LOMBARD STREET RESEARCH

Monthly Economic Review

No. 127, January 2000

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Deflation is dead

UK inflation under control, but price levels are rising almost everywhere

The "inflation vs. deflation", debate once again

One of the most important debates among economists in early 1999 concerned prospects for the global price level. A widely-held view was that "inflation is dead", while a significant minority held that the world economy might suffer outright deflation at the start of the new millennium. It is now clear that the fears of deflation were exaggerated. Price levels continue to rise in all the major industrial countries, apart from Japan, and in all the minor industrial countries, apart from New Zealand.

Excess money growth - not OPEC politics - the ultimate cause of higher inflation

Of course, the restored unity of the Organization of Petroleum Exporting Countries and the consequent rise in the oil price is a large part of the explanation. But a striking feature of the shock oil price increases of the last 30 years is that they have happened in conjunction with a buoyant world economy. (The oil price jumps in 1973 and 1974, in 1980 and again in 1990 followed years of above-trend growth in the world economy.) Excess demand, and not just OPEC politics, lay behind the price movements. At a deeper level the cause of the drastic acceleration in global inflation to double-digit annual rates in 1974 and 1975 was the rapid growth of the money supply between 1972 and 1974, and the associated boom in economic activity. Much the same comment could be made about 1980 and 1990. Is monetary analysis also useful in understanding the changing facts about inflation and deflation in the last two years, and is there any message for the future? The research paper on pp. 2 to 12 of this publication tries to give answers. The chart on p. 4 plots the growth of a broad money measure for the G7 as a whole since the 1960s. One point is obvious, that money growth - which had been a downward trend from the mid-1970s to the mid-1990s - began to strengthen in 1996. If Friedman's generalizations on the lags between money, output and prices had applied, faster world economic growth ought to have been recorded in 1997, and higher inflation in 1998 and 1999. 1997 was indeed quite a good year for world economic activity, but the forecast of more inflation in 1998 was wrong, as "the Asian crisis" struck. It was only in 1999 that the inflation threat resurfaced.

Bank of England has been highly pre-emptive in recent months

In this context the Bank of England's decision on 8th September to raise short-term interest rates by 1/4% was clever. The immediate outlook for inflation at the time was good, as a number of special adverse influences on the retail price index were likely to disappear or weaken in early 2000. But the Bank has always to look beyond the next six months. It must have decided that above-trend growth would be seen from mid-1999 onwards, taking output above its trend level by - say - late 2000 and provoking upward pressures on inflation. The latest retail price release - with the December index excluding mortgage costs, up by 2.2% on a year earlier - was disappointing, but at least the Bank has already steered monetary policy in the right direction. In an increasingly inflationary world, the UK's performance on this particular macroeconomic variable ought to be satisfactory or even quite good over the next few years.

Professor Tim Congdon 27th January, 2000

Summary of paper on

"How strong a world boom in 2000?"

Purpose of the paper

Money supply growth in most industrial countries has increased since the mid-1990s. Now that the shock of the Asian crisis has been overcome, the question becomes, "will faster money growth help to stimulate a world boom in 2000 and, if so, how will the boom compare with others in the post-war period?".

Main points

* **Money supply growth in the G7 countries ran at a mere 4% a year from 1992 to 1995, but accelerated in 1996, 1997 and 1998. Despite slowing a little last year, 1999's growth rate remained well above the levels seen in the early 1990s. (See p. 4.)**

* **The significance of 1999's dip in money growth is unclear, as it was concentrated in two countries (the USA and the UK) and was relatively brief. It may have been due to banks' attempts to shrink loans to hedge funds after the LTCM affair in 1998.**

* **Rather high money growth - in the 7% to 10% area, when expressed in terms of an annualized rate - is to be expected in the G7 in 2000. Banks in North America and Europe have ample capital, and can readily expand their balance sheets (and so the deposits which constitute most of the money supply) by mortgage lending and loans to support large corporate deals.**

* **As in the 1990s, Japan is an exception to the global pattern. But in 1999 the banks acquired increasing claims on the government, a trend likely to continue in 2000 because of the vast budget deficit. Money growth - which has been a mere 0% to 4% a year for a decade - may revive. (See p. 7.)**

* **Money growth varies markedly between different European nations, but - for Euroland as a whole - annual broad money growth is rather high at over 6%. (See p. 8, p. 9 and p. 11.)**

* **The monetary background to world economic growth is more positive now than at any time since the late 1980s, but inflation risks are also starting to emerge.**

This research paper was written by Professor Tim Congdon, with help from Mr. Gabriel Stein in the preparation of the charts.

How strong a world boom in 2000? Will more inflation follow?

Monetary analysis successfully refutes early 1999's deflation fears

Most forecasts confounded by world economy in 1999

Most forecasts in early 1999 almost totally misunderstood what was about to happen to the world economy and, in particular, to such important parts of it as the American economy. After the financial upsets in the summer of 1998, with the Russian default and the turmoil at the Long-Term Capital Management hedge fund, many economists expected 1999 to be a year of weak economic activity worldwide and perhaps of outright recession. Instead 1999 saw a continuing boom in the USA, a recovery in Europe and signs of cyclical improvement in Japan, while Asia excluding Japan achieved an impressive rebound from the crisis of late 1997 and early 1998. Faster growth transformed commodity markets, contributing to a virtual trebling of the oil price and big rises in the prices of copper, nickel and aluminium. Early 1999's fears of deflation proved unfounded.

January 1999 *Review* gave good analysis

The January 1999 issue of this *Review* gave a global macroeconomic assessment, using the money supply data from the Group of Seven industrial countries. Its verdict was that, "first,... 1999 will see continued reasonable growth in the world economy and, secondly, that the medium-term global prospect is for moderate inflation, not deflation". Compared with the prognoses of deflation, this was good analysis. What does the same exercise suggest today?

