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What is *really* happening to American inflation?

Puzzling data inconsistencies undermine the New Paradigm's credibility

Low inflation a key aspect of the "New Paradigm"

Perhaps the most important question for financial markets at the end of 1999 is, "how has the USA been able to enjoy a four-year-old boom without any rise in inflation?". Against the background of rapidly rising output and employment, the lowness of American inflation has been both a surprise and one of the key items of evidence in support of the so-called "New Paradigm". (The kernel of the New Paradigm is the claim that the trend rate of productivity growth in the USA has improved, so that faster growth can be reconciled with stable inflation at a low rate.) Widespread belief in the New Paradigm has been basic to the persistence of extremely ambitious stock market valuations in the USA and elsewhere.

Diverging measures of inflation

Financial markets were particularly pleased by figures on 28th October showing that in the third quarter the GDP deflator had increased at an annualized rate of only 0.9%. As the GDP deflator is a comprehensive measure of prices in the economy, this was taken as impressive confirmation that inflation is under control. The publication of the GDP deflator coincided with that of the "employment cost index", which was up by 0.8% (i.e., at an annualized 3.2%) in Q3, less than in Q2. But, the optimism generated by these inflation numbers may be exaggerated. They came less than a fortnight after poor figures for the producer price index. The PPI jumped by 1.1% in September, largely but not only because of higher oil prices. In the three months to September the PPI went up by 1.8% (i.e. annualizing at 7.4%). Which set of statistics is reliable? Is American inflation running at 1% or 7 1/2% a year?

USA's GDP deflator looks suspiciously low,

The USA's GDP deflator needs to be interrogated. Data on the growth of personal incomes, and so of the wages and salaries which are their dominant component, are of high quality. They show the total wages and salaries bill advancing at present by 6% - 7 1/2% a year. Company announcements point to large increases in profits, of the order of 15% - 20% a year. As wages and profits constitute the great bulk of national income, and as national income moves in tandem with GDP, nominal GDP ought logically to be increasing by at least 6% a year and probably by rather more. But that is not in line with the official figures produced by the Department of Commerce. They say that the USA's nominal GDP went up under 6% in the year to Q3 1999 and at an annualized rate of about 5% in the six months to Q3. This looks odd. Also puzzling are inconsistencies between different series on pay growth produced by the Department of Labor. Its quarterly survey on productivity and labour costs found that in Q3 1998 compensation per hour in the non-farm business sector increased at an annualized rate of 6.2%. By contrast, its monthly payroll survey estimated that in the same quarter non-agricultural hourly earnings went up at an annualized rate of 3.7%. The uncertainty about what is really happening to American inflation undermines the credibility of the New Paradigm.

while data on pay growth suffer from blatant inconsistencies

Professor Tim Congdon 29th November, 1999

Summary of paper on

"Long-termism and the British national debt"

Purpose of the paper

The UK's long-term savings institutions have traditionally relied on gilt-edged securities to cover their liabilities, a trend likely to be reinforced in coming years by pensioners' increasing demand for stable investment income. But strong public finances will restrict the supply of gilts. Can the gilt shortage be alleviated?

Main points

* **For many decades the UK's life offices have relied on the ready availability of gilt-edged securities to cover their liabilities. This demand for gilts has been enhanced by the 1995 Pensions Act, which specifies a Minimum Funding Requirement for pension funds (i.e., a requirement to hold a minimum proportion of their assets in the form of gilt-edged securities).**

* **The size of the stock of gilts in issue is related to the national debt. Under Mr. Brown's "sustainable investment rule", the ratio of net public debt to gross domestic product is to be limited to 40%.**

* **Demographic trends will raise the demand for gilts in coming years. But the 40% limit on the net-debt-to-GDP ratio will restrict the supply.**

* **Already the excess demand for gilts has contributed to a marked decline in gilt-edged yields. This has reduced the level of income savers can achieve when they convert personal pension plans into annuities.**

* **The excess demand for gilts could be alleviated by allowing pension funds to meet the MFR by holdings of corporate bonds as well as gilts. In 1998 insurance companies bought fewer gilts than pension funds, perhaps because they disliked the low yields.**

This paper was written by Professor Tim Congdon, with help from Lombard Street Research's UK Service in the preparation of the charts.

Long-termism and the British national debt

Strong public finances demand rethink of the Minimum Funding Requirement

Traditionally Britain has had a large and long-lived national debt, with similarly long-lived savings products

Britain has had a large national debt for over 250 years. In the last two-and-a-half centuries the debt has often exceeded national product and for most of the time it has been higher than 50 per cent of national product. Not surprisingly, Britain's long-term savings institutions have become accustomed to holding significant claims on the Government, mostly in the form of gilt-edged securities. In particular, these institutions have marketed products on the assumption that a sizeable and liquid market in gilt-edged securities would exist into the indefinite future. The classic example is the life insurance policy with 20 or 30 years to maturity. Traditionally, the life companies have covered the insurance liability by making projections about mortality and investing in long-dated gilts (i.e., gilts with a residual term to maturity of over 15 years). Given the very low risk of default on government securities, long-dated gilts have been an ideal instrument for this purpose. By international standards the British financial system has been unusual in the length of both the typical intended life of its products and in the term to maturity of its assets. Contrary to all the comment about "short-termism", the mainstream retail savings products sold by Britain's financial system have in fact had a notably long-term perspective by comparison with other countries.

