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Shift of deposits offshore undermines monetary data

UK money growth may be understated by Bank of England figures

Apparently very low money growth in the UK

Money supply growth in the UK has collapsed. M4 growth in the year to February was only 2.7%, which may be the lowest figure in the post-war period. Closer inspection of the data shows that the squeeze on money holdings has been particularly marked in one sector, the non-bank financial institutions. In the year to February non-bank financial institutions' M4 holdings fell by 4.5%, whereas the M4 holdings of both the household and corporate sectors increased. It would be silly to suggest a mechanical relationship between, on the one hand, the M4 slowdown and, on the other, the indifferent performance of UK equities over the last year and the strong pound. Nevertheless, one element in the fall in NBFI's M4 has been a slump in insurance companies' and pension funds' sterling deposits, which dropped from £49.2b. to £42.8b. (or by 13%) in the year to the fourth quarter 1999. If these organizations keep the ratio of their money balances to total assets stable, a 13% decline in their money holdings implies an equivalent decline in the value of all their assets. Since they account for a significant proportion of the UK's stock market, here is a possible chain of connection between sluggish money growth and the unimpressive UK stock market.

But offshore sterling deposits held by UK residents may be rising quickly,

The low rate of money growth in the UK contrasts with rather rapid monetary expansion in the USA and Euro-land. But, again, the differences between national money growth rates should not be interpreted too strictly. An almost universal tendency at present is for companies and (rich) individuals to hold their money balances in a variety of currencies and in offshore locations, and not merely in the local currency of the nation in which they live. This creates havoc with money supply data and, even more, with the job of analysing the economic significance of monetary trends. Data published by the Bank for International Settlements last November showed that the sterling liabilities (to non-banks) of offshore banks in the BIS area, which were $55.2b. at end-1998, rose by $6.1b. in Q1 1999 and $1.1b. in Q2 1999. The implication is that the annualized growth rate of these deposits in the first half of last year was almost 28%. Some of these sterling deposits may have been held by UK residents, but the proportion is unknown. Although these offshore sterling balances may seem substantial, they exclude those in the Channel Islands and the Isle of Man, which are probably over £40b.

which implies that the true rate of money growth is higher

The message here is that offshore sterling deposits - including those which belong to UK residents and which are therefore "UK money" - are probably growing at 15% a year or more. This is an important qualification to the very low 2.6% annual M4 growth shown in the Bank of England's monthly press release. The annual growth rate of all UK resident sterling deposits - both onshore and offshore - is a matter of guesswork, but it may be nearer 5% than 2 1/2%.

Professor Tim Congdon

30th March, 2000

Summary of paper on

"Inflation squall ahead?"

Purpose of the paper

Consensus forecasts expect underlying inflation (the 12-month change in the RPI, excluding mortgage interest payments) to be below its 2 1/2% target in 2001. The purpose of the paper - which follows the same format as the *Monthly Economic Reviews* of March 1992, June 1993, April 1994, March 1995, March 1996, March 1997 and March 1998 - is to consider whether this assessment will be correct.

Main points

* **Survey evidence on the immediate outlook for retail price inflation is encouraging.**

* **The strong pound is still exerting downward pressure on traded goods prices. The exchange rate, on a trade-weighted basis, is 5% higher than a year earlier.**

* **Oil prices are off early-2000 peaks. Even if oil prices only stabilise, this produces a significant favourable influence on inflation in the coming year.**

* **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.**

* **In the year to February M4 rose by 2.7%, possibly the lowest money growth figure in the post-war period. But the key determinant of money growth in the long run - lending to UK residents by banks and building societies - continues to rise by almost 10% a year.**

* **The level of output may be close to trend. Further above-trend GDP growth will lead to a "positive output gap" (i.e., the excess of actual over potential output). In these circumstances, higher inflation in 2001 is possible. But the upturn is likely to be modest relative to the UK's experience of the last 30 years.**

* **The UK's inflation outlook remains benign, at least until late 2001.**

This paper was written by Brendan Baker.

Inflation squall ahead?

UK inflation outlook good, at least until mid-2001

Present analysis similar to previous ones

A research paper of March 1998 entitled "How long before inflation rises?" considered the outlook for inflation. The paper concluded that the high money growth of 1996 and 1997 posed a threat to low inflation. In the event the Bank of England maintained a tight monetary policy in the first half of 1998, while a key feature of the year as a whole was the weakness of the world economy, largely a by-product of the Asian crisis. This cut the prices of both commodities and semi-finished products in world markets, and UK inflation stayed under control. A big fall in the oil price was particularly important. Last year was quite different. It saw a return to growth in all parts of the world economy. Moreover, the unity of the Organization of Petroleum Exporting Countries was restored, causing oil prices almost to treble. The rising oil price may have added 0.7% - 0.8% to the UK's rate of target inflation in the year to February/March 2000. (The UK's target inflation rate is an increase of 2 1/2% a year in the "retail price index excluding mortgage interest costs", the so-called RPIX index.)

Favourable influences on future inflation from oil, if prices stabilise

Oil prices are difficult to predict, but one arithmetical point is obvious. If the oil price now stabilizes, the 0.7% - 0.8% adverse effect will drop out of the RPIX. The increase in RPIX in the year to February was 2.2%. Two conclusions follow. First, with a stable oil price and the same underlying inflation pressures as in the last twelve months, the annual increase in RPIX will drop to about 1 1/2% by March 2001, in the lower half of the acceptable 1 1/2% - 3 1/2% band. (If the annual increase in RPIX were to drop beneath 1 1/2%, the Governor of the Bank of England would have to write an Open Letter of justification to the Chancellor of the Exchequer.) Secondly, and by extension, some deterioration in underlying non-oil inflation pressures could occur between now and the spring of 2001 without jeopardizing an inflation rate close to target.