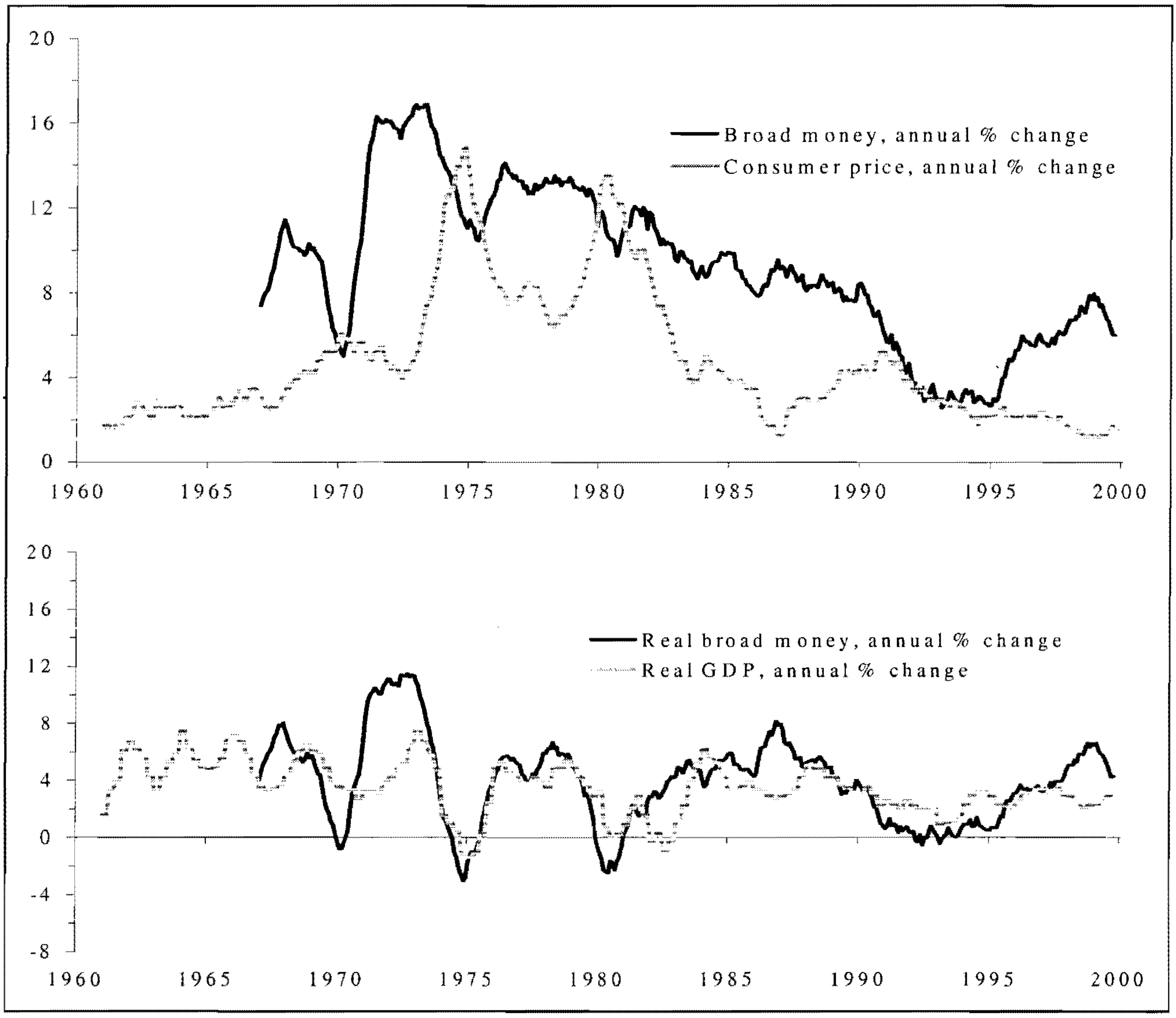
In general, money supply growth remains rather high,

The chart on p. 4 shows that the growth rate of the G7's money supply fell somewhat in 1999. Superficially, the implication is some weakening in balance-sheet strength throughout the industrial world, and perhaps less asset price buoyancy and slower demand growth. However, it is a mistake to conduct monetary analysis too mechanically. First, a drop in money growth occured in only in two countries (see p. 6 and p. 10 below), the USA and the UK, and may have been due to banks' efforts to restrict loans to hedge funds (and other so-called "highly-leveraged institutions") after the LTCM affair. The associated fall in deposits was concentrated in the financial sector. It may have some impact on asset prices and the wider economy, but not necessarily on any great scale. In view of the relative shortness of the period in which money growth fell, it may eventually be of little importance. Secondly, the drop in money growth is over. In the last few weeks of 1999 US broad money growth soared, taking the twelve-month increase in M3 back to over 8%. This is less than the figure of 11% recorded in December 1998, but it is still well above the inflation rate, and will inject further excess liquidity into the balance sheets of companies and financial institutions.