Demand for medium- and long-dated gilts enhanced by demographic trends and 1995 Pensions Act

From the mid-1960s rising inflation threatened these arrangements, partly because the high level and associated volatility of nominal interest rates complicated actuarial estimates of life companies' future solvency. The UK savings industry moved towards other assets, notably equities and commercial property, in the belief that they gave better protection against the ravages of inflation. However, UK financial institutions continue to have a huge demand for securities yielding income streams which are safe, predictable and stable in nominal terms. The boom in private sector pension provision has enhanced this demand, with the Pensions Act of 1995 introducing a "minimum funding requirement" for pensions. The MFR specifies that a pension fund must hold an increasing proportion of gilt-edged securities as its beneficiaries approach retirement age. Further, under existing legislation most personal pension plans have at some date to be converted into annuities. Insurance companies normally match annuity liabilities by holdings of fixed-interest securities, especially gilts.

UK now has strong public finances,

The achievement of a fair measure of financial stability in the 1990s has in many ways made long-term forward planning much easier for life companies and pension funds. Part of the explanation for the return to stability lies in the UK's strong public finances, as a large budget deficit is no longer a threat to monetary control. But, ironically, the strength of the public finances has started to create a new and different type of problem. While the demand for gilt-edged securities has been increased

reducing the supply of gilts

by recent trends in both pensions legislation and the changing age-structure of the population, the supply of such securities is being constrained by the low level of budget deficits and, currently, even by a budget surplus. The imbalance between supply and demand has led to a sharp rise in gilt prices and a consequent fall in yields, particularly at the long end of the curve. Falling gilt yields would not normally be deemed a policy "problem", but the result has been an associated drop in annuity rates and serious disappointment for people who have recently had to convert their accumulated pension assets into retirement income. Pension funds also fear that, because it obliges them to buy gilts at high prices, the MFR may reduce their returns.

Sales of gilts not mechanically related to PSNCR, but excess sales create difficult policy questions

At first sight, the obvious answer to the slide in gilt yields would appear to be for the Government to expand the issue of new long-dated gilt-edged securities, but there are several difficulties here. For example, if the public sector net cash requirement is given, the net value of all new issues of public debt is of course determined. (The public sector net cash requirement - or PSNCR - used to be known as "the public sector borrowing requirement" or PSBR.) If the Government concentrates its debt sales at the long end, it may have to reduce its sales in the short- and medium-dated parts of the curve, but that could upset the natural holders of short- and medium-dated gilts. Alternatively, it may maintain high levels of debt sales in all parts of the curve. Gross sales of government debt might then be in excess of the PSNCR. The excess proceeds might be used to acquire new financial assets, such as a balance at the Bank of England or foreign exchange reserves, but such options are themselves contentious and raise difficult questions of public policy. A general discussion about the purpose and overall design of fiscal and debt management policies is needed.

UK's public debt governed by "golden rule" and "sustainable investment rule"

This research paper is more modest. Its aim is to set out some facts about the UK's public debt and to suggest a small part of the answer to the problems that are now emerging. An obvious starting-point is a review of the level of the national debt and its likely course over the next few years. Mr. Gordon Brown has introduced two new rules to preserve fiscal stability, a "golden rule" which requires current expenditure to be met by taxation, and a "sustainable investment rule" which sets a limit of 40% to the ratio of net public debt to GDP and so constrains capital expenditure. The chart on p. 7 shows that in the 35 years to 1998 the golden rule was met only briefly, in the late 1960s (when the first Wilson administration complied with the terms of a loan from the International Monetary Fund) and in the late 1980s (when tax revenues were boosted temporarily by the Lawson boom). The recent *Pre-Budget Report* described a path for the "public sector current budget" over the next four years. This budget concept is not quite the same as "the general government current account", for which data have been estimated for a few decades, but it is close enough for a worthwhile historical comparison to be made. The chart demonstrates that – if Mr. Brown meets his golden rule – the public finances will be stronger on the current balance criterion than at any time since the 1950s.

Gross debt, not net debt, determines availability of gilts

But, to determine the availability of gilt-edged securities to financial institutions, it is the total debt that matters. The chart on p. 8 gives some of the relevant numbers. The net public debt climbed in the early 1990s, but is now down to 40% of GDP. Because public sector net borrowing is to remain low relative to GDP, the net-debt-to-GDP ratio is expected to fall somewhat in the next few years. It seems that Mr. Brown will also meet his sustainable investment rule. One interesting feature is that the net-debt-to-GDP ratio at present is similar to its level in the late 1980s, when there was little public discussion or concern about the availability of gilts for institutional portfolios. The same point emerges from the chart on p. 9, which shows both the net and gross financial debt relative to GDP. Of course, it is the gross debt which determines the total quantity of gilts, National Savings, Treasury bills and so on held by the private sector. (Note that the Government owns financial claims on the private sector, such as loans and tax accruals, and these have to be deducted to arrive at the net debt.)

Has supply of gilts of appropriate maturity been constrained?

The trouble may be that the maturity composition of the debt has changed, so that the supply of medium- and (especially) long-dated gilts to the institutions is inadequate. The chart on p. 10 casts some doubt on this idea. In recent years the ratio of medium-dated, long-dated and undated gilts to GDP has not been much different from what it was in the mid-1980s, although it is undoubtedly lower than it was in the 1960s and 1970s and, indeed, the preceding 200 years. (For much of the 19th century the bulk of the national debt took the form of undated securities, which were said to be "funded". The funded debt was distinguished from the short-term "floating debt", which had to be renewed – or refloated – as it matured. Here lies the origin of the term "funding", and the related notions of "over-funding" and "under-funding" which cause so much controversy.) Further insight comes from the chart on p. 11 which shows the ratio of gilts to pension funds' total assets over the 35 years to 1998. The ratio of gilts to total assets was not only much lower in the mid-1990s than in the early 1960s and early 1980s; it also remains much lower today, despite the need to comply with the MFR.