Pound is exerting downward pressure on the price level

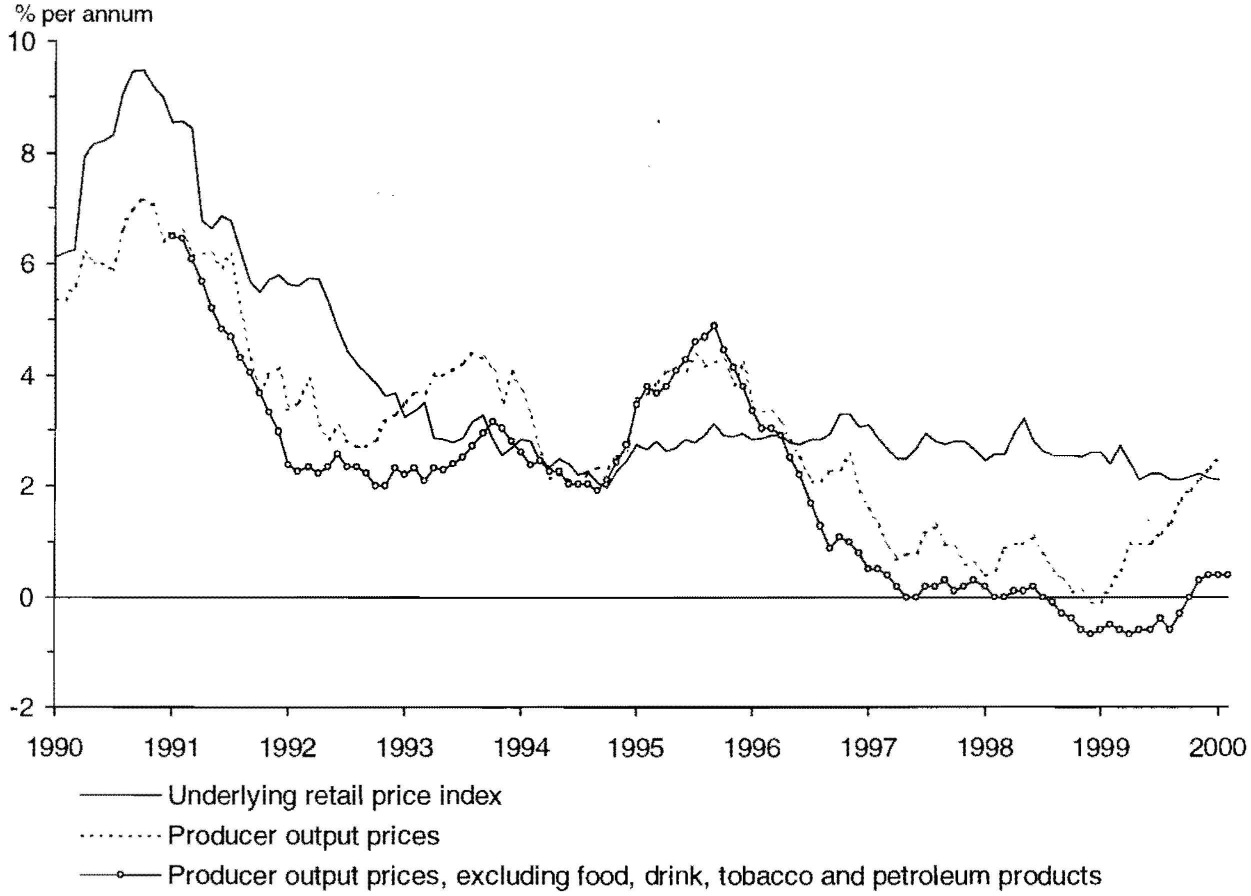
Much depends here on the exchange rate. The Bank of England has expressed concern that the disinflationary impact of sterling's sharp appreciation in late 1996 is fading. However, for the time the pound remains over-valued and downward pressures on prices in the traded sectors of the economy (manufacturing, in particular) are intense. Over longer periods of time domestic influences are the most powerful forces on the price level. A central tenet of Lombard Street Research's work is that the demand to hold real money balances is ultimately determined by real variables, implying that excessive money supply growth leads to inflation. Fortunately, the unduly fast growth of money in 1996, 1997 and 1998 has come to an end, at any rate for the time being. In fact, money supply growth (on the M4 measure) in the year to February was only 2.7%.

Inflation upturn possible in late 2001

A reasonable judgement is that RPIX inflation will remain good at least until the middle of next year. Admittedly, output may be somewhat above trend at present, while the large gains in house price houses in 1999 represent a significant positive wealth effect on consumption and domestic demand in 2000. There has to be a possibility that RPIX inflation will rise above its 2 1/2% target in late 2001, but any overshoot is likely to be modest in comparison with the UK's appalling inflation record in the 1970s and late 1980s.

Inflation performance over the last decade

Chart shows the 12-month percentage change in the RPI, excluding mortgage interest payments (the so-called "underlying" rate of inflation), in the all-items index of producer output prices for manufacturing and in the index of producer output prices (excluding food, drink, tobacco and petroleum products) for manufacturing.