implying the strongest year for world economic activity since 1988

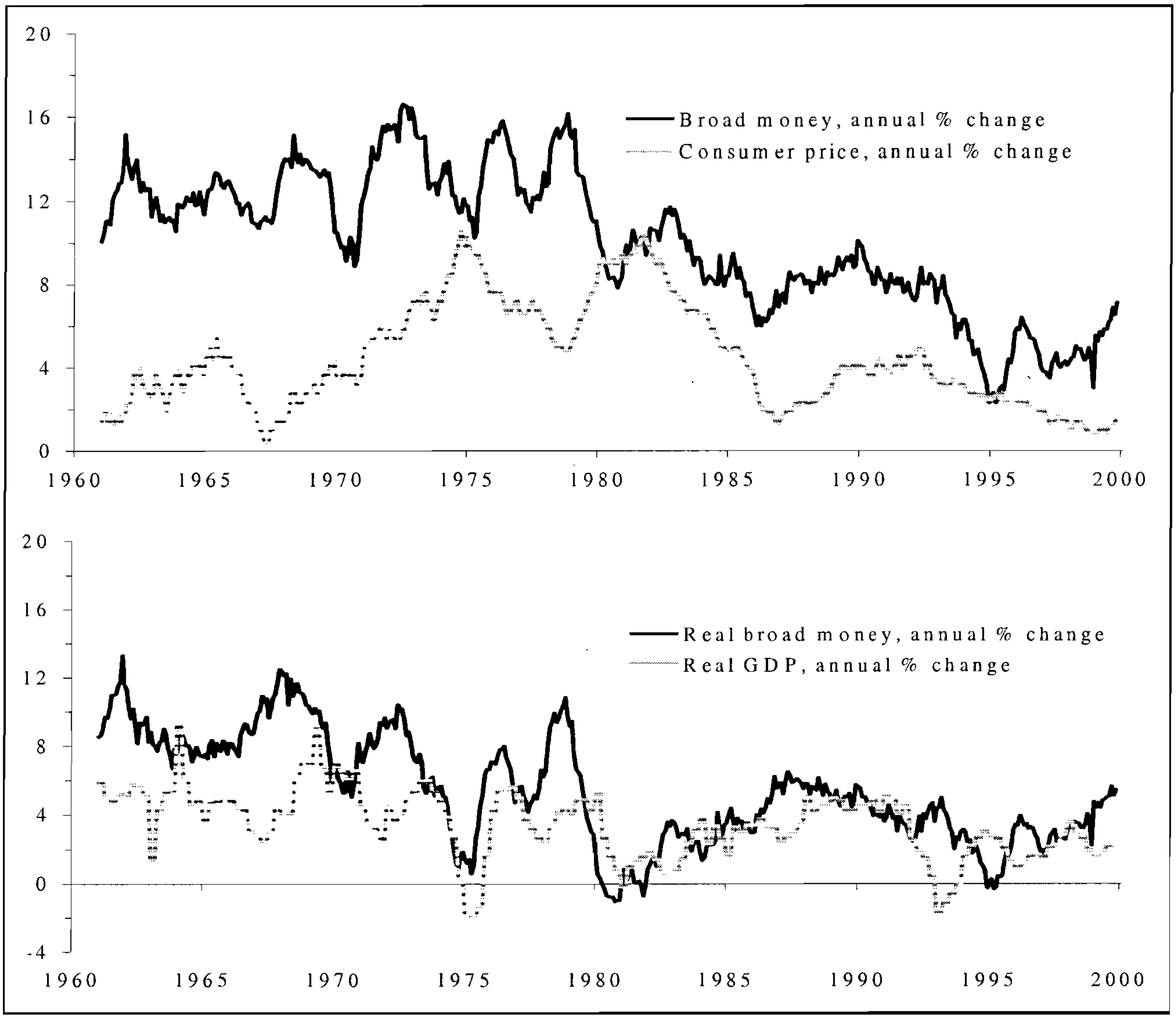
A notable feature of this survey is the steady upturn in Euroland money growth since 1997, particularly in 1999. (See p. 5.) It needs to be emphasized that the growth of bank credit to the private sector in Euroland now runs at over 10% a year. Monetary conditions are highly supportive of the cyclical recovery which is now well-defined. Despite the still sluggish rate of money growth in Japan (see p. 7), the broad message has to be that - in terms of demand and output - 2000 will be the strongest year for the world economy since the late 1980s.

Group of Seven



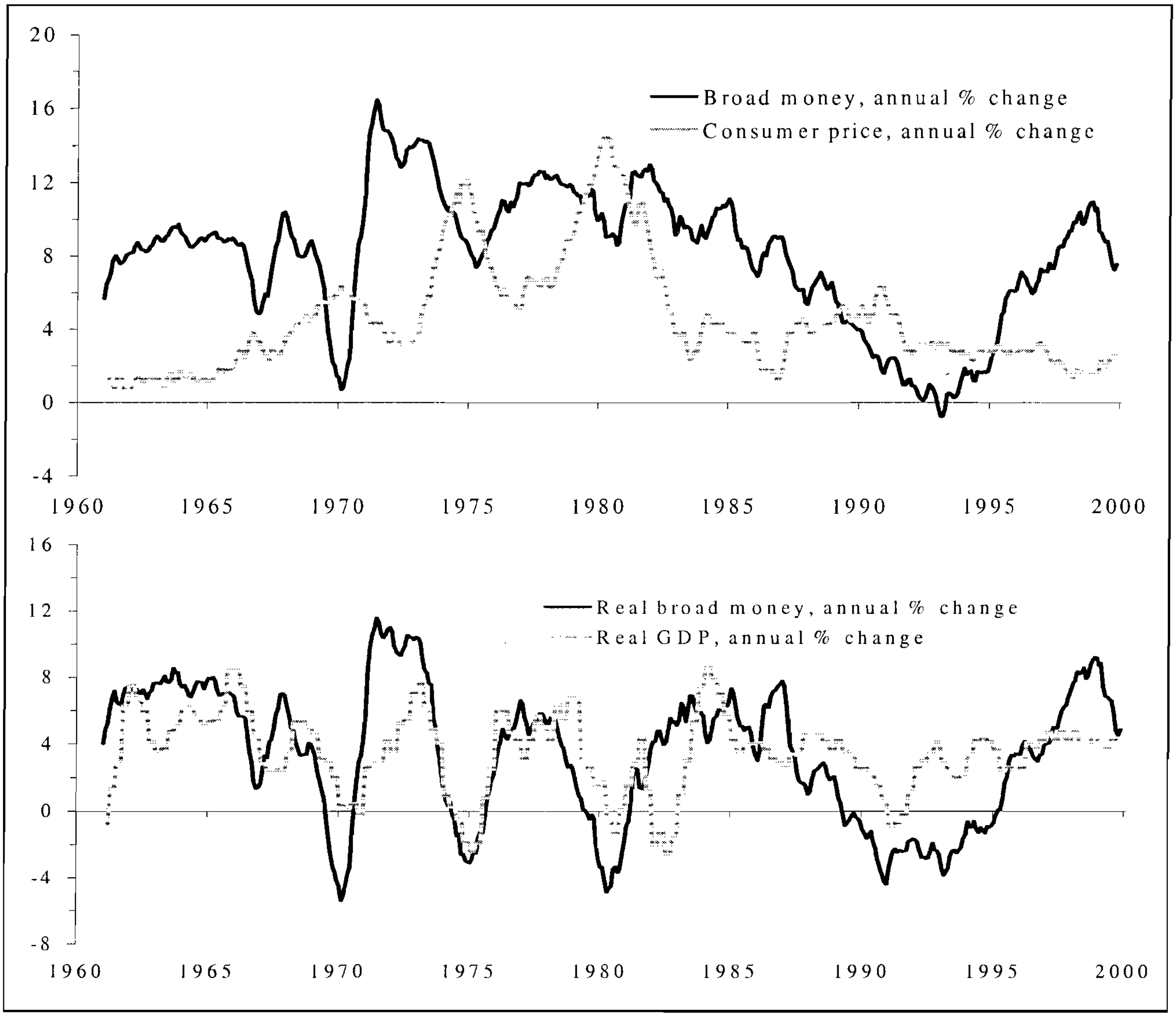
The four years from 1995 to 1998 saw accelerating monetary growth in the industrial world. This trend was reversed in 1999. The explanation is probably to be sought in central bank efforts to curb the growth of commercial bank balance sheets after the crisis at the Long-Term Capital Management hedge fund in the summer of 1998. The key central banks asked commercial banks to restrict their lending to hedge funds and investment banks' proprietary trading desks. In the spring and summer of 1999 sharp contractions were recorded in US banks' "collateralized lending" and UK banks' sterling lending abroad, a logical response to the central banks' requests. Higher money growth has resumed in more recent months. Banks' healthy capital positions imply continued strong monetary expansion in 2000.

