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Contents

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Repeating the mistakes of late 1998

Have US macroeconomic policies become openly inflationary?

Mr. Greenspan and his admirers

Mr. Greenspan is widely regarded as a hero in financial markets. His decision to ease monetary policy in late 1998 (with three 1/4% cuts in Fed funds rate over a few weeks) is judged to have prevented a recession in 1999. In the more irrationally exuberant versions of the panegyric, he is even said to have "saved the world". This appears to be a reference to the improved credibility of sovereign borrowers in international capital markets which followed the interest rate cuts, although the beneficial effect on the bonuses of bond underwriters may also be part of the story.

But US inflation is at its highest level for ten years

The post-monetarist macroeconomic consensus is that monetary policy should not be used to target real objectives, such as output and employment. The job of central banks is to deliver stable money, not surges in share prices and certainly not enhanced investment bank bonuses. On this score, Mr. Greenspan's record is questionable. The year to December 2000 saw a 3.6% increase in the producer price index and a 3.4% increase in the consumer price index. Neither figure is a disaster, but they are the highest year-to-December increases in the respective price indices since 1990. It needs to be emphasized that the measurement of the CPI change has been affected by new procedures recommended by the Boskin Report, which mean that the increase in the CPI will be *permanently* lower (by perhaps 1//2% to 3/4% a year) than before 1997. If the Boskin adjustments are reversed, US CPI inflation was over 4% a year in late 2000, much the same as in the mid-1980s. Monetary policy therefore has to be conducted carefully to ensure that inflation does not go any higher.

Simultaneous easing of monetary and fiscal policies is openly inflationary

In the last 40 years the growth rates of real M3 and real GDP have been more or less identical. In recent years the typical growth rate of US M3 has been 7% - 11% a year; in the year to December 2000 it was in fact 8.6%. Even if the trend growth rate of real output in the USA has increased to 4% (which is highly debatable), persistent M3 growth of 8 1/2% a year is consistent with 4% to 5% inflation, not price stability. Of course, in the late 1990s real money growth was well ahead of the economy's trend growth rate, and the resulting abundance of liquidity stimulated asset prices and the cyclical boom. By late 2000 some adjustment to slower growth had become necessary and, inevitably, this might hit one or two industries quite hard. But, when the slowdown did emerge, Mr. Greenspan responded quickly by a speech (on 3rd December) promising an easing of monetary policy. On 3rd January Fed funds rate was reduced by 1/2% and further cuts were signalled. The banking system responded in style, with M3 climbing by 2.0% (i.e., at an annualized rate of 24.0%!) in the five weeks to 8th January. The truth is that the Federal Reserve no longer pays attention to money supply statistics. With interest rates going down and the new President, Mr. Bush, embarking on large tax cuts, American macroeconomic policy has become openly inflationary. The European Central Bank presents an interesting contrast, with its December *Monthly Review* reiterating the importance of money supply targetting to the control of inflation.

Professor Tim Congdon 31st January, 2001

Summary of paper on

"At least trend growth for world economy in 2001"

Purpose of the paper

According to empirical work carried out Milton Friedman in the 1950s and 1960s, changes in money supply growth tend to precede similar changes in output growth with a relatively short lag (of about six months to a year) and in inflation with "long and variables lags" which may be two years or more. With this framework in mind, what do recent monetary developments in the main industrial countries imply for output and inflation in 2001 and later?

Main points

* **Money supply growth - on the broad measures - continues to run at 7% a year or more in the G7 industrial countries, noticeably higher than in the early 1990s. (See p. 5.) As the last three-and-a-half decades have seen real money balances rising less than 1% faster than real output, the medium-term implication seems to be inflation of about 3% a year.**

* **But the upturn in money supply growth has been concentrated in North America and Europe; Japanese credit and money growth is still held back by its crippled banking system. (See pp. 10 -11.) The upturn in money growth in North America and Europe can be explained by the banks' improved profitability and their consequent desire to expand balance sheets more rapidly.**

* **A slowdown in credit and money growth in North America and Europe is unlikely at current interest rates. (See p. 4.) The prospect in 2001 is therefore for at least trend growth in demand and output in these two vital areas of the world economy. The Japanese situation is murkier.**

* **With the level of output somewhat above trend in North America and Europe, a trend or above-trend change in output implies a build-up of inflationary pressure. Inflation in the 4% - 5% vicinity would be consistent with the 7% - 10% growth rates of broad money now common in the industrial world.**

* **The inflation outlook is worst in the USA, where the Federal Reserve has become cavalier about high money growth; it is more satisfactory in the Euro-zone, where the European Central Bank has adopted a traditional monetarist approach. Japan may suffer further deflation.**

This research paper was written by Professor Tim Congdon, with help from Lombard Street Research colleagues in the preparation of the charts.

At least trend growth for world economy in 2001

Money trends point to further demand growth, although slower than in 2000

Frenzy of concern about slowdown/ recession

Early 2001 has seen a frenzy of concern about a possible recession in the USA, and agitation about an allegedly severe slowdown in the Euro-zone and the UK. This research paper - which follows a similar format to that in previous January issues of the *Monthly Economic Review* - considers whether monetary trends in the main industrial countries support the widely-held pessimism about global macroeconomic prospects.

Inflation is ultimately determined by difference between money growth and trend rate of output growth

The claim that in the long run the demand to hold real money balances depends preponderantly on other real variables, particularly real incomes, is one of the most well-established in economics. Over the 36 years to 2000 the average annual increase in real output in the Group of Seven large industrial countries was 3.5% and the average annual increase in real money was less than 1% higher at 4.4%. The similarity of the changes in real money and real output is striking, particularly as it survived huge swings in the growth rate of nominal money. What do the latest global money trends imply for economic activity and inflation in 2001 and 2002?

"Money" more or less the same thing as bank deposits

In answering this question it is useful and important to remember the driving-forces behind monetary expansion. Nowadays, in all relevant economies, the principal constituent of the money supply is the deposit liabilities of the commercial banks. The banks are of course profit-maximizing organizations, which must constantly balance the extra return from expanding their balance sheets against the extra risks from over-exposing their capital to potential bad debts. In general, their capital marches in step with their balance sheets. A fair generalization is that, if banks' capital is adequate and growing by 10% a year, then their managements will seek to grow assets by about 10% a year. The growth rate of the deposits included in money supply measures is likely to be similar.