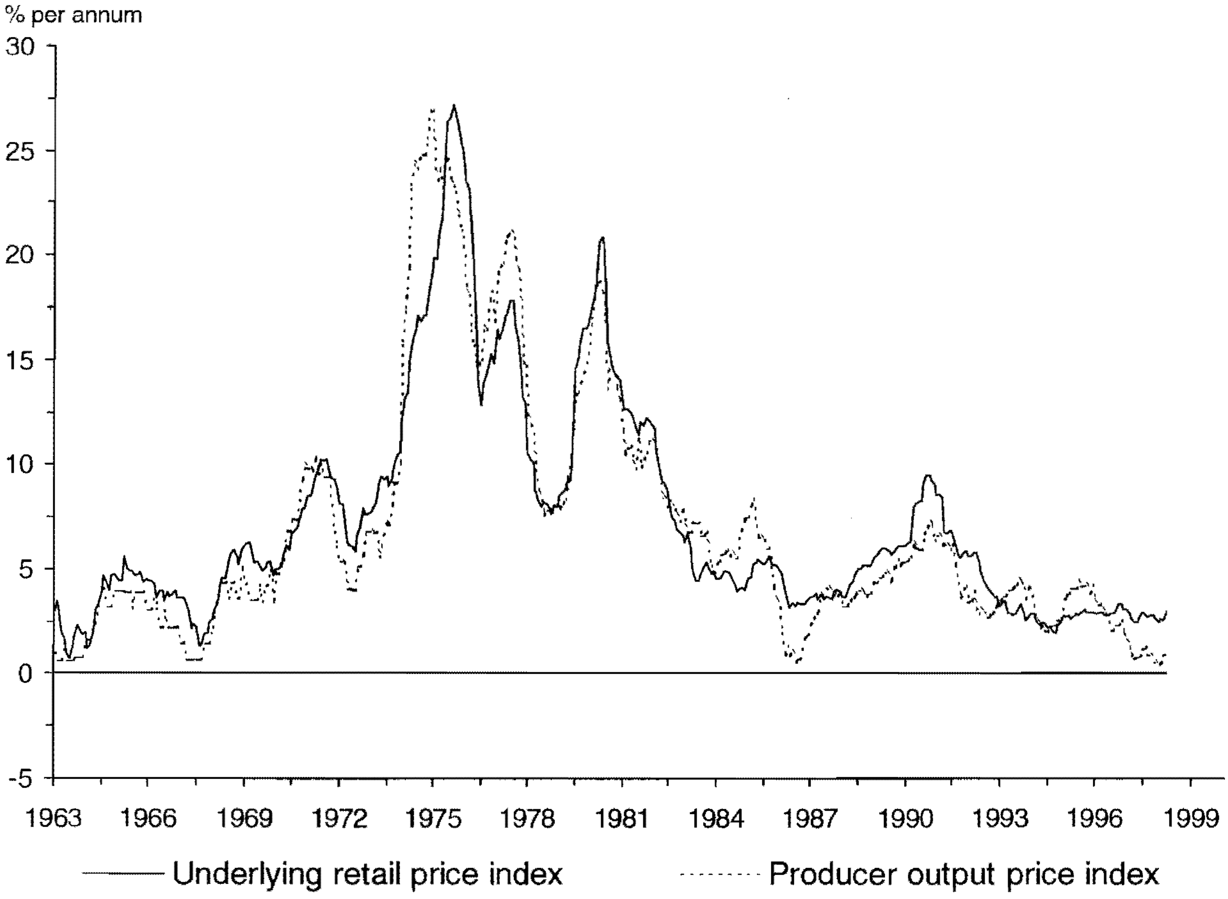


Source: ONS Economic Trends.

Petrol and fuel oil added 0.8 percentage points to the 2.2% rate of underlying inflation (that is, the 12-monthly percentage change in the retail prices index, excluding mortgage interest payments) in February. There are likely to be some lagged affects from earlier high crude oil prices yet to come through into forecourt petrol prices, as well as the 2p/litre duty increase announced in the March 2000 Budget. Allowing for these, but assuming crude prices stabilise from March onwards, the contribution to the annual rate of inflation from petrol will peak in the first half of 2000, remain positive over the rest of the year and disappear from March 2001. Next spring the annual increase in RPIX could fall close to 1 1/2%, if non-oil inflation pressures remain unchanged. Underlying retail inflation was last below 2% in 1967.

A long-term perspective

Chart shows the 12-month percentage change in the RPI, excluding mortgage interest payments (the so-called "underlying" rate of inflation), and in the index of producer output prices (home sales) for manufacturing.