Euroland



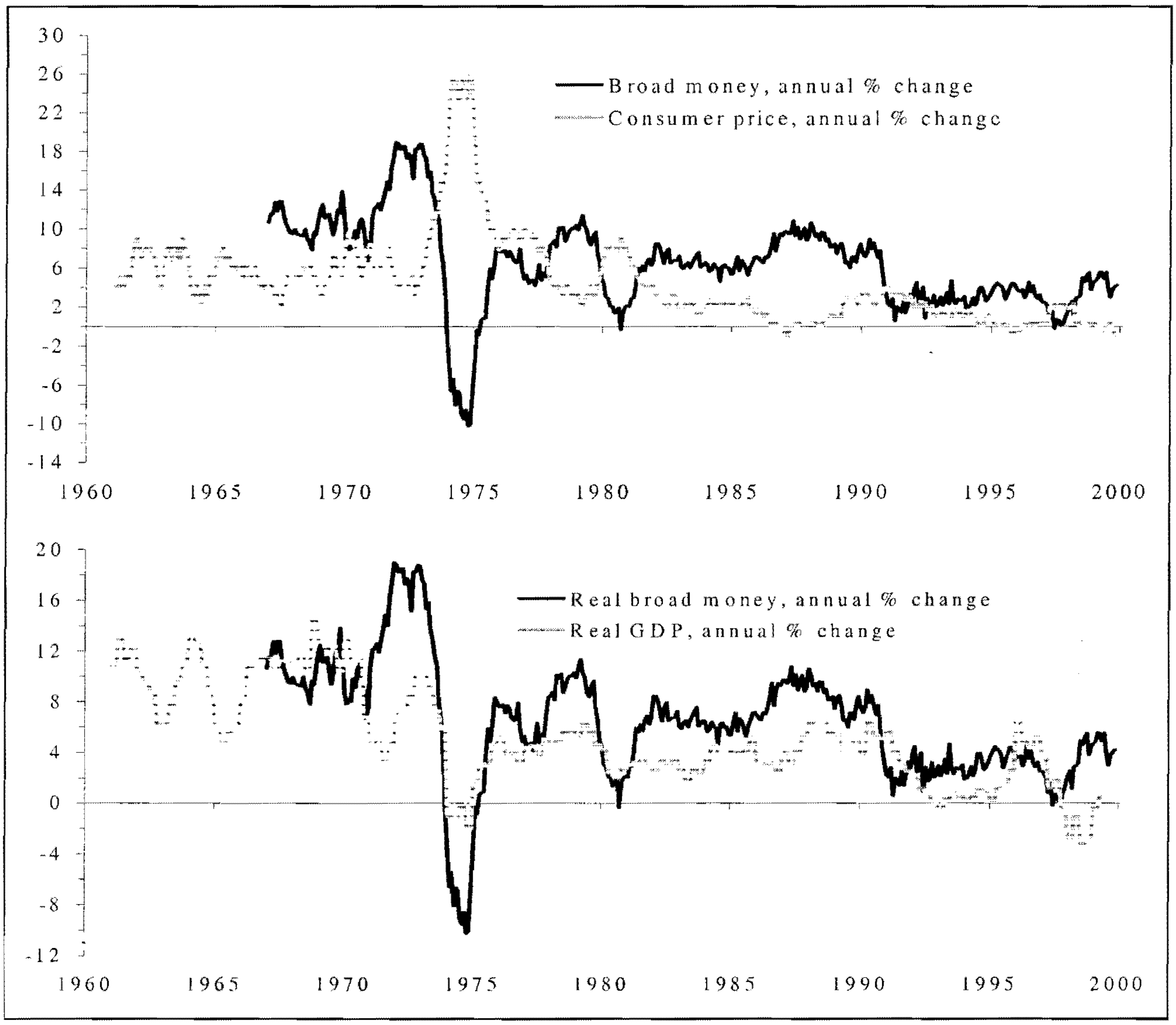
Monetary growth decelerated in Euroland in the mid-1990s, as the Maastricht criteria for monetary union began to bite. Governments restricted their budget deficits so that in several countries they were able to repay bank debt. The resulting declines in banks' assets reduced their deposit liabilities, which form most of the money supply. Although interest rates fell, bank credit to the private sector did not increase by enough to offset the contractionary effect of improving public finances. This situation changed in 1999. With the euro becoming a currency "in its own right" on 1st January, uncertainties about the monetary union abated and credit growth revived. In the year to September mortgage credit increased by 12%. With record levels of merger and acquisition activity, often financed by bank borrowing, the annual rate of M3 growth moved up to over 6%.