Low inflation of mid and late 1990s due to banking crises of early 1990s

If this line of thought is accepted, an explanation for the low inflation of the mid- and late 1990s emerges readily. In the early 1990s the banking systems of many countries were short of capital, partly because of bad debts arising from the unwinding of asset price excesses in the late 1980s. They had to shed assets or restrict asset growth in order to protect their shareholders' threatened equity reserves. The shortage of bank capital therefore implied static or slow-growing bank credit to the private sector, and subdued growth in broad money. In other words, it was the global dearth of bank capital in the early 1990s which was responsible for the low inflation of the mid- and late 1990s. The argument has a great merit. It does not appeal to any revolutionary change in the pace of technological advance, or in the structure or institutions of the leading economies to account for the drop in inflation; it does not rely on the hypothesis of a miraculous New Era and it does not require the wholesale junking of traditional economic theory. But - if the shortage of bank capital and low money growth were responsible for the low inflation of the late 1990s - a warning has to be delivered about the inflation outlook now.

But banks now have ample capital and are keen to expand, implying money growth close to double-digit annual rates

The trouble is that - in most but not all countries - banks are now profitable and well-capitalized, and their managements are keen to expand. Roughly speaking, a typical bank management team in the industrial West aims at a return on capital of 15% - 20%, while the average actually achieved may be in the 10% - 15% area. After allowing for tax and dividends, retentions amount to 8% - 10% of capital, which then becomes the target growth of the balance sheet. It is a fair generalization that the current profitability and retention practices of banks in North America and Europe imply 8% - 10% growth rates of the deposit liabilities which constitute most of broad money.

Money growth in the USA is much too high

The following survey of money growth in the industrial world discusses how these forces have operated in recent years. The USA was the first economy to escape from the macroeconomic shackles of its banking crisis. As shown by the chart on p. 6, the annual rate of broad money growth - as measured by M3 - climbed briskly from almost nil in 1993, 1994 and early 1995 to 7% - 8% in 1996, and has stayed above 7% ever since. Real broad money growth in late 1998 was the highest since 1972 and, as in 1972, it was associated with asset price excitement. Nominal money growth slowed a little in the autumn of 2000, but a speech signalling monetary policy easing by Mr. Greenspan on 3rd December has been followed by a surge in credit and money growth. In the five weeks to 8th January the weekly-average level of M3 soared at an annualized rate of 24.0%! While this may be exceptional, the trend annual growth rate of US broad money remains in the 8% - 10% area. Despite a rise in inflation, real money growth is above 5%, which is consistent with further balance-sheet strength *and at least trend growth in domestic demand in early 2001*. It is a not entirely irrelevant detail that - in a clear departure from the norm in the 1990s - money growth in Canada accelerated sharply in late 1999 and 2000. (See p. 12.)

The European Central Bank has a more traditional anxiety about excessive money growth

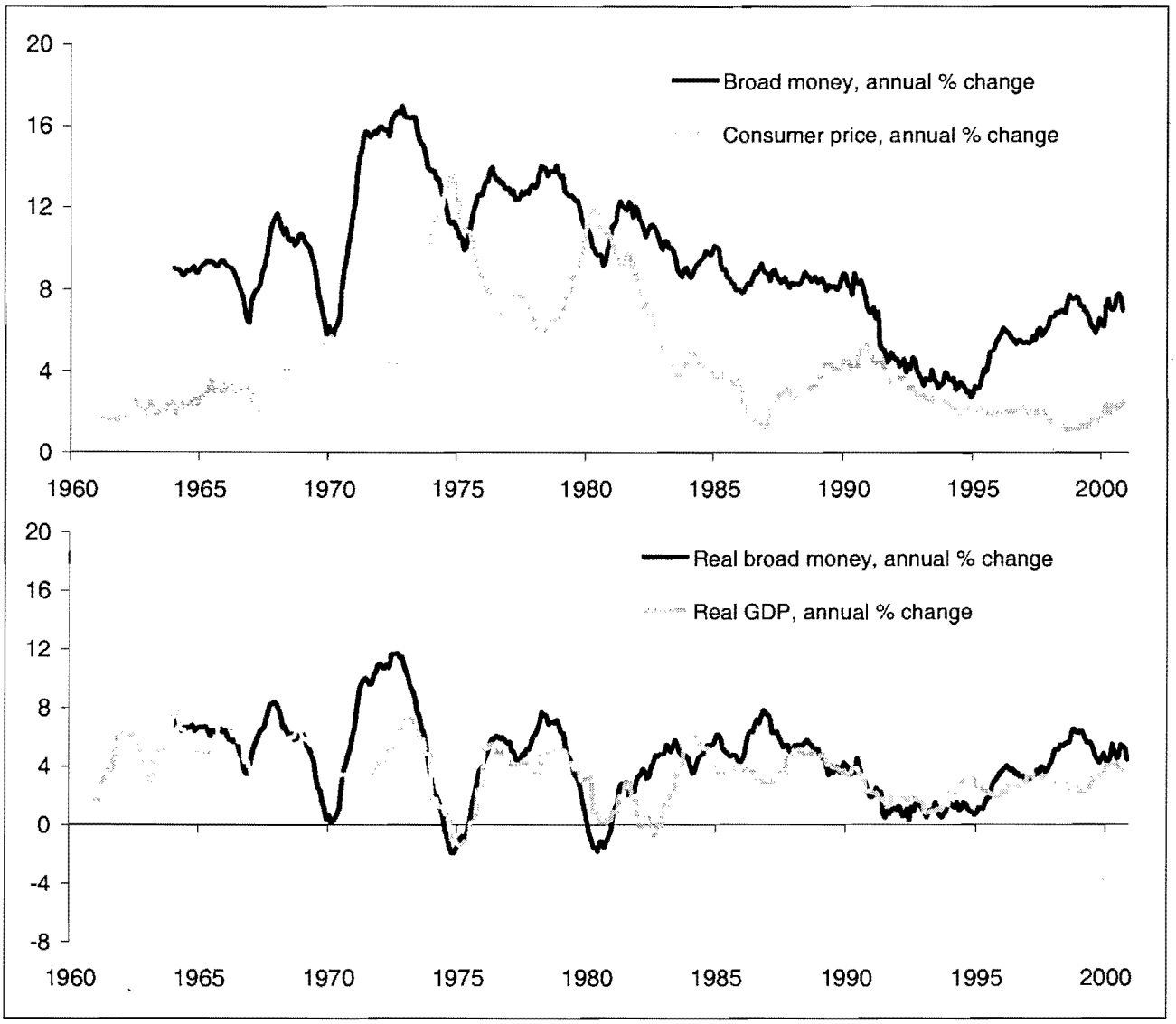
The situation in Europe is quite different. Unlike the Fed, the European Central Bank has emphasized that it watches money supply growth carefully, because of the medium-term relationship between money and inflation. Bank credit to the private sector grew at an annual rate of about 10% in 1999 and 2000. While broad money growth was somewhat slower, it was above the target level of 4 1/2% a year. Arguably, the ECB's M3 measure understates the true level of euro-denominated deposits because it does not include non-resident deposits or euro deposits held by residents in banks outside the Euro-zone, both of which grew quickly (probably by about 20%, but the data are imperfect) in 2000. (Note that this survey does not have a section on the UK, where the numbers in 2000 were close to those in the USA and the Euro-zone.)