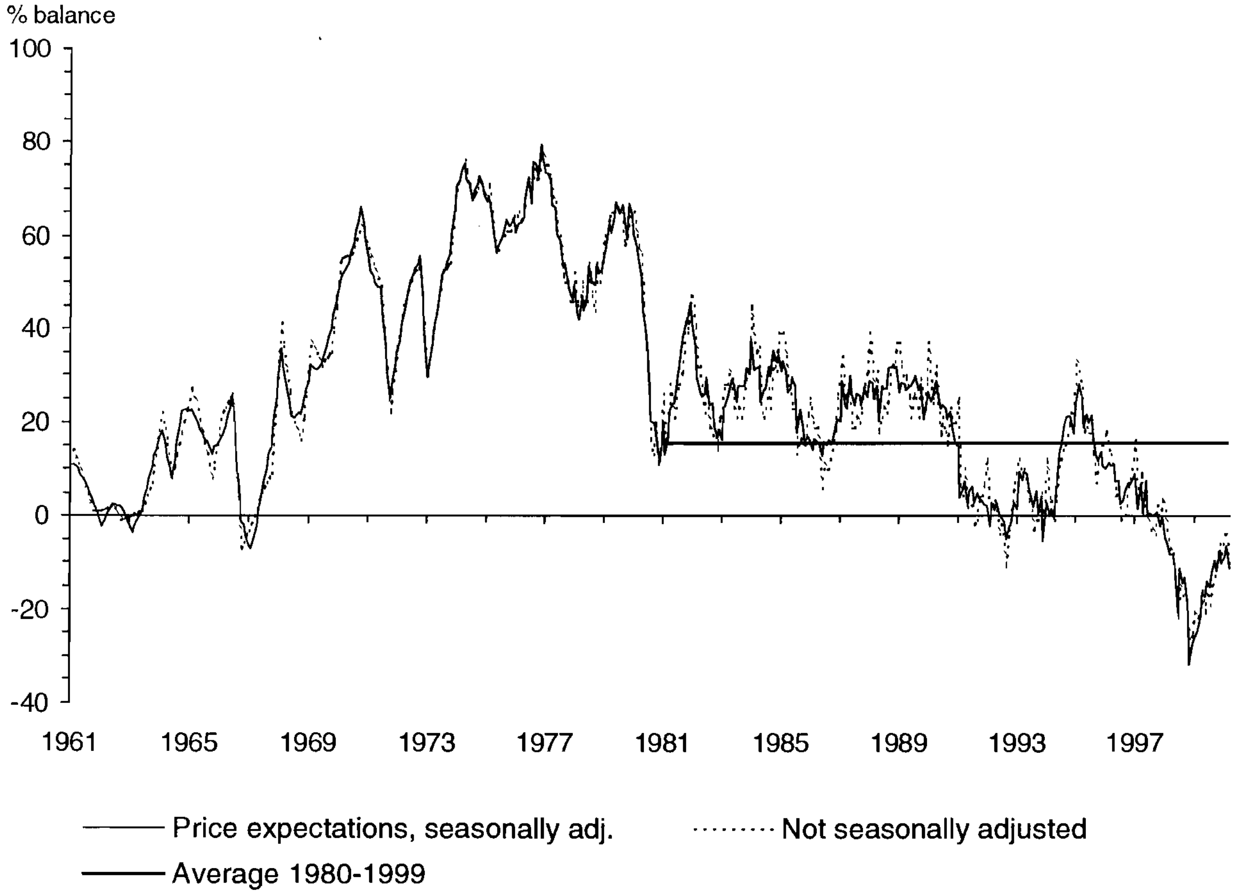


Source: ONS Economic Trends.

The UK's inflation performance since 1993 has been remarkable by the standards of the preceding 30 years. For seven years the annual increase in the RPIX index has been close to 2 1/2% with little variation. From an institutional perspective, the basic cause of this improvement has been the de-politicisation of interest rate decisions, symbolized by the granting of independence to the Bank of England in 1997. Although UK output may be slightly above trend at present (see p. 7), the outlook for the annual increase in RPIX is fine at least until mid-2001. Nevertheless, some upward pressures on inflation are emerging from the tight labour market. Labour-intensive services purchased on a discretionary basis (such as haircuts and insurance) account for a quarter of the retail price index. In the year to February their prices rose by 5.7%, up from 4.2% in February 1999 and the fastest rate of increase since June 1993.

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. EZX11 method used for seasonal adjustment.

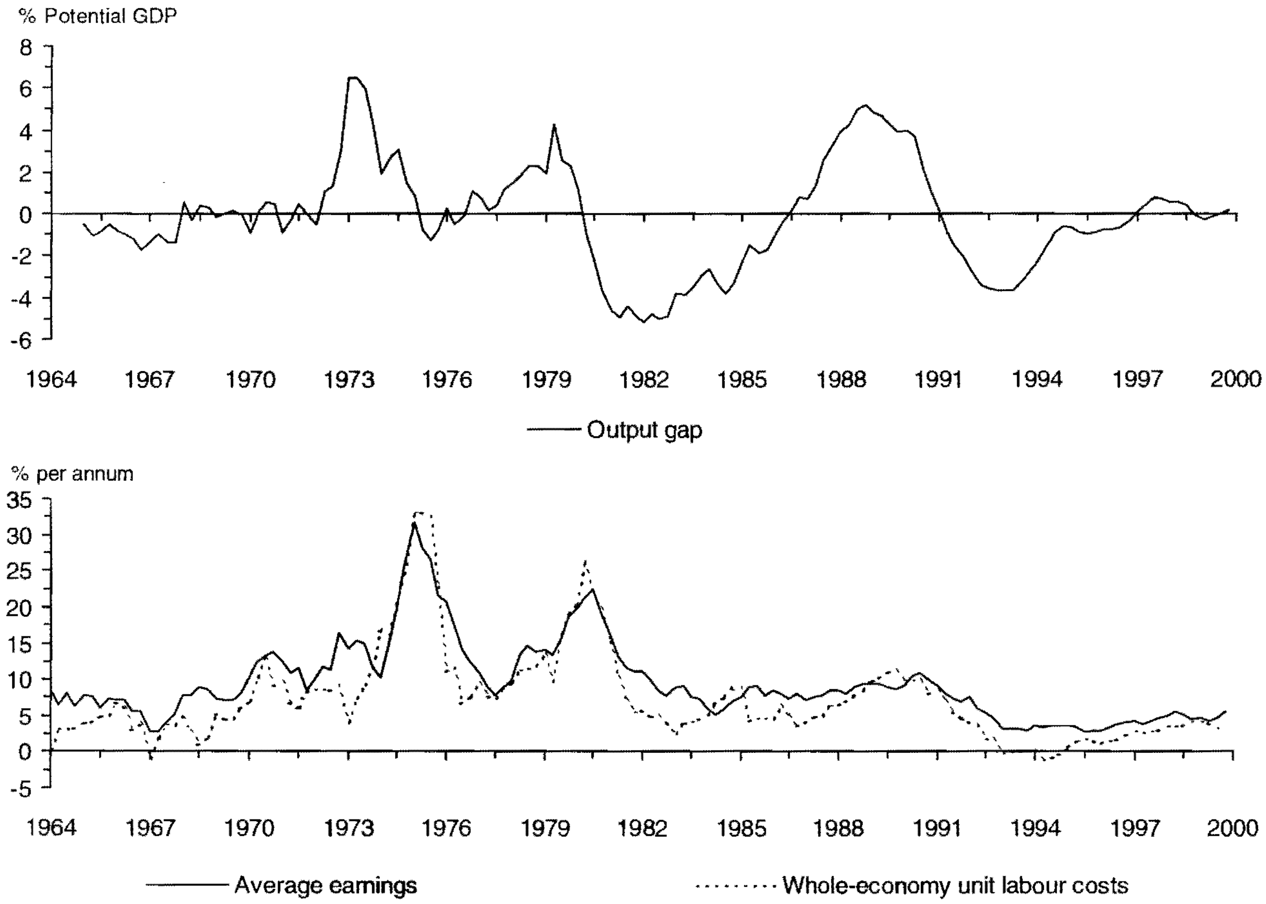


Source: CBI Monthly Trends Enquiry.