United States



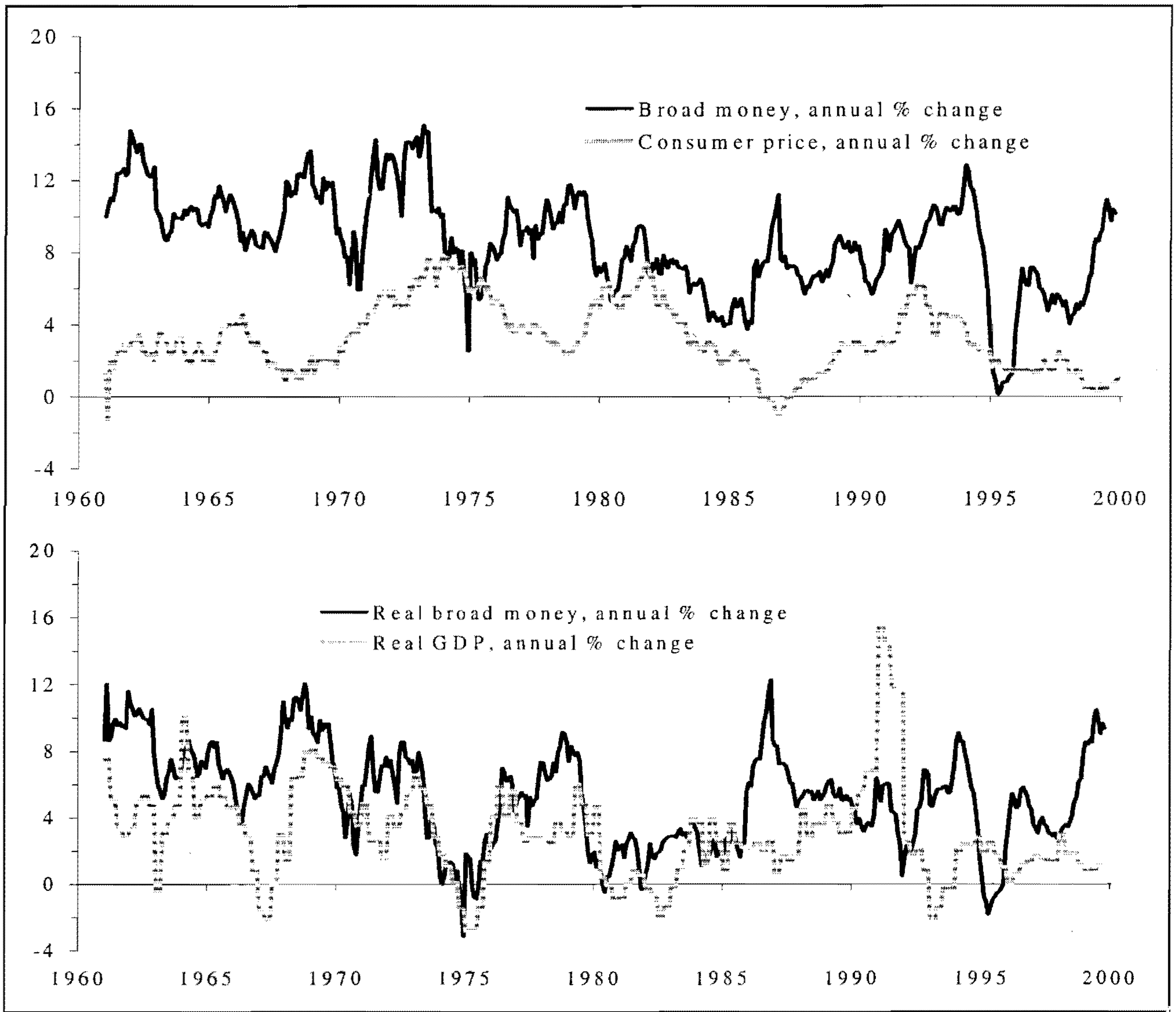
As discussed on p. 4, the fall in US money growth in mid-1999 was probably due to Fed-inspired cutbacks in credit to over-leveraged financial institutions. If so, the dip in money growth is likely to prove transitory. Indeed, towards the end of the year a dramatic upturn in money growth emerged, with the annualized growth rate of M3 exceeding 15% in the three months to end-December. (This has been blamed partly on the Fed's efforts to support bank liquidity over the Y2K period.) In the first three quarters of 1999 the pre-tax profits of the USA's financial sector were above $150b., up by 4.7% from a year earlier and almost double their level in 1994. As American banks have strong profits and capital, and remain keen to expand, annualized broad money growth will stay in the 7% - 10% area in early 2000. Buoyant asset prices and robust company balance sheets are key reasons for expecting further above-trend growth in the USA.