Big interest rate cuts are inappropriate

To conclude, nominal money growth in North America and Europe is running - fairly consistently - at an annual rate of 7% or more. With the trend growth rate of industrial world output at about 3% a year, real money balances are ample. They remain supportive of asset prices and economic activity, and point to trend *or even above-trend* growth in demand and output in 2001. *Over the medium term inflation must be expected to return to the 4% - 5% vicinity, unless central banks take firmer action to restrain unduly high growth rates of credit and money. Large cuts in interest rates are certainly not appropriate.*

Group of Seven

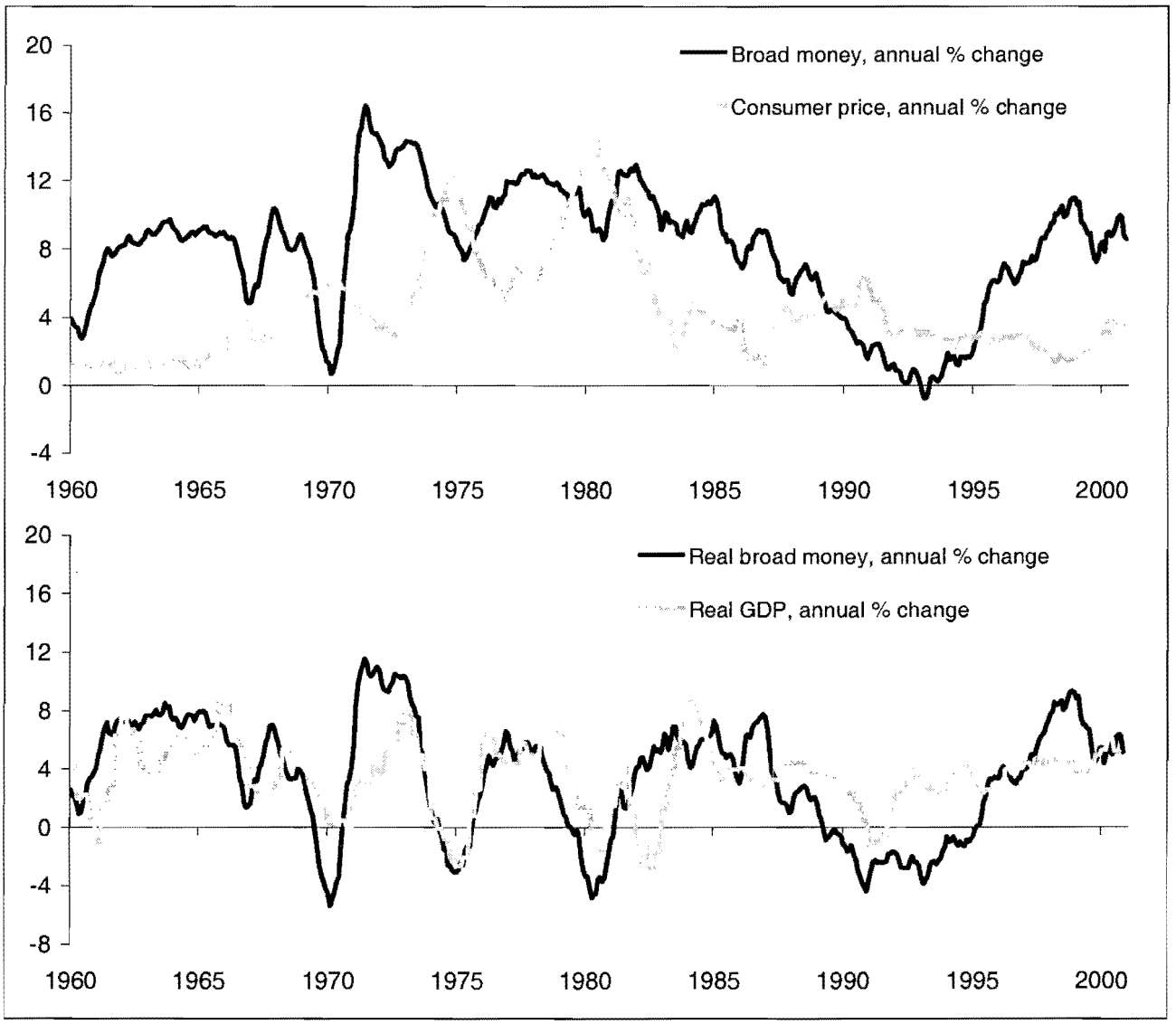
- Money, output and inflation



In the four years to end-1994 the average annual growth rate of G7 nominal broad money was just over 4%, with a tendency to decline. It was the industrial world's lowest money growth, over a sustained period, since 1945. When allowance is made for the "long and variable lags" between money and inflation about which Friedman warned in the 1960s, an argument can be made that this was the key causal influence on the low inflation of the mid- and late 1990s. However, in the five years to end-2000 the average annual growth rate of G7 nominal broad money was nearly 6½%. As money growth stayed depressed in Japan, the upturn in money growth was particularly marked in North America and Europe. In these two areas it was associated with above-trend growth in real money, and - in accordance with traditional patterns - it led to strong company balance sheets, buoyant asset prices and above-trend growth in demand. In 2000 itself G7 nominal broad money increased by 7%. Despite the rise in inflation, real broad money growth remains at about 4% a year, which is consistent with at least trend growth in industrial world demand in 2001.

