Comments on the US economy and EMU

Theme 1. Extremely buoyant mortgage applications in the USA

Boom in US domestic demand to continue

In my fax of 22nd May I argued - continuing a theme in our research since early 1997 - that rapid growth in broad money, and particularly in wholesale money balances, is the dominant cause of the asset price bubble now evident in the USA. I also said that the soaring stock market and inappropriately low bond yields lay behind the buoyant housing market. Moreover, the housing market is the key to fluctuations in personal sector expenditure, including spending on the volatile big-ticket items which are so important to the business cycle.

My main point in this fax is to reiterate the message, but with renewed emphasis. The last few weeks have seen not only another jump in the stock market, but also some very striking figures on mortgage applications from the US Mortgage Bankers Association. The data are available on a weekly basis, but we prepare a three- month moving average to iron out the erratic weekly movements. On this basis, *mortgage applications to purchases houses in June were remarkable in two ways.*

First, *they were running at levels more than 30% higher than in June 1997.*

Secondly, *they reached a new peak for 1998 and are now at by far the highest level in this cycle.*

We have a good equation on the relationship between the mortgage applications series and home sales. As is very logical, the mortgage applications to purchase series leads home sales by three months. *It follows that US housing market activity will **increase** this autumn.* In the rest of the year new housing starts - a classic leading indicator for the economy - will at worst stabilize at a very high level and probably rise further. (If you want the data in more detail, please contact me on 0171 337 2977 or my colleague, Mr. Alex Skinner, who works for our International Service, on 0171 337 2984.)

If so, it is most unlikely that domestic demand will slow down, as is generally assumed. The growth of domestic demand will continue to run at an above-trend rate and outweigh the contractionary effect of negative net exports, causing

- a further increase in the positive output gap, and

- continued widening of the current account deficit.

The Greenspan boom in the USA today has many resemblances to the Lawson boom in the UK in the late 1980s. It is not quite so extreme as the Lawson boom, while "the Asian crisis" is an excuse of sorts for the mismanagement of monetary policy. But in 1999 and 2000 the US economy will have to deal simultaneously with domestic over-heating and the largest balance-of-payments deficits ever recorded.

Theme 2. At last the ECB gets down to work

A very interesting and controversial decision on reserve requirements

After all the talk, the ECB has finally started to take measures which might make the single currency feasible. In particular, it has announced that monetary control will be secured in Europe partly by a system of minimum cash reserves. These are to be varied between 1.5% and 2.5% of bank deposits as a way of influencing banks' behaviour, including the rate at which they expand their balance sheets and so determine the money stock (on the broad definitions).

Some bankers have complained that the use of reserve requirements is an outmoded method of monetary control and urged their complete abandonment, on the British model. It was expected that the ECB would resist these views. However, the ECB announcement is a surprise in two ways,

- First, *the level of the reserve requirement is remarkably low*, compared with the reserve requirements previously set on a national basis.

- Secondly, *the ECB appears consciously to be trying to prevent the transfer of banking business to offshore centres (such as London), where the reserve requirement will not apply*. By setting the reserve requirements at such a low figure and planning to pay interest on the balances, the ECB will blunt the incentive to conduct wholesale euro banking business in London rather than in Frankfurt or Paris.

It is important to emphasize that the ECB's decision will have ***important effects on the profitability of both commercial and central banks across Europe***. For example, the Banca d'Italia will lose between 10% and 15% of its liabilities, while Italian commercial banks will benefit from being able to redeploy profitably funds (now tied up in the central bank) equal to 3% - 4% of their assets.

However, the consequences of the decision for monetary control are very double-edged. *The ECB's announcement in effect represents quite a major easing of monetary policy in such countries as Italy, Spain and Ireland.* Yet - as Teitmeyer complained yesterday - these are the very countries that at the moment are recording the highest money supply growth rates in Europe.

How does the ECB propose to curb money supply growth in the high- money-growth countries and not affect the low-money-growth countries? Is it considering measures which discriminate between countries? Would such measures be politically legitimate or even viable?

Professor Tim Congdon **10th July, 1998**