Japan



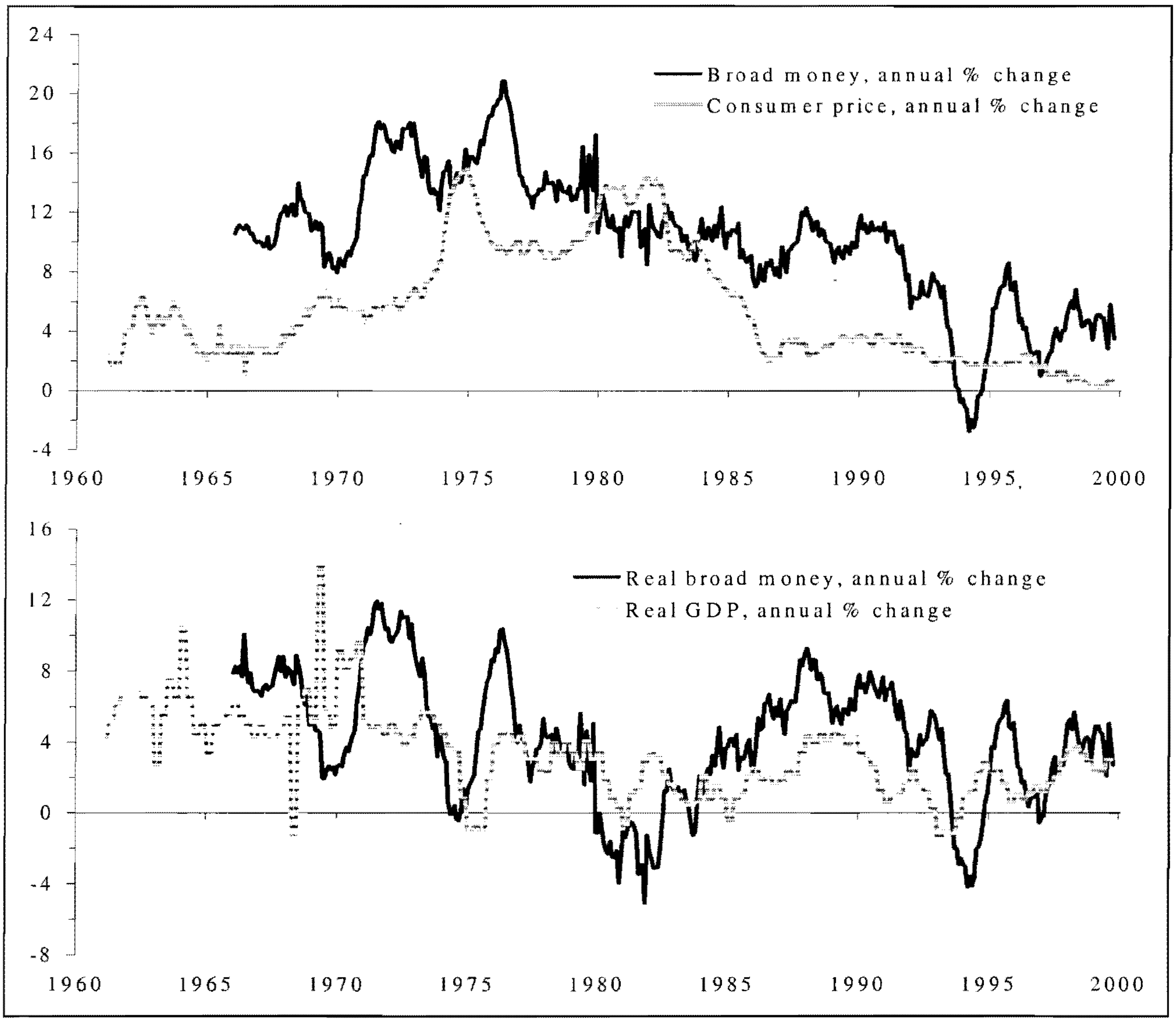
Partly because of international pressure, Japanese policy-makers are trying to stimulate money growth. For example, they have introduced medium-term variable-rate government debt, in the expectation that it would be attractive to the banks, and so would expand both banks' assets and deposit liabilities. Monetary financing of the budget deficit has been substantial in the last two years. According to the credit counterpart arithmetic in the November 1999 issue of the Bank of Japan's *Financial and Economic Statistics Monthly,* the banking system's holdings of government bonds increased by 7,839b. yen (about $75b. at an exchange rate of 105 to the $) in 1998 and by 19,180b. yen (over $180b.) in the first three quarters of 1999. (By contrast, bank credit to the private sector has fallen.) As the budget deficit is now enormous, money growth may rise in 2000.

Germany



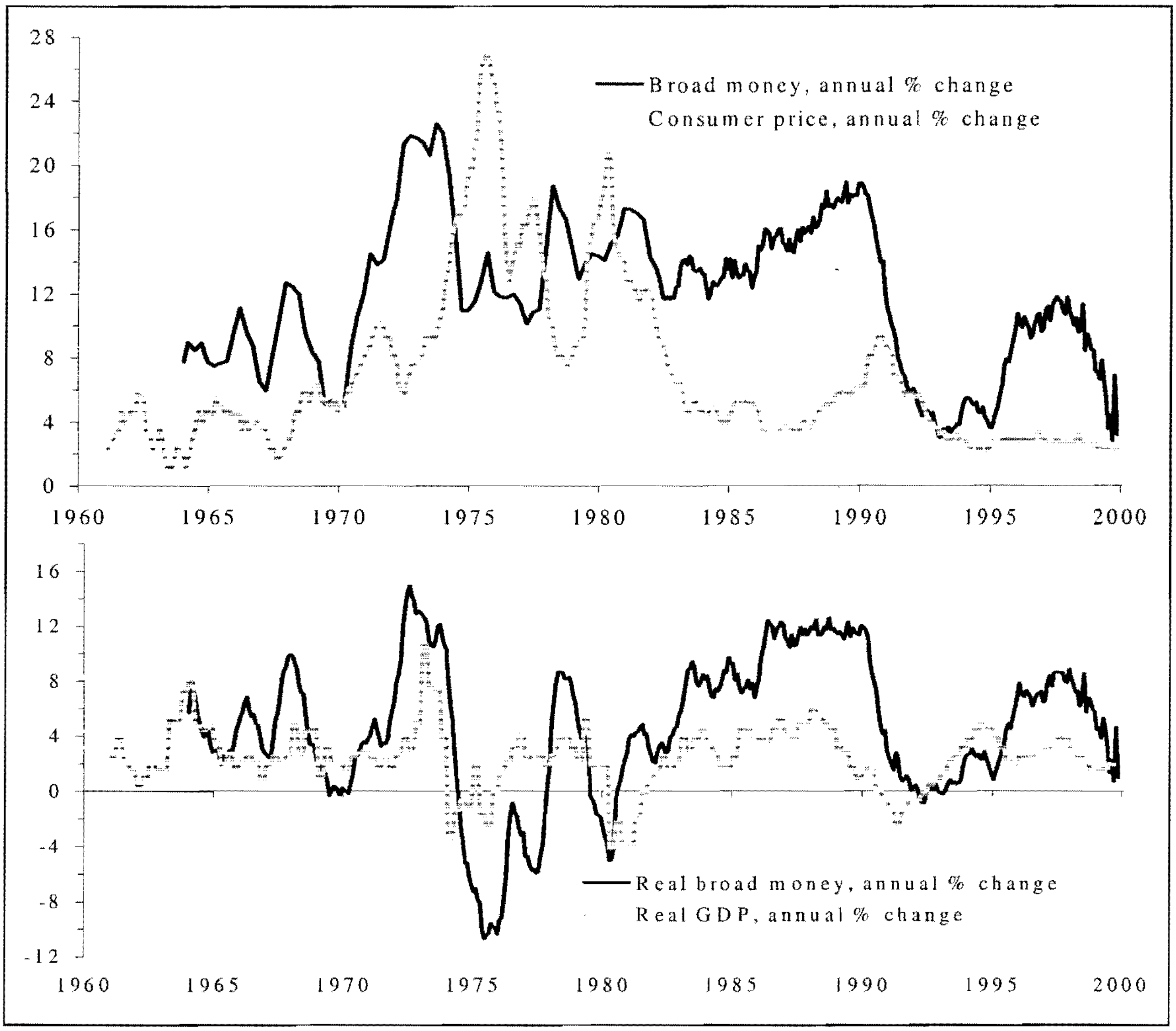
As Germany is only one member of the new European single currency area, the Bundesbank is no longer in the driving seat of a distinctive German monetary policy. The European Central Bank determines short-term interest rates in Germany, just as it does in every other Euroland country. The Bundesbank's views on the latest Germany money numbers - which show an almost double-digit annual %age increase - might be interesting, but they can no longer be obtained from its *Monthly Report.* This publication - once so eloquent on the subject - has simply stopped talking about German money supply statistics. At any rate, the upturn in German money growth is part of a more general European pattern. It has been associated with healthy company balance sheets, a wave of mergers and acquisitions, and a surge in share prices. It presages above-trend growth in 2000.