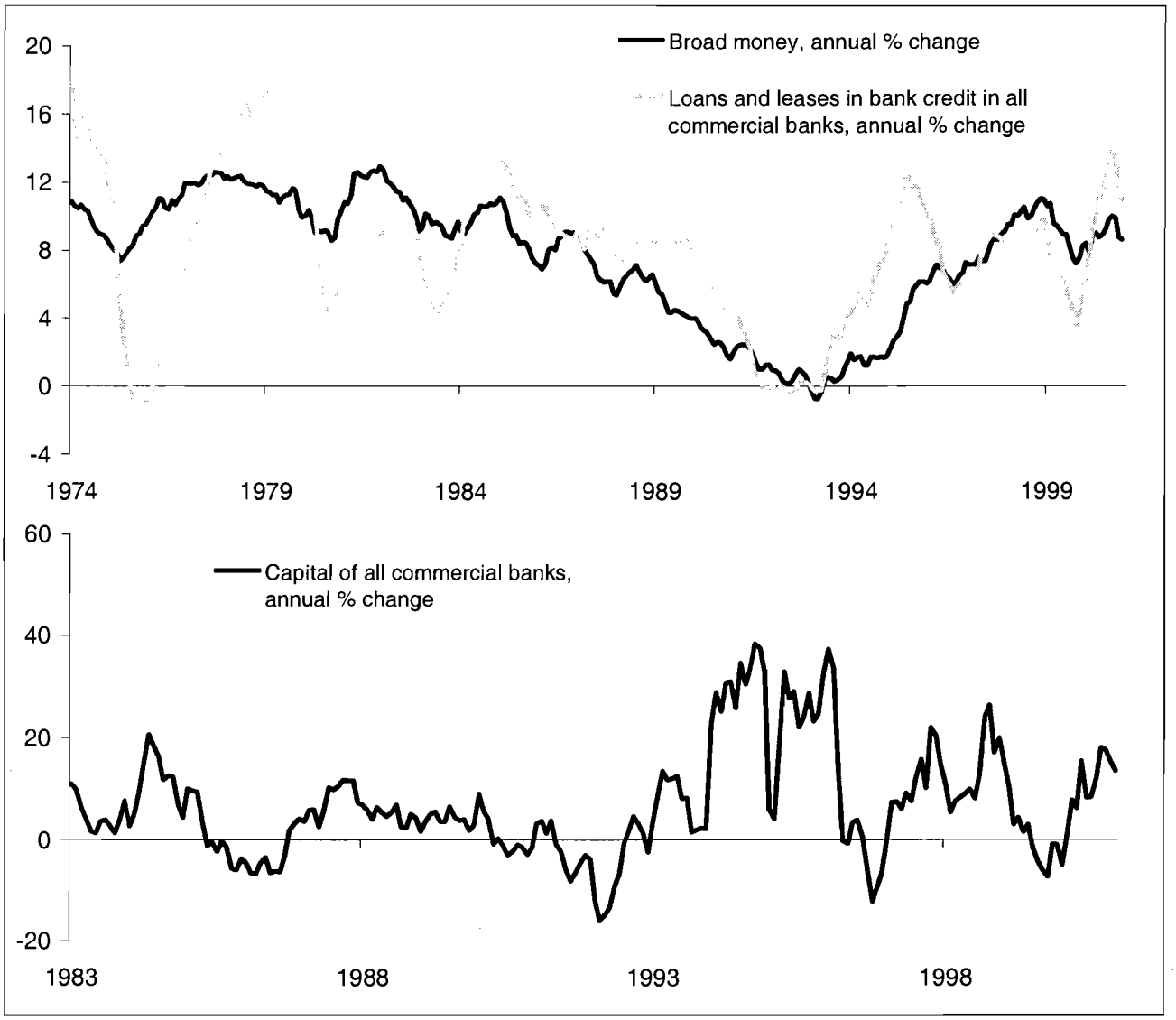
United States

- Money, output and inflation



The contrast between slow money growth in the early 1990s and rather high money growth in the late 1990s was a global phenomenon (apart from Japan), but it was particularly pronounced in the USA. Despite fears of "credit crunches" in late 1998 and late 2000, bank credit to the private sector typically grew at double digit annual rates in the three years to end-2000, while the average annual growth rate of nominal M3 was 9.4%. Over the forty years from 1960 to 2000, real broad money growth has been virtually the same as real GDP growth. With the trend growth of the US economy variously estimated at between 3% and 4% a year, the implication would appear to be an eventual rise in inflation to the 4% - 6% area. Inflation has indeed been rising, but has been restrained by the strength of the dollar and, more debatably, by an improvement in productivity growth. Following a speech by Mr. Greenspan on 3rd December asking banks to relax credit standards, banks have grown their balance sheets aggressively. The annualised growth rate of M3 in the five weeks to 8th January was 24.0%.

