.



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

Claimant count unemployment fell by 416,000 in the year to January 1998, reducing the unemployment rate by 1½% to 5.0%. The more reliable Labour Force Survey (LFS) also showed a significant fall, to an unemployment rate of 6.6% in Autumn 1997. Short-term unemployment in the LFS is at its lowest since 1980. A tight labour market is now causing average earnings growth to accelerate. The annual increase was 4¾% in December, while rising pay settlements suggest that earnings growth will accelerate to over 5% this year. Private sector earnings are already rising by 5% a year, with the whole economy average reduced by public sector earnings growth of 2½% per annum. Assuming that productivity rises at a trend 2% a year, earnings growth above 4½% a year is not consistent with 2½% inflation in the medium term.

Two measures of labour market slack

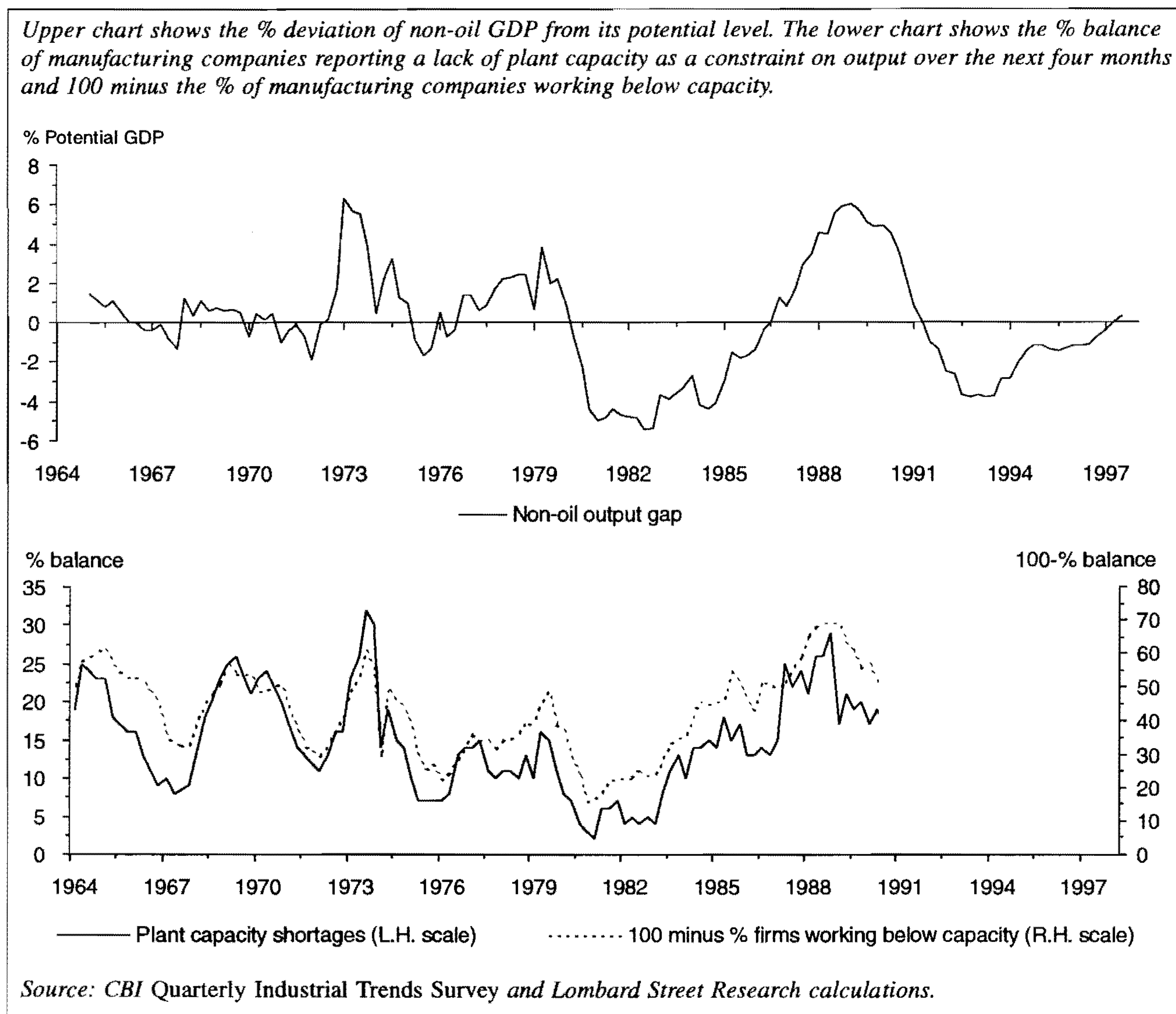


Upper chart shows the % deviation of non-oil GDP from its potential. The lower chart shows the balance of manufacturing companies reporting shortages of skilled labour to be a constraint on output over the next four months and unfilled vacancies at job centres as a % of the workforce.

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