UK pension funds' gilt holdings still low by past standards

Life office and pension fund assets rising relative to GDP

Do the long-term savings institutions have much ground for complaint? Given the statistics, it might not appear unreasonable to expect them to restore the gilt-to-total-asset ratios that they have had at various times in the relatively recent past. However, this assessment would be superficial. It needs to be remembered that the combined assets of the life offices and pension funds are higher relative to GDP today than ever before, largely because people have moved out of direct holdings of equities into institutional savings and because National Savings have declined drastically as a savings vehicle. The need for a safe fixed-income asset to meet pension fund and annuity liabilities is therefore increasing (relative to GDP), while the sustainable investment rule will restrict public debt and so the supply of gilts (again, relative to GDP). Although the demand-supply imbalance may not have been too severe until now, it is likely to be aggravated in future by the interaction between demographic trends and Mr. Brown's (otherwise admirable) commitment to fiscal stability.

Insurance companies have moved away from over-priced gilts into corporate bonds

What is the way out? The chart on p. 12 hints at a solution (or, at any rate, part of a solution). The UK's life offices match their liabilities by holding corporate bonds as well as gilts. (In the 1960s the life offices' combined holdings of gilts and corporate bonds were much larger than their equity holdings.) The chart shows that in the last two years the life offices' gilt purchases have been smaller than the pension funds'. This was a reversal of the normal pattern because life companies traditionally have a higher requirement for fixed-income assets. The explanation emerges with the numbers for 1998, which show huge buying of "other UK company securities" (mostly corporate bonds) by life offices and no such buying by pension funds. In fact, life offices' gilt purchases in 1998 were a lower proportion of their total asset acquisition than in any of the previous five years. An obvious hypothesis is that the life offices thought that gilt yields had fallen too low relative to the yields on corporate bonds and exploited the difference by making a fairly big allocation shift.

Pension funds' corporate bond holdings not fully eligible in MFR assessment

Unfortunately for the pension funds, they could not pursue the same strategy. The 1995 Pensions Act implies that pension funds can comply with the MFR only by holding gilts. (They may also – to a very limited degree - deem high-quality bonds issued by companies as covering the MFR. The extent of such coverage depends on the wording of the 1995 Pensions Act, and actuarial and legal interpretation.) In effect, the pension funds are forced to buy the over-priced gilts, while the life offices have greater discretion and are taking advantage of the legally-imposed inflexibility of the pension funds' asset selection. The MFR ought to be relaxed, so that pension funds can match their liabilities with corporate bonds as well as gilts. This would stimulate further the already thriving sterling-denominated corporate bond market. (Broader philosophical questions might be raised about the propriety of government intervention in the asset allocations of private investment vehicles. Supporters of free markets might say that the MFR is just another example of such intervention causing trouble. At any rate, the trouble could be easily remedied. Ironically, the MFR was introduced by the last Conservative Government, which is supposed to have believed in free markets.)

The MFR should be relaxed, to include corporate bonds

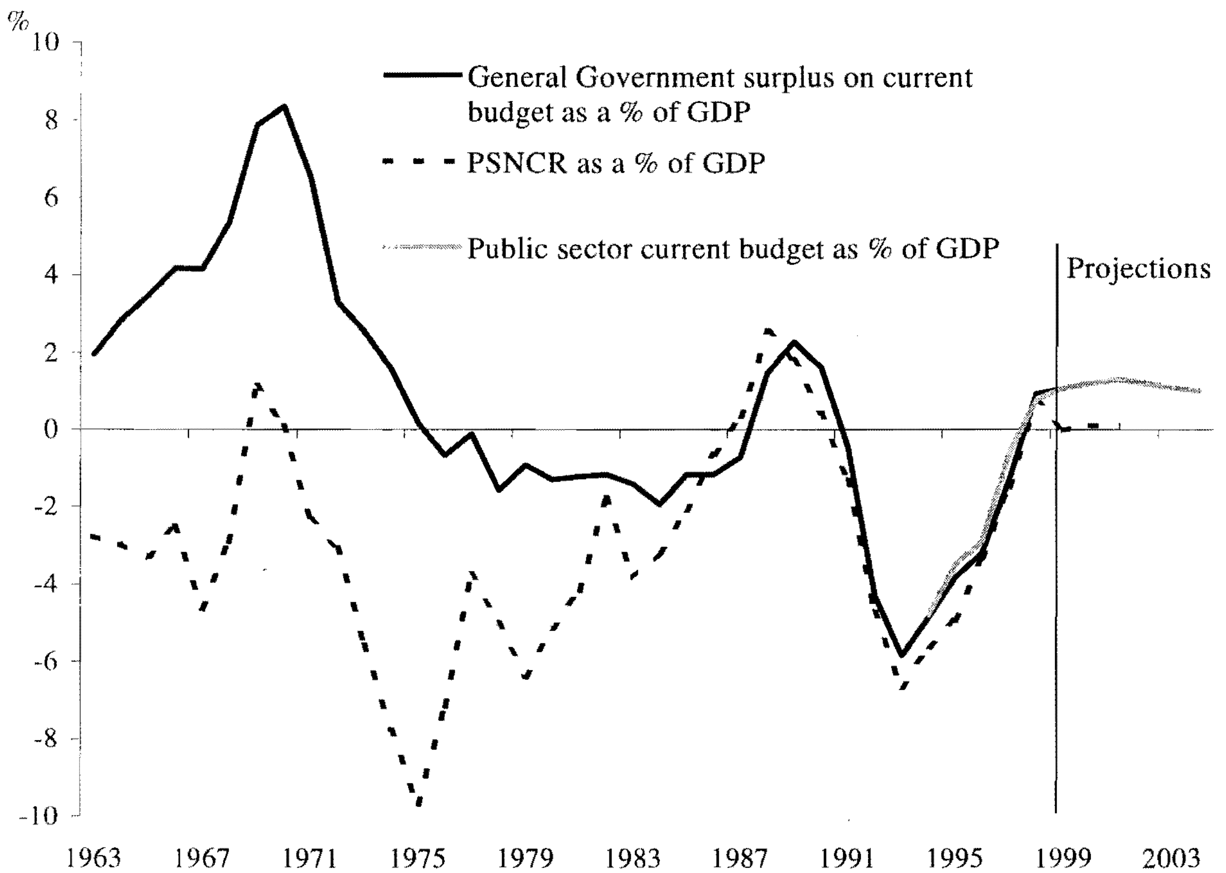
The right answer to the looming imbalance between the demand for and supply of gilt-edged securities is to allow pension funds to meet the MFR by buying corporate bonds; the wrong answer would be to modify or withdraw the sustainable investment rule, which – in conjunction with other measures taken by Mr. Brown – has given reassurance to financial markets that New Labour means what is says about financial stability.