France



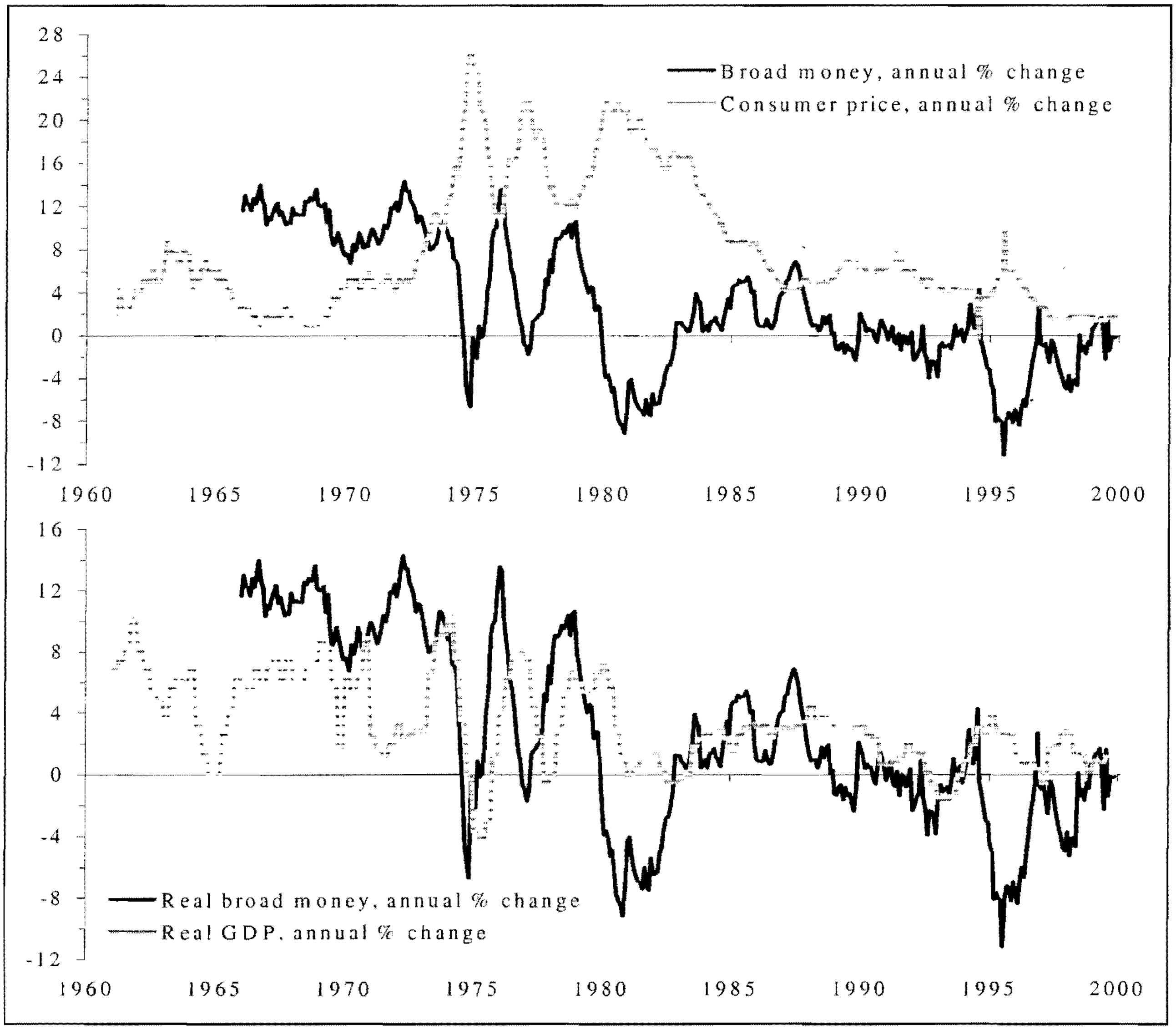
As in other European countries preparing for monetary union, broad money growth in France was slower in the early and mid-1990s than in the 1980s. But - in contrast with the pattern in most of its neighbours - French money growth did not increase in 1999. This is surprising, as the expansion of both credit and money appeared to accelerate in 1998, while the French economy has grown strongly in recent quarters. Closer examination of the data shows that bank credit to companies has been growing at a moderate rate of about 5% a year, but the increase in bank credit to households was running at about 8% a year last autumn. The housing market slowed in mid-year, but has been better recently. 1999 was a good year for the French economy, with GDP growth of 2 1/2% after 3 1/2% in 1998. 2000 should also see growth running at a trend rate or faster.