GDP growth in 1997 as a whole was at an above-trend rate, currently estimated at 3.2%. But upward revisions to official statistics, common at this stage of the business cycle, are likely to give a final figure of around 4%. There is now a positive output gap (i.e., an excess of output over its trend level). Until this is eliminated by a period of below-trend growth, inflation will be on an upward trend. Evidence from the labour market is consistent with a positive output gap. Vacancies rose throughout 1997 and are now above levels of the late 1980s. Skills shortages in manufacturing have crept up slightly, but remain well below levels in the 1980s boom. However, the latest survey from the British Chambers of Commerce showed significant skill shortages in the services sector. This survey also reported difficulties in recruiting unskilled and semi-skilled staff.

Two measures of capacity utilisation



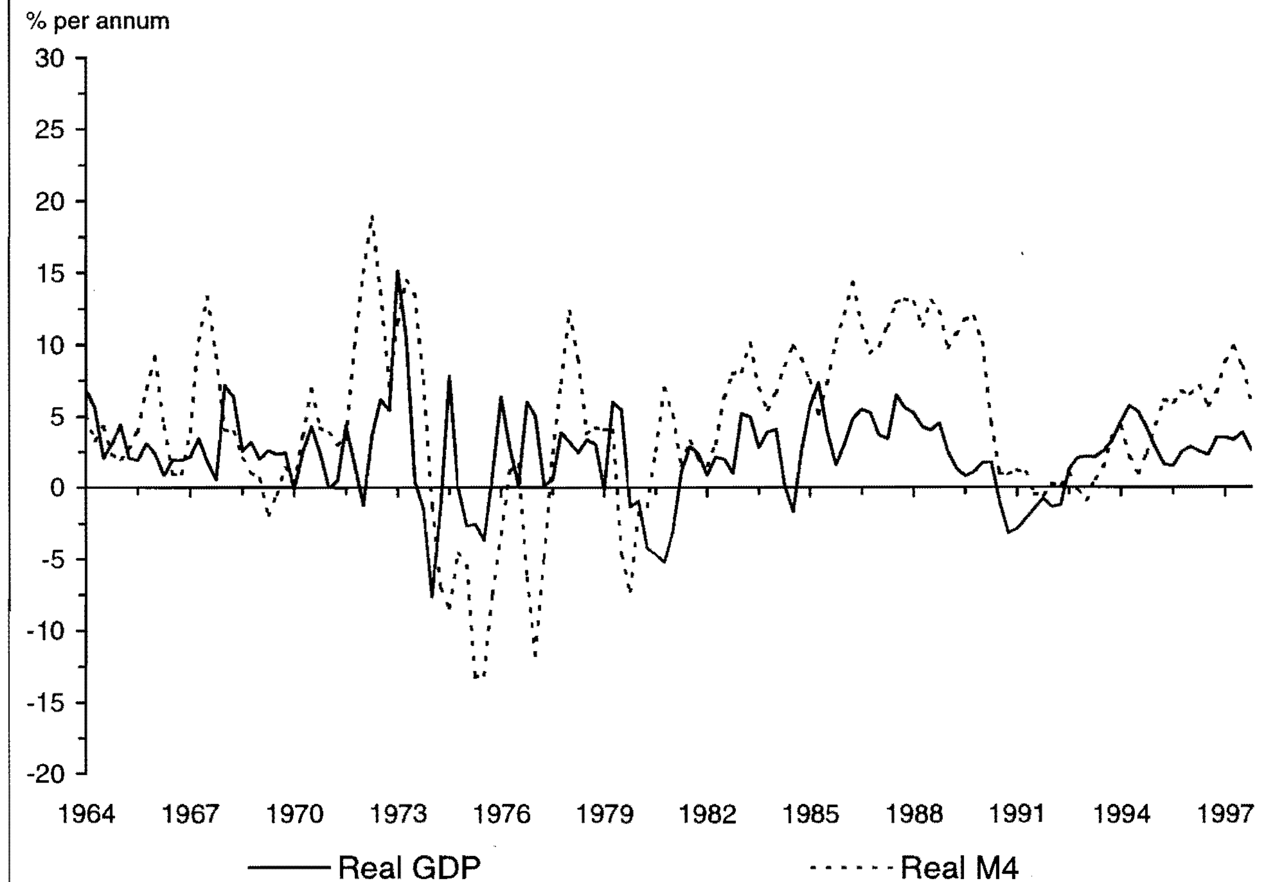
Upper chart shows the % deviation of non-oil GDP from its potential level. The lower chart shows the % balance of manufacturing companies reporting a lack of plant capacity as a constraint on output over the next four months and 100 minus the % of manufacturing companies working below capacity.