Sustainable investment rule should be retained

"Golden rule" exacting by past standards

Small surplus on current account exceptional in last 35 years

Chart compares general government current account with PSNCR and the public sector current account, all expressed as a % of nominal GDP at market prices. A minus sign indicates a deficit. The figures for the public sector current account include projections from the 1999 Pre-Budget Report and are based on financial years rather than calendar years. GDP forecasts are Lombard Street Research estimates.



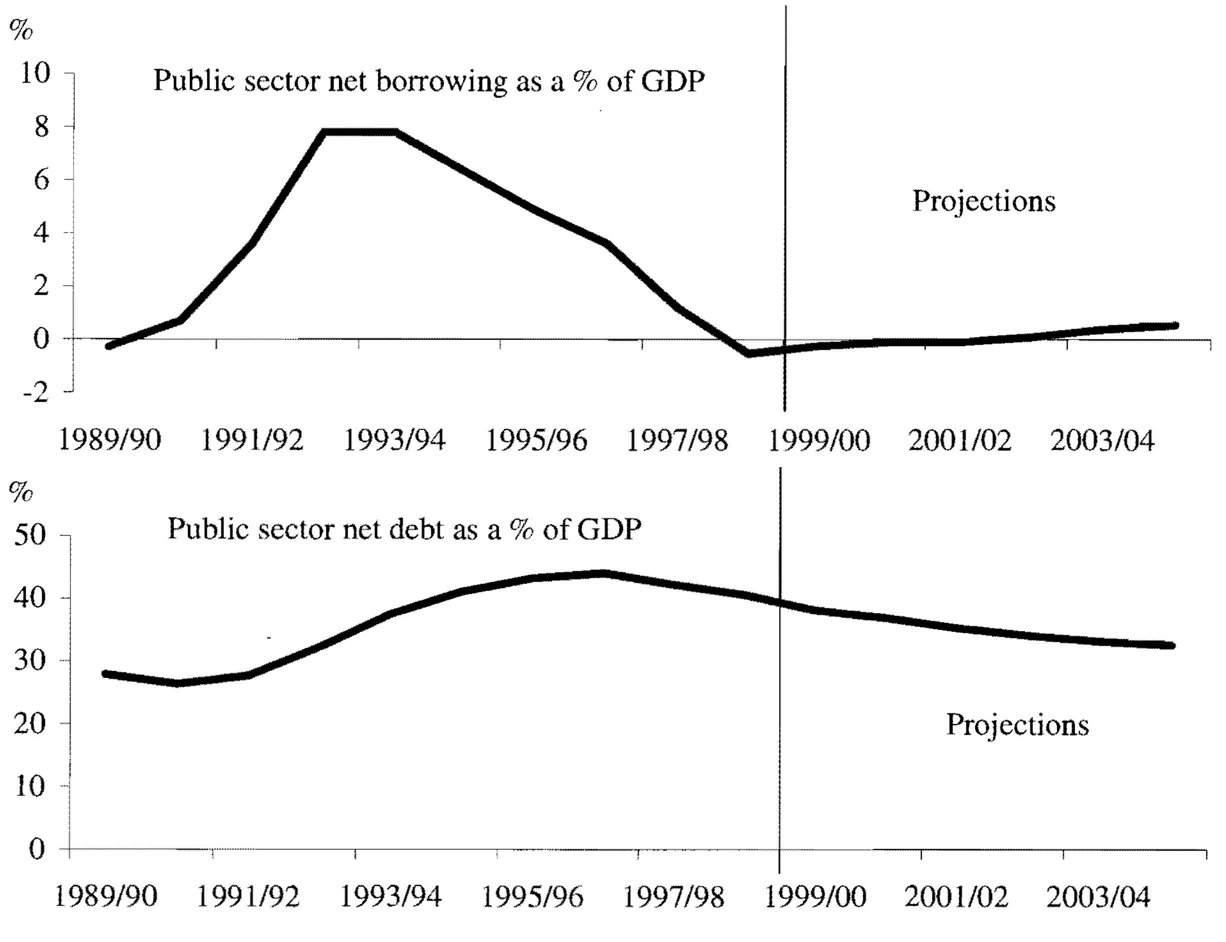
Source: Office for National Statistics, 1999 Pre-Budget Report, Lombard Street Research