Rising oil and commodity prices have put producers' margins under pressure. But their pricing power remains weak. Excluding items affected by duty changes (such as tobacco and petrol) or with erratic prices (such as food), output prices were only 0.4% higher in February than a year earlier. Data from the ONS show that import prices, excluding oil, fell throughout 1997, 1998 and the first half of 1999. But they rose slightly in both the third and fourth quarters. Survey evidence from the CBI and Chartered Institute of Purchasing and Supply indicates that producers are less willing to cut prices. The balance of CBI members expecting to cut prices in the coming four months was 11% in March, half that of a year earlier. But this compares with a 35-year average of +24% of members expecting to raise prices. Sterling, on a trade-weighted basis, is 5% higher than a year ago, arguing that UK factory-gate prices will remain under pressure from cheap imports for the time being.

Labour cost developments

Upper chart shows the percentage deviation of 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.

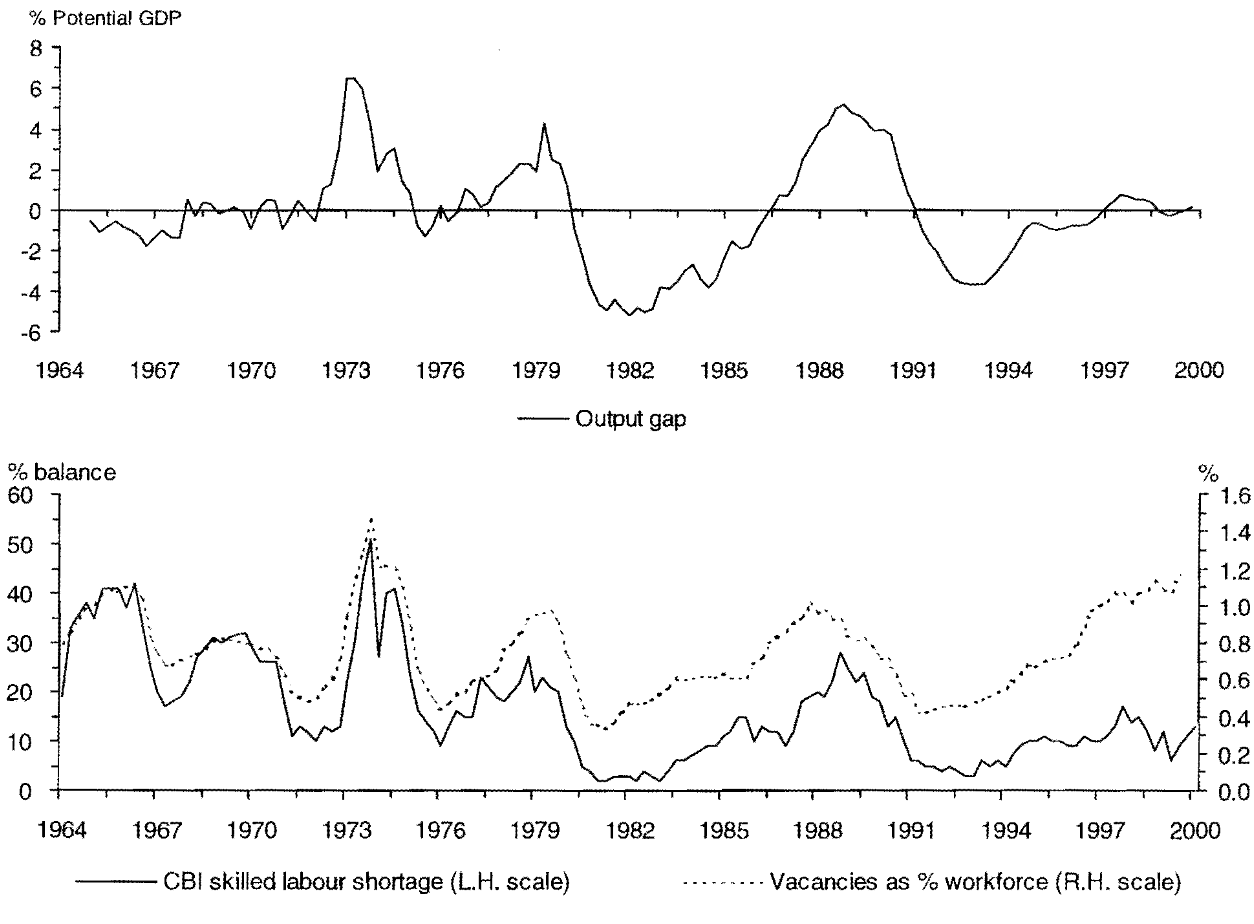


Sources: ONS Economic Trends *and Lombard Street Research calculations.*

One widely accepted concept in economics is that there is a "natural rate" of unemployment, below which pay inflation will rise in response to labour shortages. Claimant count unemployment has been below its 35-year average of 5.8% since June 1997. Annual average earnings growth has risen from 4.2% to 5.9% in the three years to January. Average earnings includes bonus and overtime payments. On a real basis, growth in basic pay has also increased. When deflated using the RPI, excluding mortgage interest payments, data from pay specialists Industrial Relations Services show a 0.6% annual real increase in basic pay settlements in 1999, above the average of the last 10 years of 0.2%, but less than the 0.8% increase in 1998. The failure of pay inflation to quicken more when the unemployment rate is at a two-decade low appears to undermine the natural rate theory. One explanation is that the labour market reforms of the last two decades have lowered the natural rate.

Two measures of labour market slack

Upper chart shows the percentage deviation of 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 percentage of the workforce.