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

Official statistics say that manufacturing output increased by 1½% in 1997, after a rise of 0.3% in 1996. They also show that manufacturing output fell by 0.4% in Q4 last year. But, although manufacturing is weak, it is not in recession. The CBI survey has a positive balance on its output question, in sharp contrast to the negative balances which characterised past recessions. Survey evidence from the Chartered Institute of Purchasing and Supply also points to continued modest expansion in manufacturing output. Despite the negative influence from exports, the continued strength of domestic demand keeps companies busy. Both of the CBI's measures of capacity utilisation are also consistent with rising output. The proportion of firms working below capacity in the CBI survey fell by 10 percentage points in the year to Q1 1998.

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: ONS Economic Trends *and Bank of England* Monetary and Financial Statistics.

The analysis on pp. 8 and 9 indicates that a sustained period of below-trend GDP growth is necessary to close the positive output gap (i.e., the excess of actual over trend output). Historical experience suggests that this is unlikely without subdued levels of real money growth. The recession earlier in the 1990s was accompanied by negligible real changes in the money supply. But the series increased by 6% or more a year between 1995 and 1997. Changes in real M4 have tended to lead changes in real GDP by six months to a year. Thus, one message from recent monetary trends is that below-trend growth in domestic demand is unlikely in 1998. Resilient domestic demand is hard to reconcile with talk of a recession in 1998, a possibility suggested by, for example, the National Institute.