New Labour had a well-defined fiscal framework when it came to power in 1997, with the central purpose being to prevent a repetition of the Old Labour pattern of excessive government spending followed by devaluation. The framework was defined by "the golden rule" and "the sustainable investment rule".(See the March 1999 issue of Lombard Street Research's *Monthly Economic Review*. As noted there, the new framework could not be located in any familiar British left-wing intellectual tradition, and would be better described as "neo-Gladstonian" than "Keynesian".) One result was extensive re-labelling of old concepts and the introduction of some new concepts. Thus, the golden rule is understood as having been met if "the public sector current budget" is in balance or small surplus. As the idea of a public sector current budget as a focus for policy-making is new, data for it before the 1990s are difficult to find. But it is very close to the "general government current account", where the relevant series is readily available back to 1963. The chart shows that - if New Labour adheres to its golden rule - it would be achieving a standard of fiscal rigour only briefly matched in the last 35 years.

Total borrowing to be curbed

Debt to fall relative to growing GDP

Charts show public sector net borrowing and net debt, both as a % of nominal GDP at market prices. Projections come from the 1999 Pre-Budget Report.



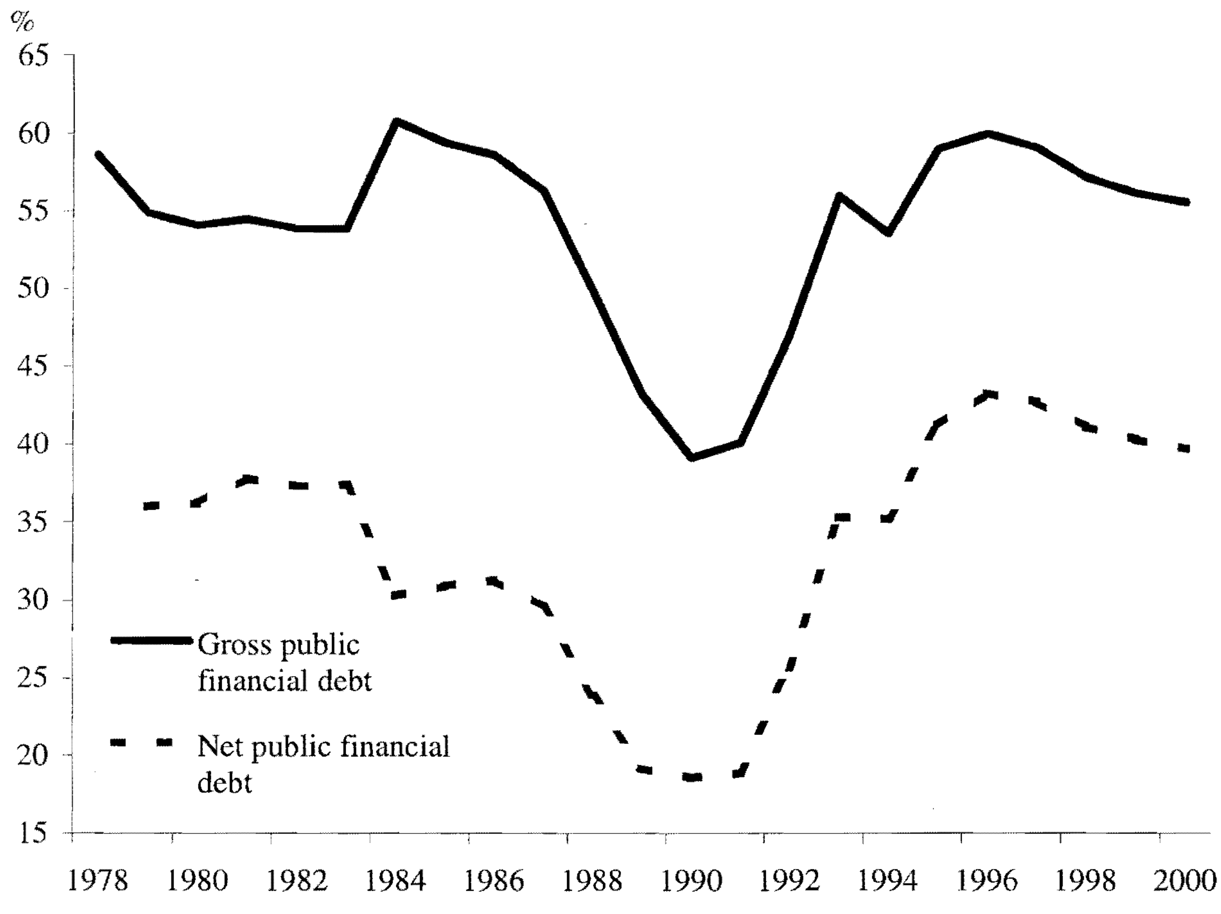
Source: Office for National Statistics, Pre-Budget Report

The golden rule does not by itself guarantee control over public debt, because it does not apply to capital spending. As explained in the text, the key constraint on capital spending is the "sustainable investment rule", which limits public sector net debt to 40% of GDP. A slightly lower ratio of debt to GDP had in fact been touched, very briefly, in the late 1980s. Otherwise the UK's national debt has typically been much higher - relative to GDP - throughout the past 250 years. Moreover, much of the debt was historically very long-term in nature. Indeed, the UK was a most unusual country, because a significant proportion of its Government's debt was undated. The first big undated issue was the 3% Consolidated stock established (by consolidating a number of existing issues) by Pelham, the then Chancellor of the Exchequer, in 1749. In the 1760s the 3% Consols and other undated issues represented more than half a national debt of over £100m. In the 19th century Consols were both a core asset and the valuation benchmark for newly-formed mutual life insurance companies and friendly societies, forging a demand for long-dated gilts which continues to this day.