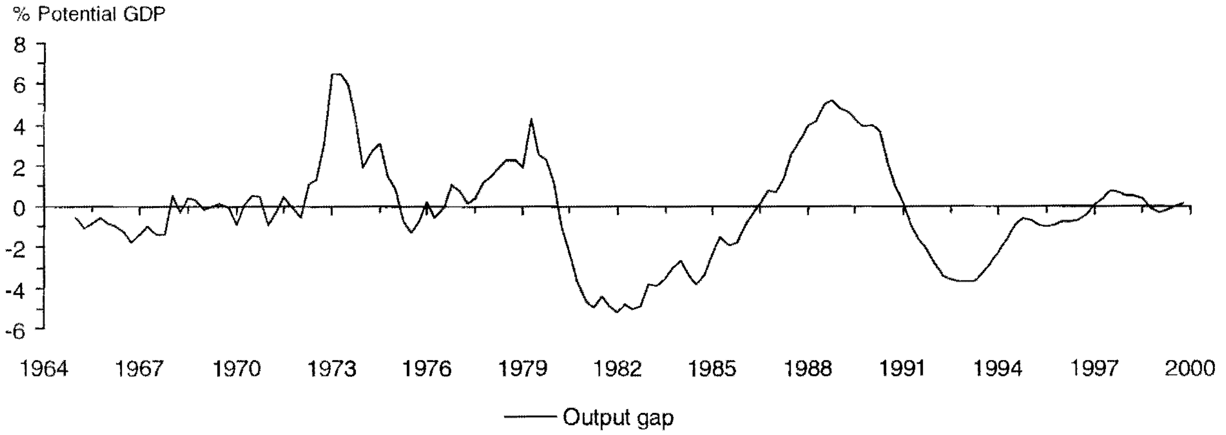


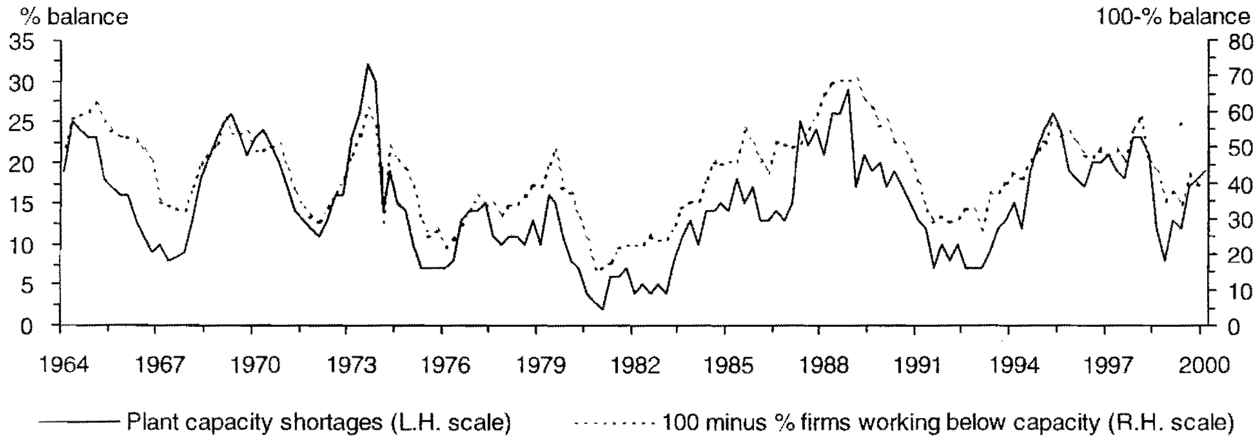
Sources: ONS Economic Trends, *CBI* Quarterly Industrial Trends Survey *and Lombard Street Research calculations.*

The solid line in the lower chart shows the balance of CBI members expecting shortages of skilled labour to limit production in the coming months. In the 1960s and 1970s this series moved closely with the ratio of vacancies at Jobcentres to the size of the workforce. Since 1980 their paths have been less similar. One explanation is the reduction in manufacturing output as a proportion of GDP. In 1958 the ONS estimated it to have a 37% weight in national output, but this had fallen to 22% by 1995. The broader vacancies-to-workforce ratio is at its highest since 1973, indicating a tight labour market. But pay inflation is only rising modestly. (See page 7.) Pay specialists Industrial Relations Services report that employers are not citing labour shortages as an important pressure in pay negotiations. This corroborates the view that employment legislation and changes to unemployment-related welfare in the 1980s and 1990s increased efficiency in the labour supply.

Two measures of capacity utilisation

Upper chart shows the percentage deviation of 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 percentage of manufacturing companies working below capacity.