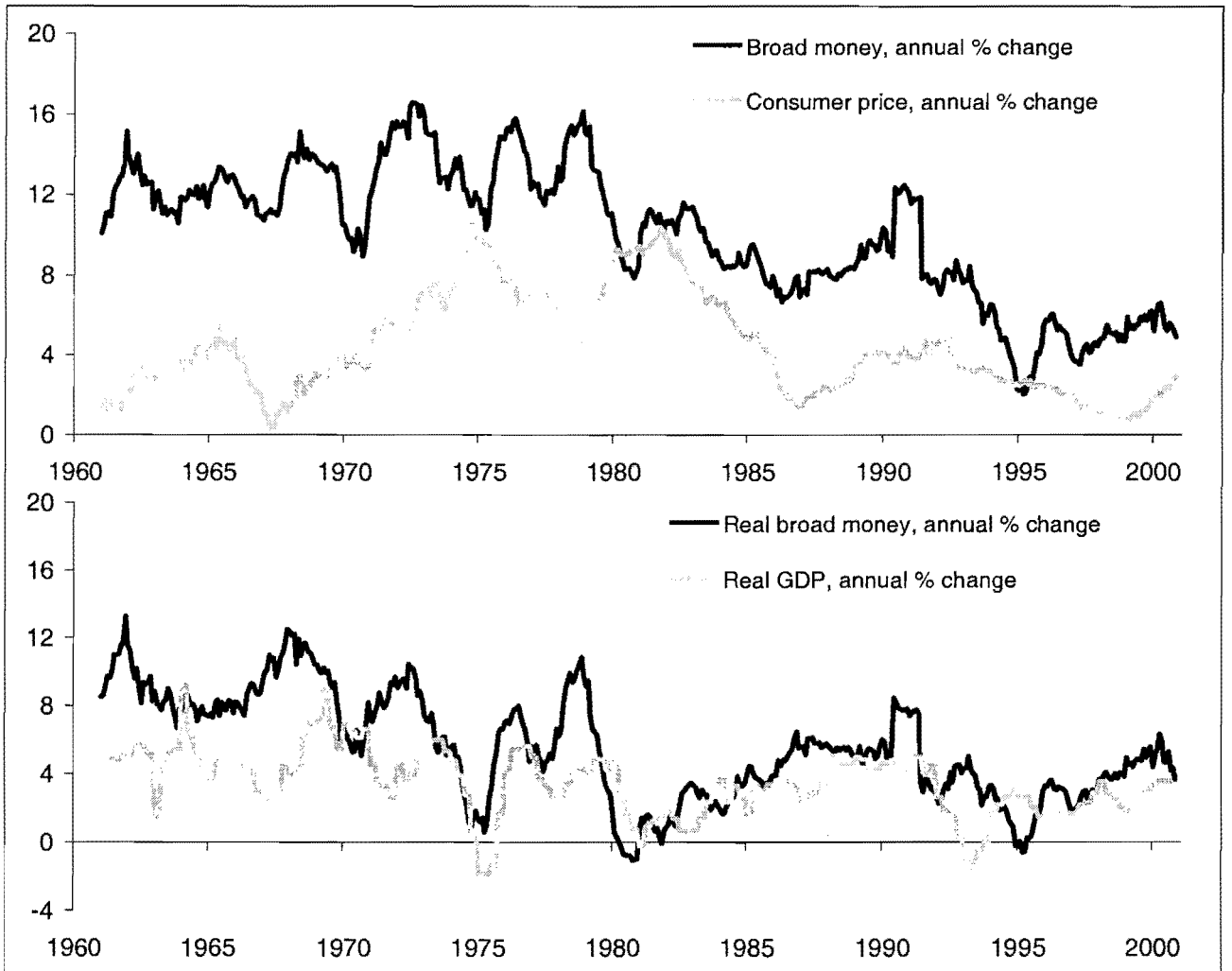
- Money, credit and bank capital



Banks have claims on three types of agent - the public sector, private sector non-banks and the overseas sector. As the external assets of American banks are small relative to total assets, the analytical focus can be on the public and private sectors. In the early 1990s banks were short of capital because of the heavy incidence of bad loans in real estate and the Third World, and they restricted new lending. US commercial banks' "loans and leases" - the bulk of their lending to the private sector - were lower in April 1993 than in December 1990. The chart shows how sharply this credit category recovered in the 1990s. In the three years to December 2000, when financial markets sporadically worried about "credit crunches", the compound annual growth rate in "loans and leases" was 8.8%; in the year to December 2000 itself "loans and leases" increased by 10.9%. It would be strange to believe that the current move to lower interest rates will moderate this credit expansion or lower the associated growth in broad money. On the contrary, early 2001 will see continued rapid growth in credit and money.