"Sustainable investment rule" a tough constraint

Is inflation no longer to erode the value of public debt?

Chart shows general government gross and net financial liabilities as a percentage of nominal GDP at market prices. The data comes from OECD publications and uses OECD projections for 1998, 1999 and 2000



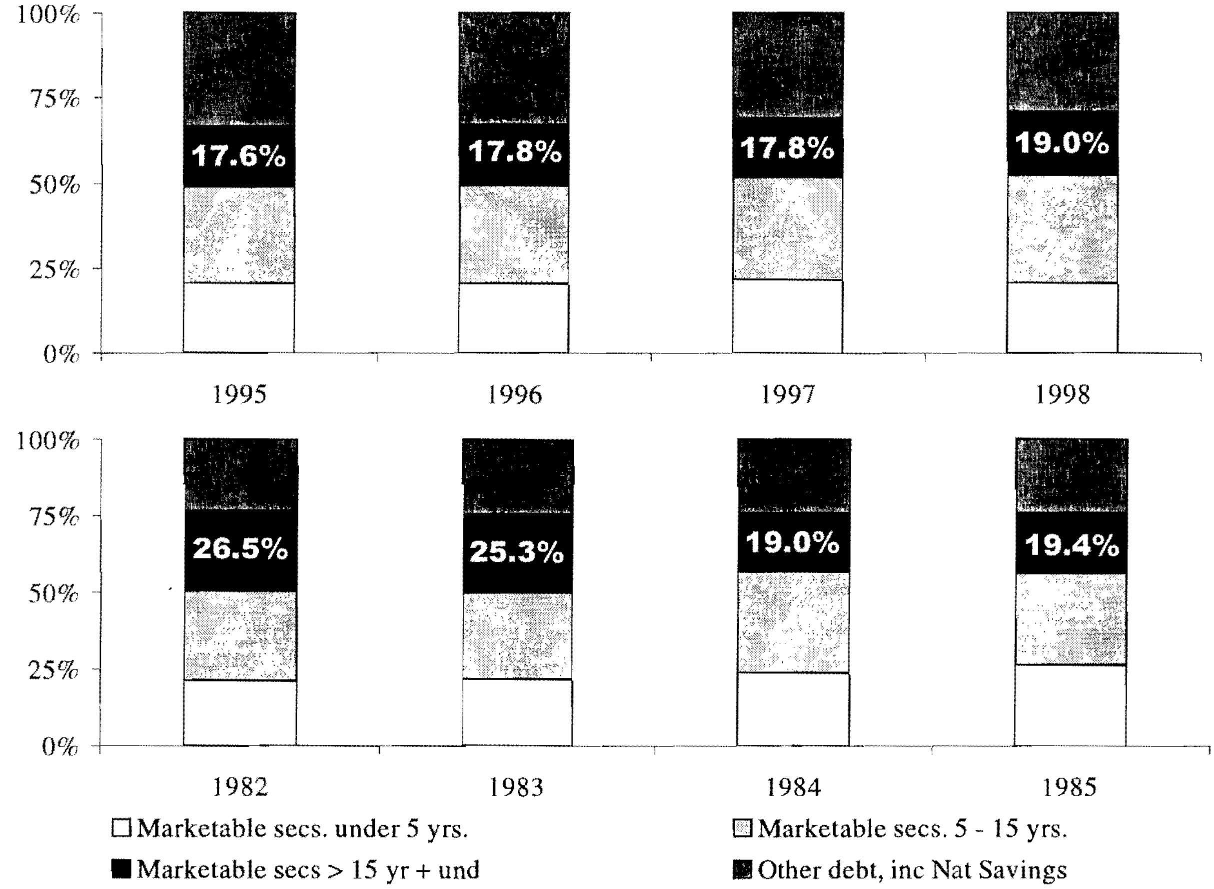
Source: OECD Economic Outlook

The chart on this page is based on data from the Organization of Economic Cooperation and Development, which is somewhat different from that published by the Government. One obvious point is that the ratio of gross public debt to GDP is not much lower today than in the late 1970s and 1980s. A reasonable implied question is, "if the debt is similar in relation to GDP to its level 20 years ago, why are financial institutions exercised by a shortage of gilts?". This question is sharpened by noting that the maturity composition of the debt was not greatly different in 1998 from what it had been 15 years earlier in 1983. (See the bar charts on p. 10.) Part of the answer may be that the long-term savings institutions want to have a higher proportion of their assets in fixed-interest securities, particularly gilts, today. Quite apart from the institutional and demographic considerations discussed in the main text, the attractions of gilts are enhanced by lower and more predictable inflation. It is important to recognize that the apparent stability of the debt-to-GDP ratio in the late 1970s and early 1980s owed much to the effect of inflation in eroding the real value of the debt.