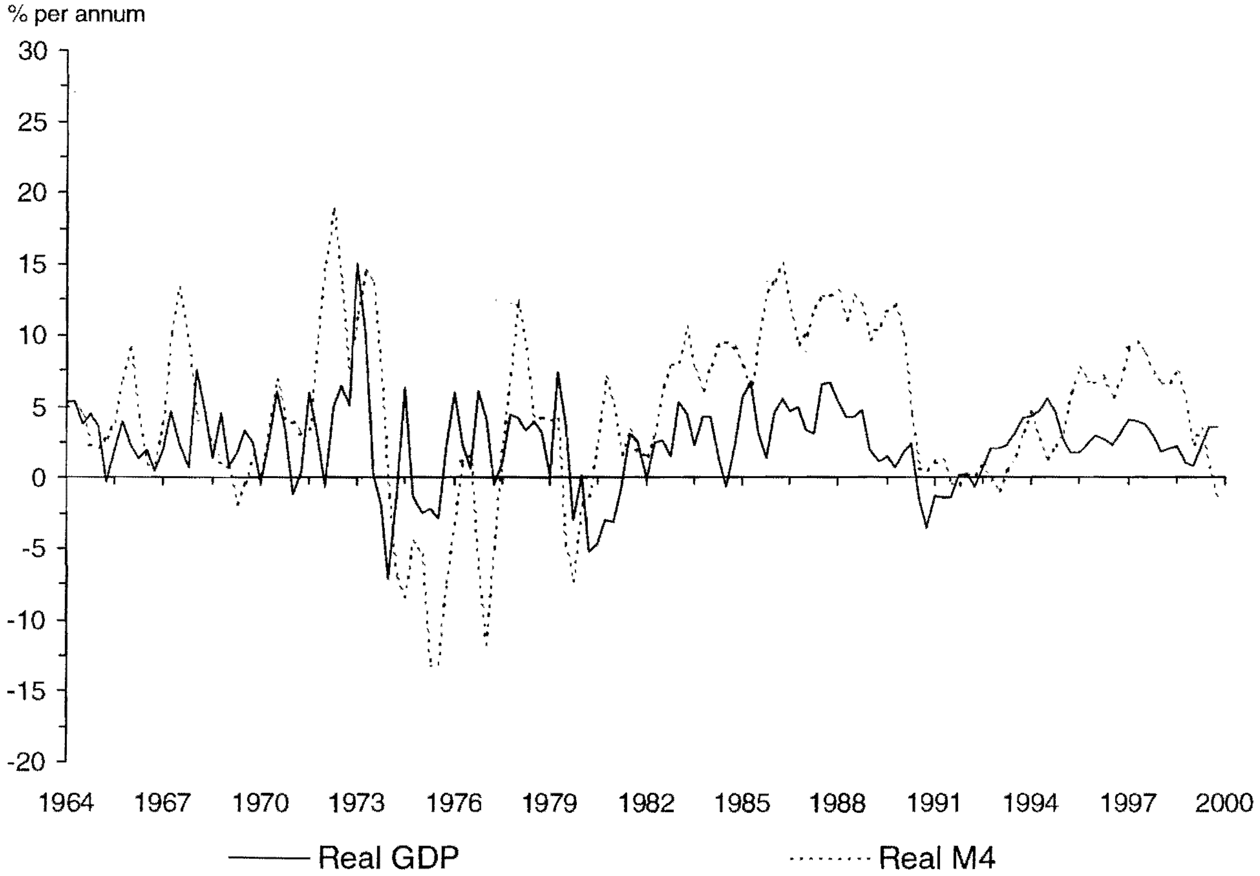


Source: CBI Quarterly Industrial Trends Survey *and Lombard Street Research calculations.*

The upper chart shows Lombard Street Research's estimate of the "output gap" (the difference between actual and potential output) over time. Output gap calculations are controversial and subject to a margin of error. Nevertheless, they are a useful modelling tool favoured by both the Treasury and Bank of England. We estimated that the UK's output gap turned positive in the fourth quarter. With GDP growth expected to remain above its trend rate over 2000, this will widen the positive output gap. In the current upturn we project it will peak at +1% of GDP. This is modest in comparison with booms in the 1970s and 1980s when it was above +3% for periods of two years and longer. The subdued nature of this cycle suggests that interest rates may not need to rise much above 6% to keep inflation under control.

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.

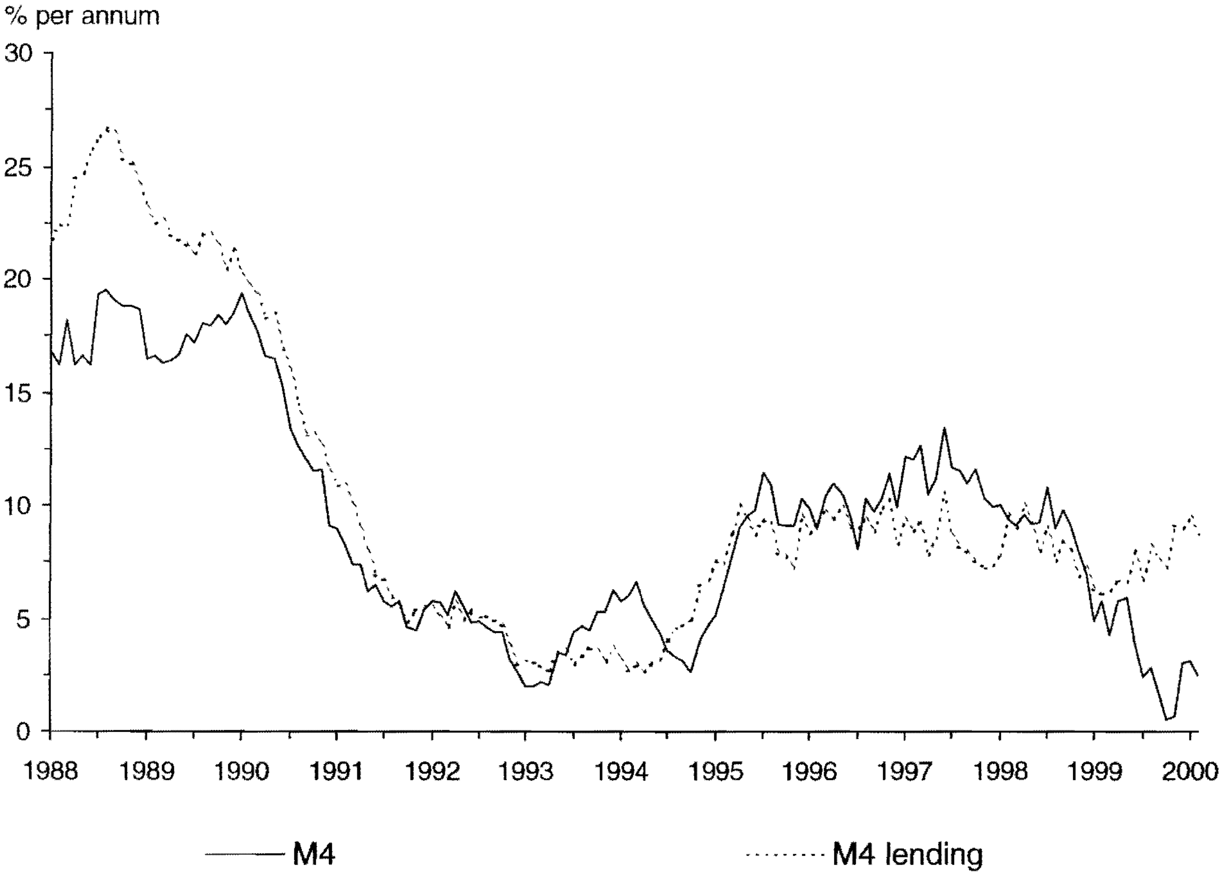


Sources: ONS Economic Trends *and Bank of England* Monetary Statistics.