Euro-zone

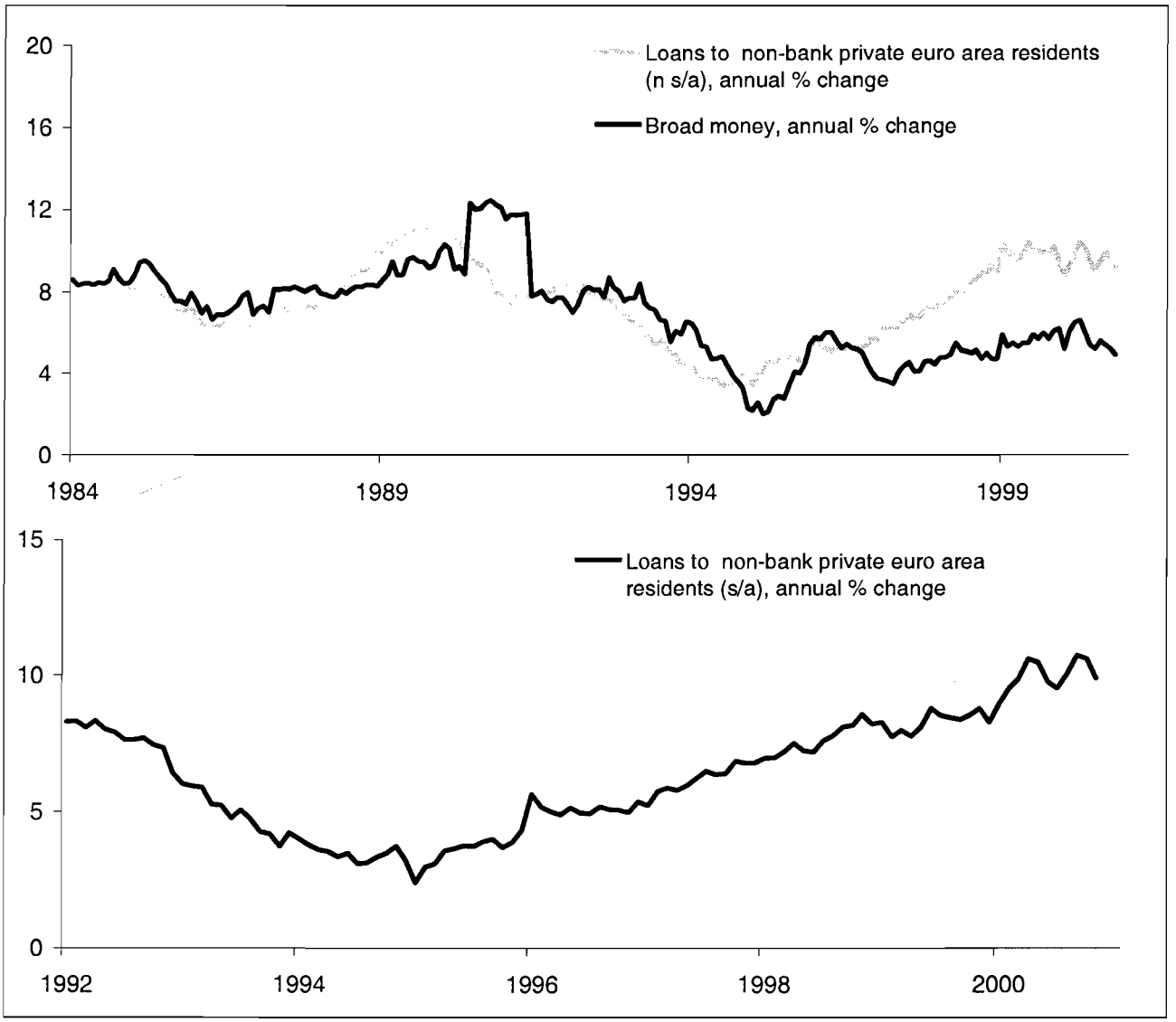
- Money, output and inflation



Note: Broad money data prior to 1980 compiled by Lombard Street Research from national sources. Post-1980 data compiled by European Central Bank

The European Central Bank - unlike the USA's Federal Reserve, but like the Bundesbank before it - continues to regard control of the quantity of money, on the broad definitions, as fundamental to the maintenance of price stability. The December issue of the ECB's *Monthly Bulletin* included a two-page review of "the reference value for monetary growth". It noted that, "The decline in M3 income velocity over the sample from 1980 to 2000" was "relatively close to 1% per annum on average". With trend output growth in the Euro-zone put at 2% to 2½% a year, and price stability defined as a 1%-a-year rise in the price level, the ECB decided "to reconfirm the existing reference value for monetary growth, namely an annual growth rate of 4½% for the broad aggregate M3". The charts show that nominal M3 has been somewhat higher than this in recent years and that real M3 growth in the late 1990s was much stronger than in the mid-1990s. This was undoubtedly an important influence on the Euro-zone's cyclical recovery.