Long-dated gilts still abundant?

"Longs" as large a part of the national debt as in the mid-1980s

Two charts show the maturity composition of the national debt in the two periods, 1982 to 1985 and 1995 to 1998. (They also show the split between marketable securities - dominated by gilts - and other kinds of debt.) The % figure shows long-dated marketable securities as % of total national debt.



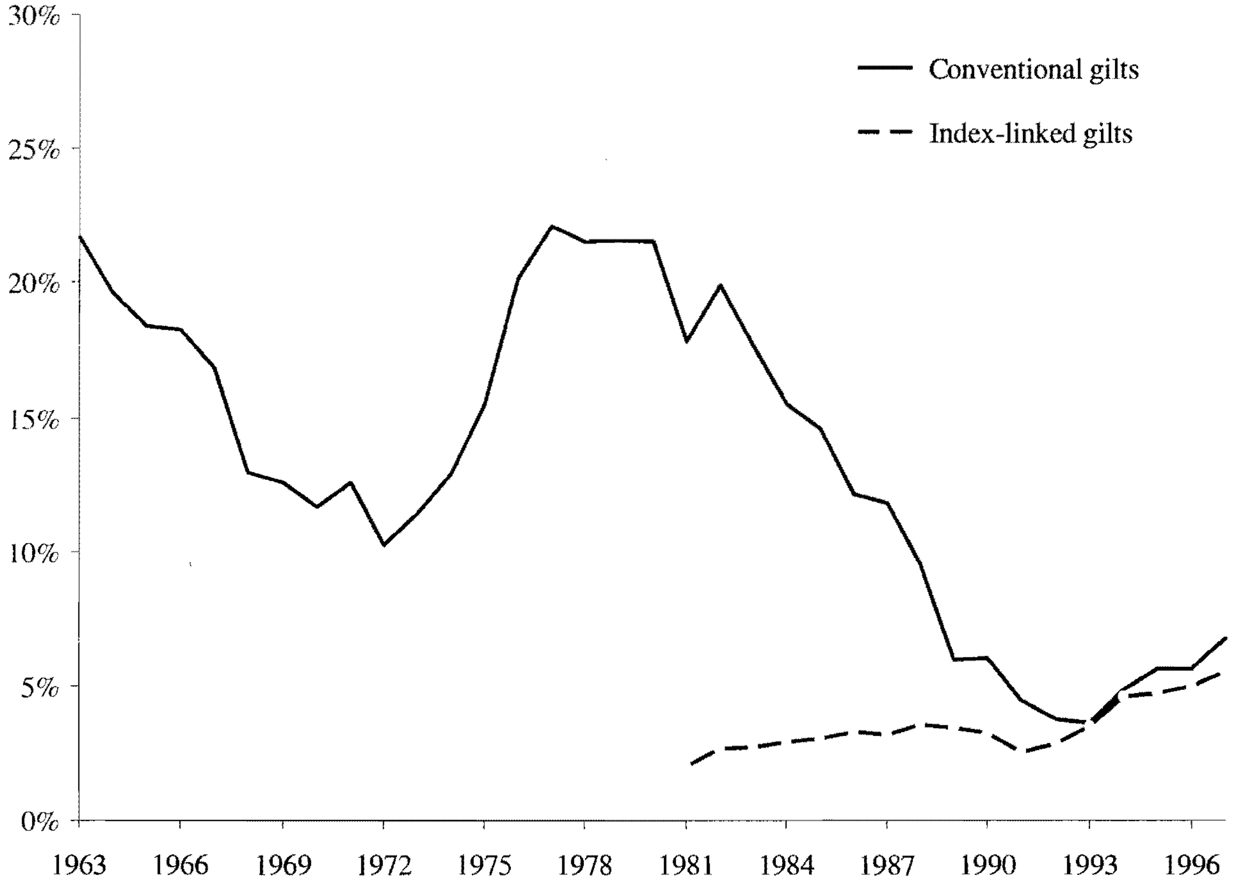
Source: ONS Financial Statistics

The sharp drop in gilt yields in recent years, and the consequent complaints about a shortage of gilts and low annuity rates, might seem to imply that the composition of the national debt has changed. In particular, there is a tacit accusation that the Treasury and, more recently, the Debt Management Office is not issuing enough long-dated gilts. The charts show that the accusation does not really fit the facts. The ratio of long-dated gilts to the national debt fell sharply between 1983 and 1984, but this change in composition was barely noticed at the time and was certainly not the subject of hostile comment from the long-term savings institutions. The ratio of long-dated gilts to the national debt rose slightly between 1995 and 1998, and in 1998 was much the same (19.0%) as it had been in 1984 (19.0%) and 1985 (19.4%). The ratio of the national debt to GDP was lower in 1998 than in the mid-1980s, but not dramatically so. Changes in the demand for gilts, not in the supply, seem to be critical in explaining the alleged "shortage".

The exodus from gilts

Pension funds' gilt weightings collapsed in 15 years to 1995

Chart shows the ratios of conventional and index-linked gilts held by pension funds to total assets, end-year annual data. Index-linked gilts were first issued in 1981.