A well-attested principle in economics is that in the long run the demand to hold real money balances is a function only of real variables. When deflated using the retail price index, excluding mortgage interest payments, M4 increased by 6.4% and 8.9% in 1998 and 1999, respectively. This compares with a long-term norm of 4 1/2%. Given the period of above-trend money growth, sustained weak domestic growth in 1999 seemed unlikely. This was indeed the case. In the second quarter 1999 domestic demand was unchanged on the first quarter. But, apart from that one very weak quarter, it rose by 0.5% or more a quarter in 1998 and 1999. 0.5% growth gives an annualised increase of 2.0%, roughly in line with trend GDP growth. Real M4 has been falling recently, which argues against a strong upturn in the rest of 2000.

Recent monetary trends

Chart shows the six-month annualised percentage change in nominal M4 and M4 lending since 1988. Seasonally-adjusted monthly data.

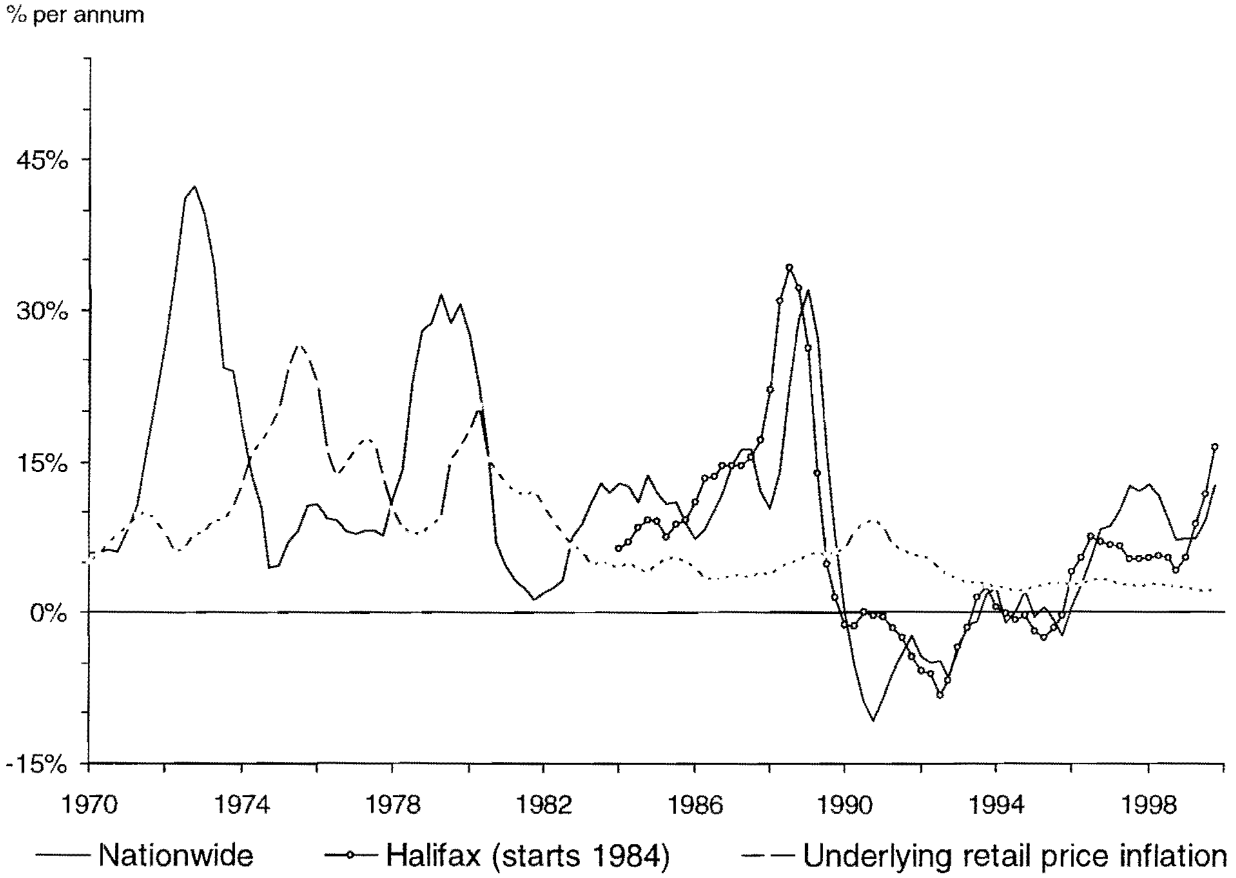


Source: Bank of England Statistical Abstract.

Annual money growth has slowed since the middle of 1997. In the year to February M4 rose by 2.7%, possibly the lowest money growth figure in the post-war period. A large negative external credit counterpart undermined M4 growth in 1999, but over the long term the external credit counterpart has a negligible effect on money growth. The dominant influence is bank and building society lending to UK residents. In the six months to February this increased at an annualised rate of 8.8% and the series has been rising at an annualised rate of 9% since November, up from 6% at the start of 1999. Credit expansion should slow as the effects of higher interest rates feed through, but for the moment it is robust. A complication is that UK institutions are moving deposits offshore. Anecdotal evidence suggests that the favourable tax regime in Ireland has attracted substantial amounts of UK institutions' M4 to Dublin. (See p. 1.)

House price inflation and retail price inflation

Chart shows the annual percentage change in house prices according to the two sources and the annual percentage change in the RPI, excluding mortgage interest payments (the so-called "underlying" rate of inflation). Quarterly data.



Source: Nationwide, Halifax and ONS Economic Trends

The three large surges in house price inflation in the 1970s and 1980s were followed by upturns in retail price inflation. One explanation is that a positive "wealth effect" stimulates consumption, often funded with equity withdrawal. Equity withdrawal takes place when mortgage borrowing facilitates expenditure other than for housing investment. In our February 2000 *Quarterly Economic Forecast* we estimated that it came to 1.1% of disposable income in 1999, after seven years of equity injection. Also, greater house-building activity boosts demand for labour and materials. Increased reports of shortages of skilled builders in the Royal Institution of Chartered Surveyors' surveys suggests that supply bottlenecks are emerging. Interest rates have been raised by 1% to 6% and further increases are likely. But it may be too late to prevent some deterioration in non-oil retail price inflation in 2001.