United Kingdom



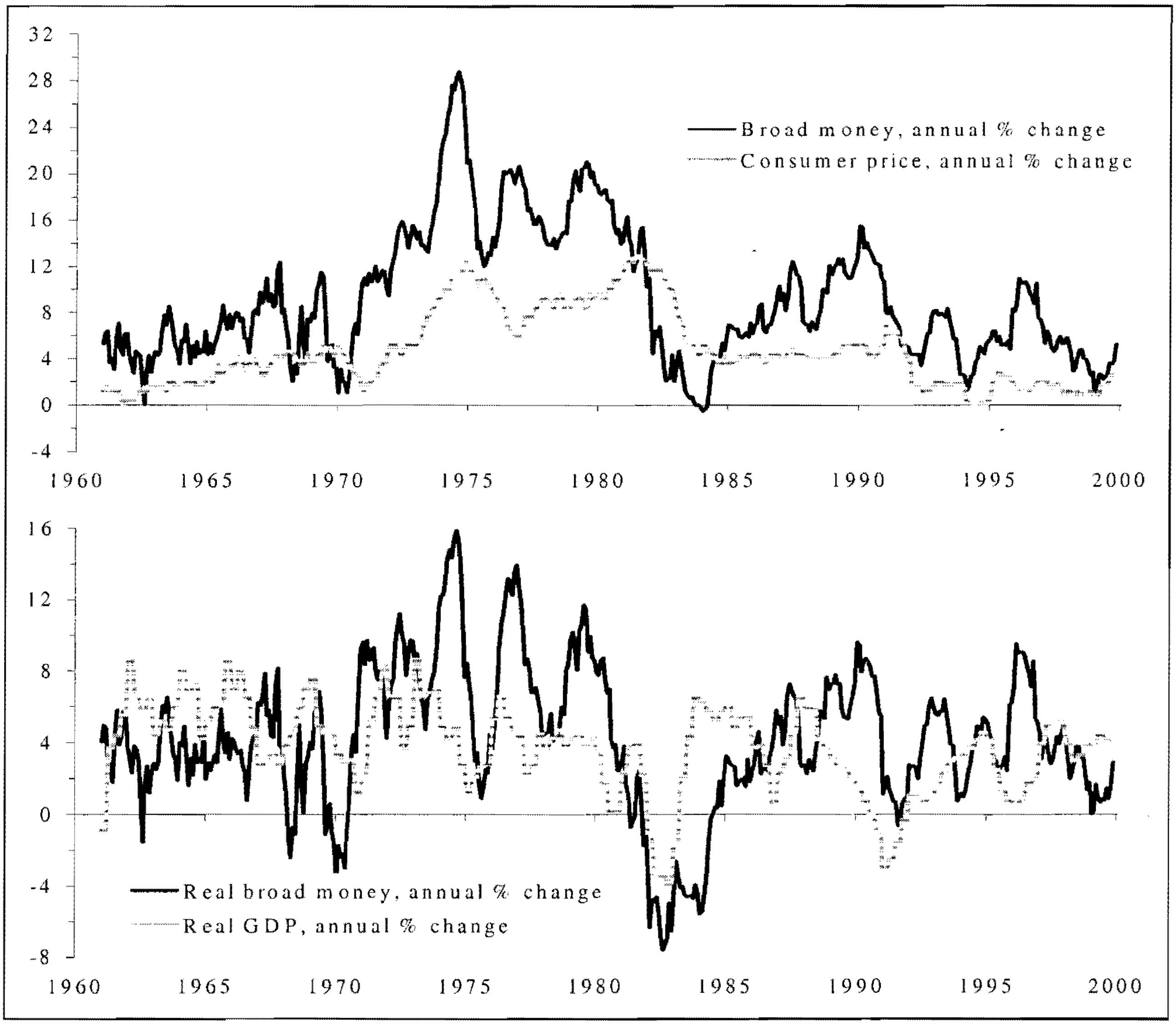
UK broad money growth collapsed in 1999. This unexpected development was entirely due to external influences on the money supply. In essence, banks in the UK reduced their sterling loans to foreigners, while the overseas sector increased substantially their holdings of sterling deposits. The effect of banks' loan cutbacks (which may have been partly due to self-imposed curbs on lending to hedge funds) was to reduce the total quantity of sterling deposits; the effect of the increasing proportion of sterling deposits in foreign hands was to lower the sterling deposits held by UK residents, which are the dominant constituent of the money supply. Bank lending to the private sector grew at an annual rate of about 7%. The slowdown in money growth has eliminated excess liquidity in the UK's financial system, but seems unlikely to persist in 2000.

Italy



Italy's money suply data have become difficult to interpret, as methods of statistical collection have been altered by Italy's accession to Euroland. According to *International Financial Statistics*, the total of demand and other deposits at Italian banks in October was 558.2b. euros, slightly down from 569.0b. euros in January. However, the same source shows a drastic plunge from 947.2b. euros in the preceding month (i.e., December 1998). This was evidently due to a series break, whose interpretation requires access to detailed national sources. Consolidation moves in the Italian banking sector will improve its profits and capital adequacy, while the Olivetti/Telecom Italia deal showed that companies are as eager to gear up balance sheets in Italy as in the rest of Europe. The *IFS* does in fact report steady expansion in domestic credit in the first ten months of 1999.

Canada



Canada is to a large extent an economic satellite of the USA, as American companies are the dominant buyers of its mineral, timber and foodstuff exports. However, it does have some autonomy in monetary policy. In late 1998 Canadian M3 growth went briefly into reverse and the annual increase fell to almost nothing, just as M3 in the USA was booming. By contrast, in 1999 Canadian money growth increased, whereas in the USA a marked slowdown in money growth occurred in the spring and summer. (See p. 6.) Mortgage borrowing is buoyant, with housing permits still rising. As in the USA further increases in interest rates will be necessary in 2000, but - even factoring their effect into the assessment - the economy seems likely to expand at an above-trend rate. Canadian interest rates are at present slightly lower than those in the USA, at variance with the usual historical pattern.