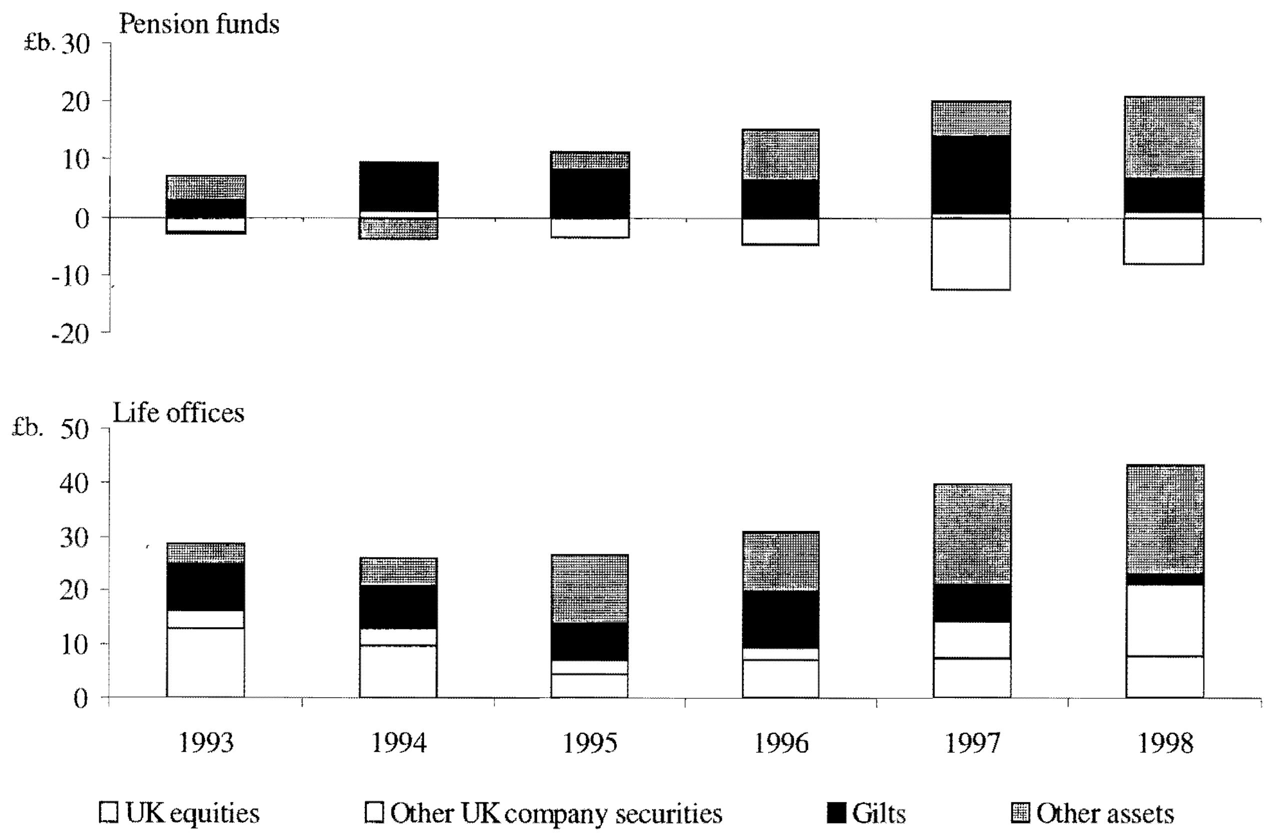
Source: ONS Financial Statistics

The 1995 Pensions Act was ostensibly a response to the Maxwell scandal, but the Act's most important new features - particularly the MFR - had no obvious connection with Maxwell's misdemeanours. The chart shows that UK pension funds had in fact made a big move out of gilts in the late 1980s. The decline in the ratio of gilts to total assets was partly due to revaluations, which raised the value of equities relative to other assets. However, it also reflected a conscious decision on the part of pension fund managers to cut gilt weightings. Pension funds sold about £12b. of gilts in the four years to 1991, while still making significant purchases of UK equities. This may have been a response to the irresponsible monetary policies pursued in the late 1980s and to the associated fears of rising inflation. As the chart shows, the shift out of gilts was particularly marked for conventional gilts, as index-linked gilts encroached on their territory from 1981. Despite official statements that the Government does not wish to prescribe pension funds' asset allocations, the MFR will lower UK pension funds' equity weightings from the extremely high levels recorded in the mid-1990s.

MFR distorting asset selection?

Insurance companies, but not pension funds, buy corporate bonds

Charts shows annual new inflows (i.e., purchases less sales) into assets by pension funds and life offices. Inflows are split into four categories: UK equities, gilts, other UK company securities and other assets. The ONS does not give a breakdown of "other UK company securities" between preference shares and, loan stocks, bonds and notes. But Bank of England capital issues data suggest that bond issuance has dominated activity in recent years.



Source: ONS Financial Statistics

The charts show the the composition of all the new assets acquired by pension funds and life companies. The pension funds' net acquisitions of new assets were low in the mid-1990s because of excellent investment peformance and the consequent scope for so-called "pension holidays" (i.e., periods without pension fund contributions).By contrast, insurance companies have been substantial net buyers of financial assets in recent years. Whereas pension funds were moving out of gilts in the 1980s, they have been substantial buyers since 1994. But - according to official data - they have not been heavy investors in a category called "other UK company securities", which includes corporate bonds. In 1997 and 1998 they bought only £757m. and £980m. respectively of such securities; in the same two years insurance companies bought £6,865m. and £13,330m. The position has not changed in 1999. In the first six months pension funds acquired £871m. of "other UK company securities", while insurance companies acquired £12,880m. The differing acquisition strategies may be due to the distorting effect of the MFR.