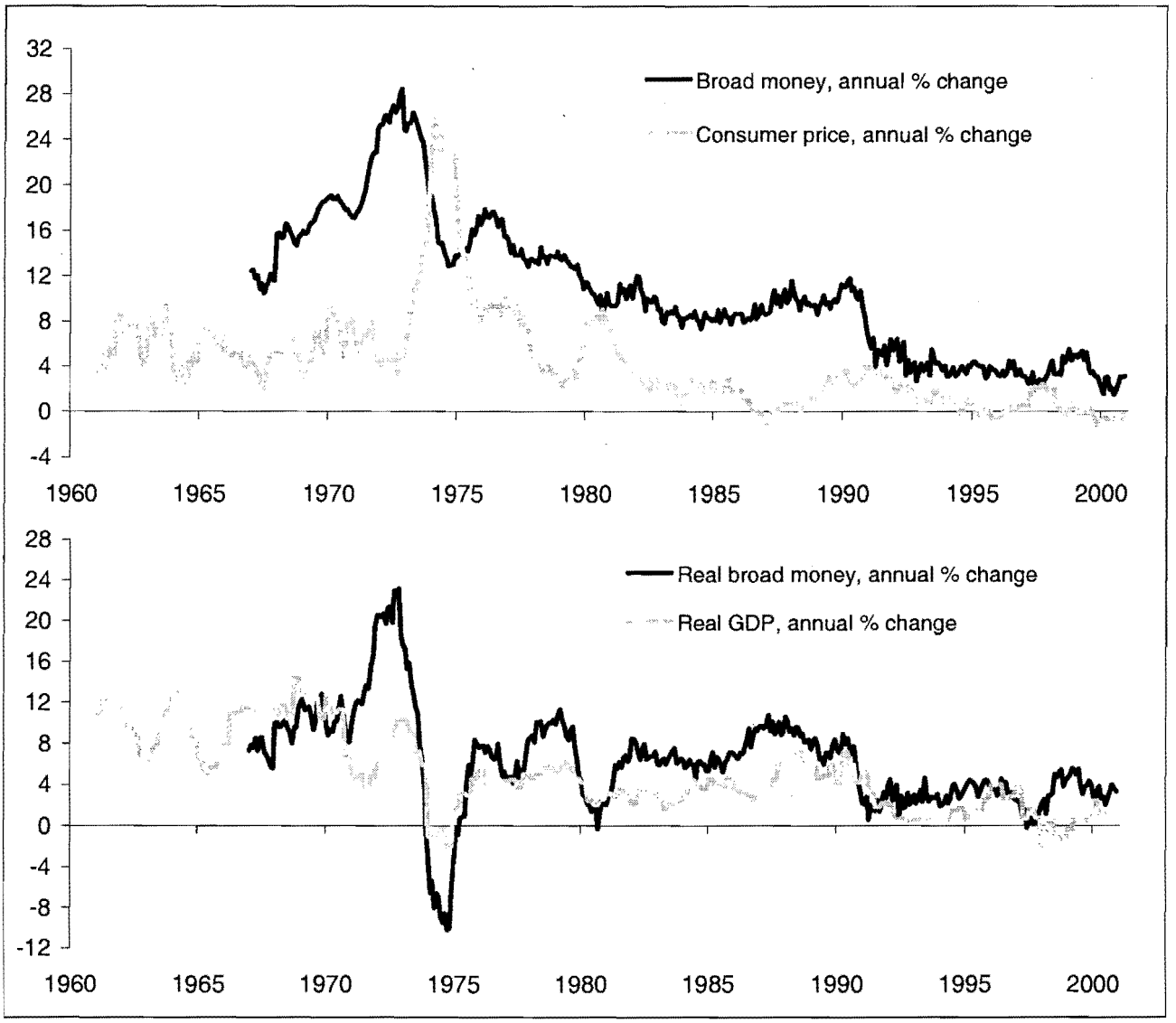
- Money and credit



Despite the ECB's good intentions on money growth, the fall in European interest rates in the two years to early 1999 stimulated a powerful credit boom. As the chart shows, the increase in Euro-zone bank credit decelerated in the early 1990s, for much the same reasons as in the USA and in other European countries, such as the UK and Sweden. Banks lost money because of a heavy incidence of bad loans in the downturn of 1990 to 1993, after the Bundesbank's dear-money response to the German unification boom. They therefore had to restrict balance-sheet growth, implying slower growth of the deposit liabilities which constitute most of broad money. The trough in credit growth came in 1994 and 1995. The return of profits and a period of balance-sheet convalescence was followed in 1996, 1997 and 1998 by a sharp acceleration in credit growth to a roughly 10% annual growth rate in 1999 and 2000. The growth rates of banks' loans to the private sector and their deposit liabilities are related, although not identical, and the ECB may have to raise interest rates again to curb the expansion of credit and money.

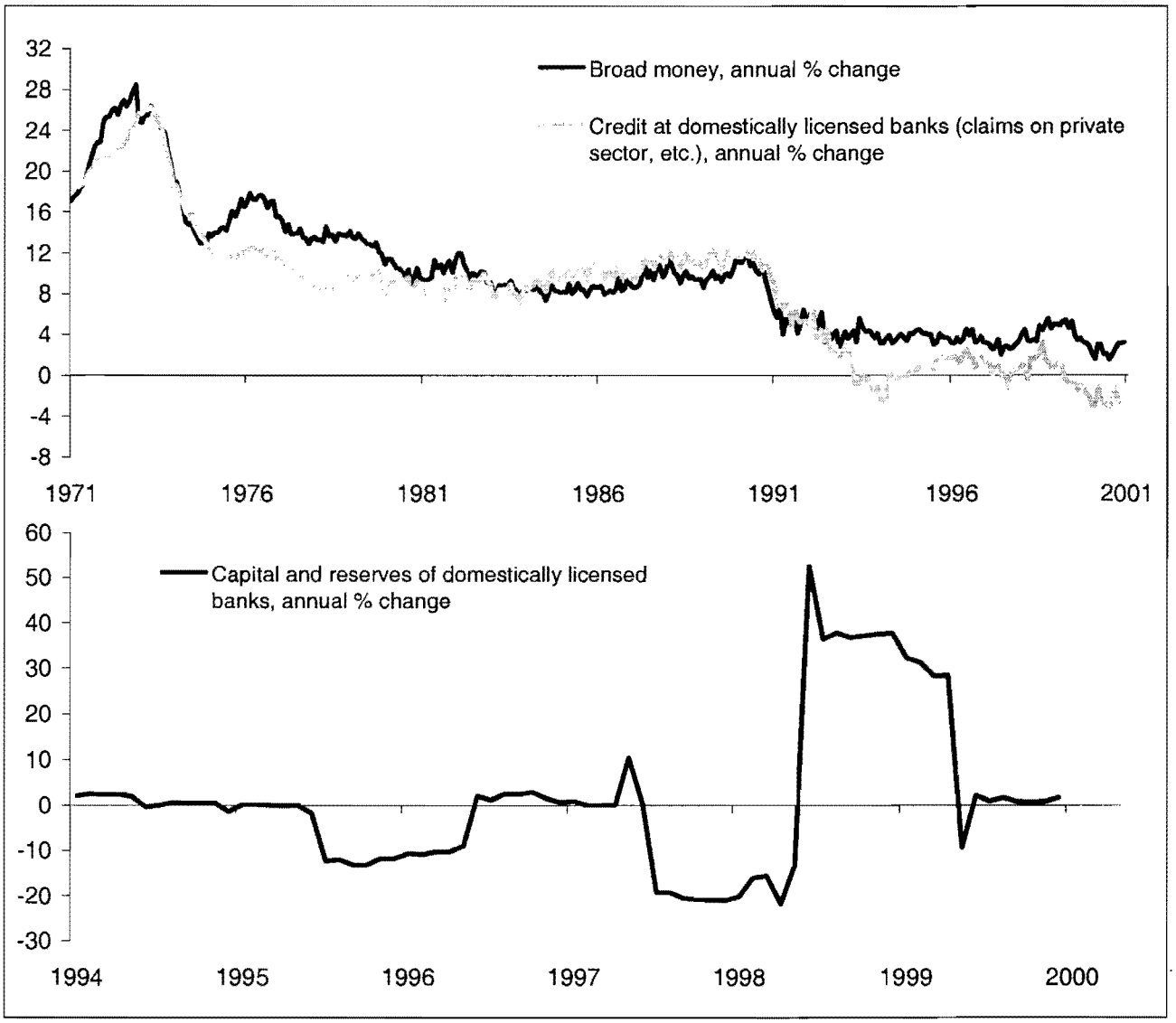
Japan

- Money, output and the price level



With one exception, all the big industrial countries had the same pattern of credit and money growth in the 1990s. A sharp drop in the early 1990s was followed by stabilisation in the mid-1990s and a marked acceleration from 1996. The big exception was Japan. As the chart shows, the annual rate of broad money growth - which had typically been in the teens or higher in the 1960s and 1970s - fell to 10% in the 1980s and under 5% in the 1990s, and showed no sign of recovering as the decade progressed. It would be wrong to blame the sluggishness of output growth in Japan over a period as long as ten years on the slow rate of money supply increase, as money cannot have "real" effects on potential output in the medium and long runs. In fact, real money growth was persistently higher than real output growth in the 1990s, raising the ratio of money to GDP. This has prompted some economists - such as Professor Paul Krugman - to interpret Japan's failure to escape from its economic doldrums as the result of a Keynesian "liquidity trap" (i.e., an increase in the demand to hold real money balances).