Recent monetary trends

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

% per annum

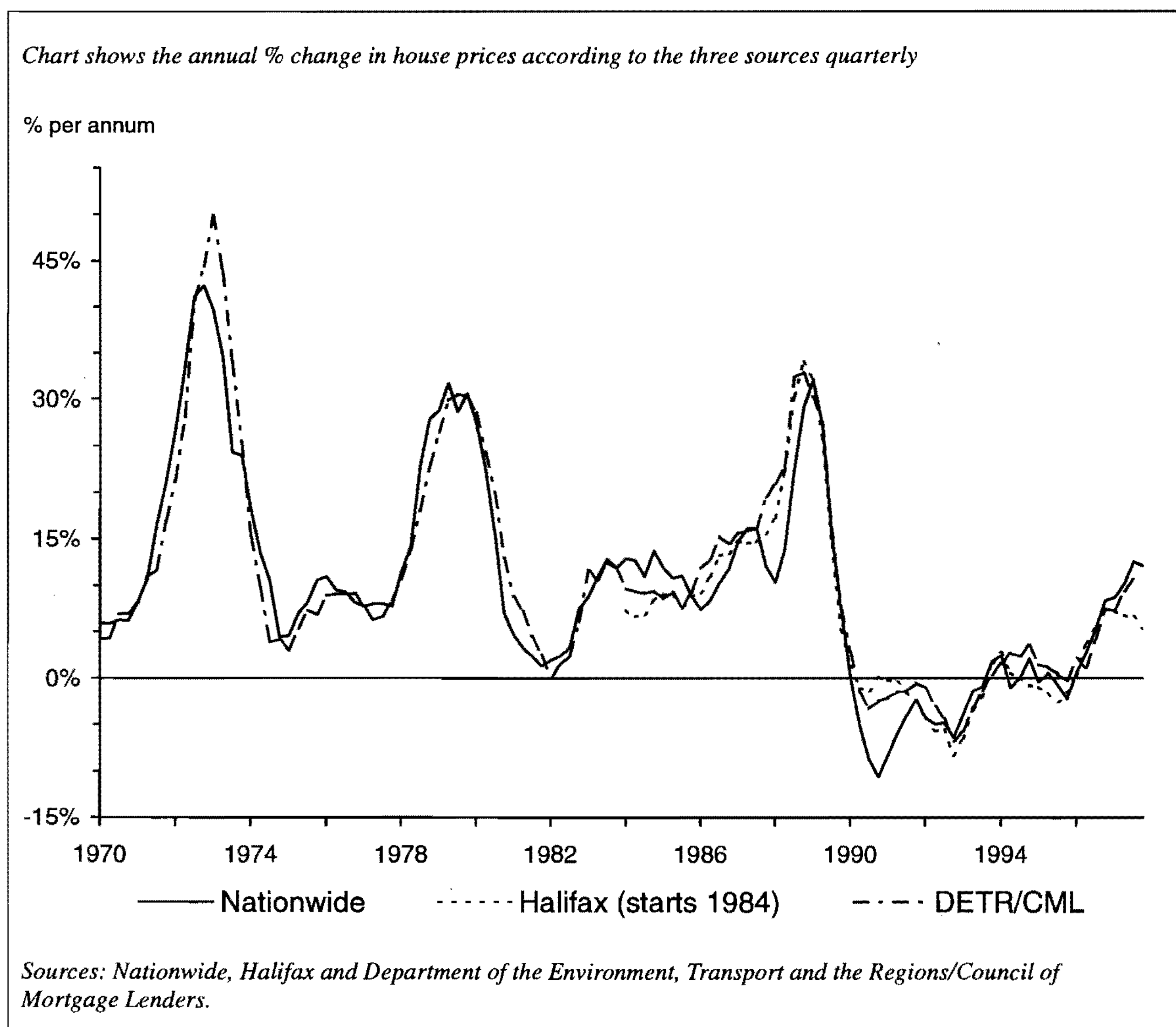
M4 ------ M4 lending

Source: Bank of England Monetary and Financial Statistics.

M4 increased at an annualised rate of 8.1% in the six months to January, compared with a recent high of 13.5% in June 1997. After warning of the inflationary threat of a rapid expansion in the money supply, the Bank of England has expressed a note of relief at the slowdown. But it is not clear whether money growth will continue to decline. Recent rates of increase are not compatible with low and stable inflation in the long term. Companies have been raising finance through bond issues rather than bank loans, a trend which has been encouraged by the inverted yield curve. In spite of interest rates rises, personal sector credit demand has held up. The amount of debt owed by individuals increased at a six-month annualised rate of 7.5% in January, if anything, a little faster than in the middle of 1997. Robust personal sector loan demand is difficult to reconcile with significantly lower money growth.

House price inflation

Chart shows the annual % change in house prices according to the three sources quarterly



Sources: Nationwide, Halifax and Department of the Environment, Transport and the Regions/Council of Mortgage Lenders.

Another cycle in the housing market is under way, although not on the same scale as in earlier upturns. House prices started to recover from the early-1990s housing slump in the mid 1990s. But significant and sustained rises only came in 1996. Estimates differ over the pace of increase in 1997. The Nationwide and Council of Mortgage Lenders surveys suggest growth of 10% last year. But according to Halifax data, the increase was 6.4%. However, one message from the results is that most households' most valuable asset - their home - rose in value at between two and four times the underlying rate of inflation (i.e., the 12 month increase in the RPI excluding mortgage interest payments). House price inflation is a leading indicator of retail price inflation. Historical experience suggests that 1999 will be a somewhat more difficult year in terms of inflation.