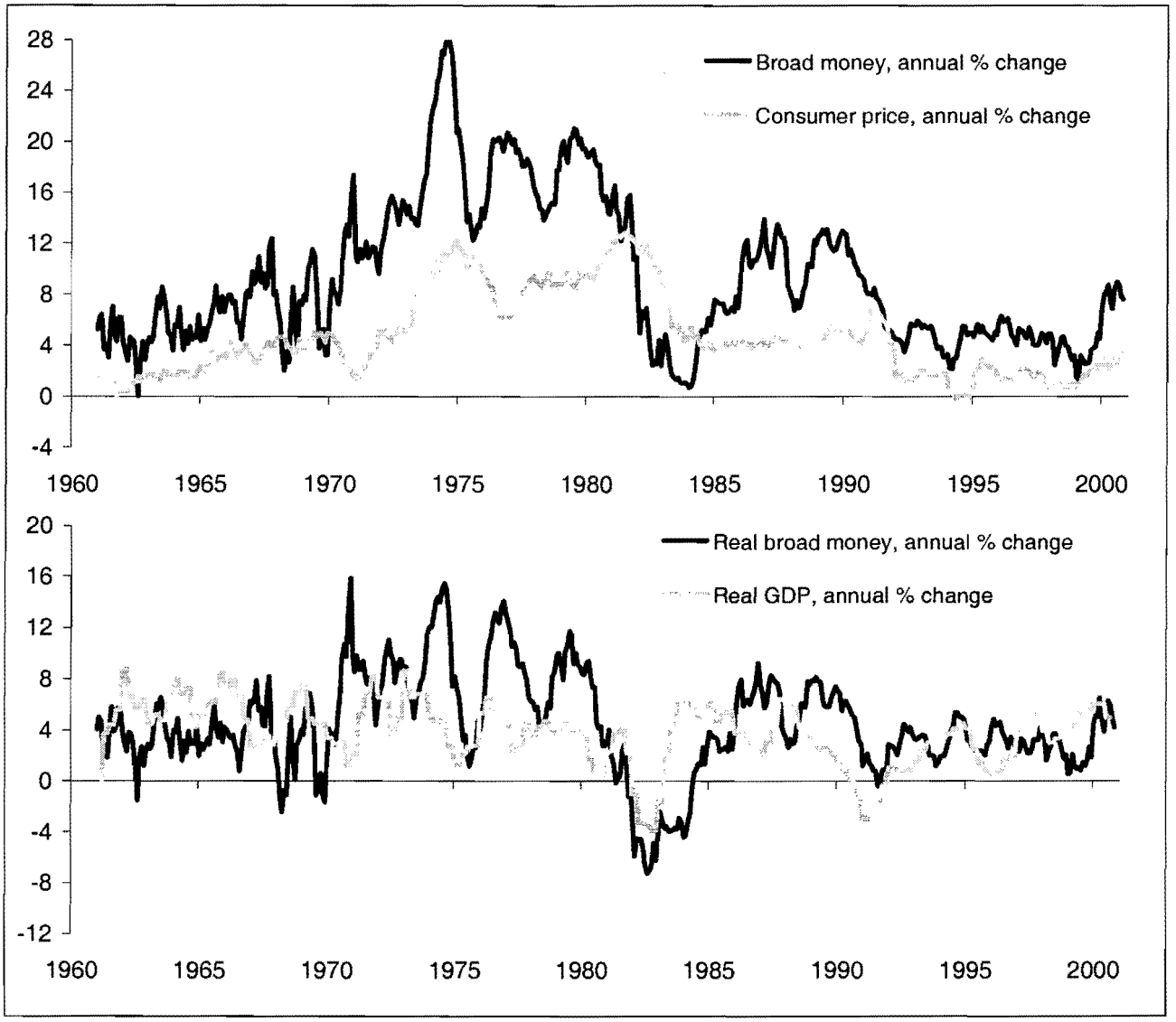
- Money, credit and bank capital



Krugman's emphasis on the liquidity trap may be misplaced. The polemical function of the liquidity trap in macroeconomic debate was to deny that large increases in money balances could stimulate an economy, because they would merely by absorbed by an increased demand to hold them. Fiscal policy would then become the most important instrument to boost demand, establishing a case for "a somewhat comprehensive socialisation of investment" (in Keynes' words). But, as the charts here and on p. 10 show, Japan has at no stage in the 1990s enjoyed rapid monetary expansion. On the contrary, broad money growth was stuck at 3% - 4% a year. The immediate explanation for the weakness of money growth is to be sought in bank credit to the private sector, which has recently been contracting. At a deeper level, the trouble has been the erosion of capital in the banking system, as Japan's financial institutions recognise the bad debts inherited from the "bubble economy" of the late 1980s. The puzzle is the failure of the government to borrow on a larger scale from the banks, which would increase the rate of money growth.

Canada

- Money, output and inflation



Canada is often regarded as a monetary satellite of the USA and therefore of little interest in the assessment of global money trends. But this is not quite right, as Canadian interest rates and money growth rates differ from those in the USA, and Canada's GDP is the seventh highest in the OECD. Indeed, for much of the 1990s the Bank of Canada pursued a more rigorous anti-inflation line than the Federal Reserve in the USA. This is evident from the chart which shows that broad money growth did not revive in the mid-1990s, in an obvious contrast with the USA. (See p. 6) At any rate, the situation changed abruptly in 1999, with broad money growth doubling from 4% a year to 8% a year. Share prices jumped by over 50% in the year to the third quarter 2000, which may be interpreted partly as a by-product of excess liquidity in the economy. The high money growth and this asset price strength will support Canadian demand, whatever happens in its large neighbour to the south.