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A reminder about the long run

Short-run shocks must not disturb long-run stability

Long-run relationship between money and national income, with link between broad money and asset prices

A relationship between the rates of increase in the quantity of money and nominal national income is one of the most reliable and important in macroeconomics. The great majority of studies find that in the long run the demand to hold money balance is a stable function of a small number of variables, notably national income. The long-run relationship between money and national income holds, despite many difficulties in understanding and interpreting the short-run linkages between money, asset prices and expenditure. The linkages must nevertheless involve broad measures of money, not narrow. In a modern economy, with its extensive array of capital assets and deep financial markets, it is thoroughly implausible that holdings of notes and coin (which make up most of narrow money) have any bearing on asset price determination.

In the last 30 years M4 has typically risen about 2 1/4% a year faster than nominal GDP,

Over the 55 years since the end of the Second World War broad money and nominal gross domestic product have increased at about the same annual rate of 9%. Since financial deregulation began in 1971 broad money, on the M4 measure, has increased somewhat faster - about 2 ¼% a year - than nominal GDP. If the post-1971 pattern were assumed likely to persist, the annual growth rate of M4 consistent with 2 ½% retail inflation would be about 7% - 7 ½%. (The logic here is simple. The trend rate of nominal GDP growth in real terms is usually put at 2 ¼% - 2 ½% a year. With inflation targeted at 2 ½%, the acceptable annual rate of increase in nominal GDP is about 5%. The adjustment for the assumed rise in the ratio of money to GDP is 2 ¼% a year, giving a money growth rate consistent with the target inflation figure of 7% - 7 ½%.)

which implies that M4 growth above 7 1/2% a year is too high,

On this basis the Bank of England ought to worry about any money growth figure much above 7 ½% a year. In the year to September M4 rose by 8.0%; in the three months to September the annualized growth rate was 11.0%. On the face of it, the Bank should at least acknowledge that money growth is too high. But the clear message from the Monetary Policy Committee's *Minutes* is that most of its members do not care about money supply data. Indeed, a wide range of other publications from the Bank of England imply that the overwhelming majority of its officials find the subject difficult and tiresome, even when they think it relevant to the task of maintaining low inflation. (The Bank of England is unlike the European Central Bank in this respect.) At current interest rates mortgage credit is buoyant, while the newspapers are full of schemes and projects which would require extra bank credit. (For example, the offers for BT's infrastructure would involve huge bank borrowings.) The banks are able to expand their balance sheets, including their deposit liabilities, at close to double digit annual rates. Various topical preoccupations (Afghanistan, anthrax) will have some effect on demand and output in the UK over the next few quarters, but policy-makers have to be reminded about the economy's long-run behaviour. Broad money growth rates of 8% or more cannot be reconciled indefinitely with retail inflation of 2 ½%.

but Bank of England appears not to care about this

Professor Tim Congdon 30th October 2001

Summary of paper on

"The consumer boom cannot last"

Purpose of the paper

In the six years to 2001 UK consumption has grown by over 3 1/2% in every year and on average by about 4% a year. This has been well above the concurrent growth in national output. The paper asks whether such rapid consumption growth can continue.

Main points

- **In the long run the growth of UK consumption has been almost identical to the growth of output. Thus, in the 52 years 1949 to 2000 inclusive household consumption rose in real terms at a compound annual rate of 2.61%, barely distinguishable from the 2.55%-a-year compound increase in gross domestic product. (See p. 6.)**

- **Also in the long run the growth rates of the UK's exports and imports have been very similar. (See p. 8.)**

- **But the late 1990s departed from these patterns. The growth of consumption outpaced that of gross domestic product, while from 1995 to 2000 import volume advanced at a compound annual rate of 9.7%, well ahead of the 7.0% figure recorded by exports. (See p. 9.)**

- **The question arises, "how has the UK been able to afford such a big gap between its extra production and its extra consumption?". Part of the answer is that the current account deficit has widened. Indeed, the net export imbalance - expressed as a %age of GDP and in terms of constant 1995 prices - is wider now than ever before. (See p. 8.)**

- **But the widening of the current account measure of the UK's external payments has been much less severe than that of the net export imbalance. Investment income has been surprisingly buoyant, while the relative price of imports and exports ("the terms of trade") has moved remarkably in the UK's favour in recent years.**

- **The favourable terms-of-trade shift is to be explained partly by commodity price developments, partly by a move upmarket (towards more specialised products) by UK exporters and partly by a boom in the UK's international service industries.**

- **The consumption boom cannot last. A two-year period of annual consumption growth of 1% - 1 1/4% or a three-year period of consumption growth of 1 1/2% to 1 3/4% is needed eventually.**

This paper was written by Professor Tim Congdon.

The consumer boom cannot last

International developments have helped UK consumption and New Labour

Late 1990s a remarkable period for consumption growth

Household consumption rose in real terms by more than 3 1/2% in every year from 1996 to 2000. Another rise of about 4% will almost certainly be recorded in 2001. The UK has never previously achieved a six-year period with consumption growing at an annual rate above 3 1/2%. At the last general election Mr. Blair could, without any distortion of the facts, have recalled Macmillan's famous boast ahead of the 1959 general election and said "you've never had it so good". Despite the never-ending newspaper headlines about a recession - actual, potential, threatened or imaginary - the British people have enjoyed a big increase in their living standards since 1995. In rough terms their consumption has gone up by about a quarter in little more than half a decade. By any historical yardstick, this has been a remarkable period.

Consumption growth not matched by higher output

However, the evidence on the UK's underlying growth performance in recent years is mixed. Despite Mr. Gordon Brown's concern about an alleged shortfall of the level of productivity in the UK beneath that in other industrial economies, the growth of productivity has been mediocre since the mid-1990s. As the consumption boom began in early 1996, one period for comparison is the five years from the second quarter (Q2) of 1996 to Q2 2001. The official data show that output per job in the whole economy advanced by 1.5 % a year, somewhat beneath the generally assumed long-run norm of 2 1/4 % a year. (In the period more precisely under New Labour, from mid-1997 onwards, the figure was 1.6% a year.) There is certainly no evidence here of any supply-side miracle.

Long-run equivalence of consumption and output growth disturbed in late 1990s

But in the long run output and consumption must be related. Over the whole period since national accounts were first prepared in their modern form in 1948, the UK's gross domestic product has increased on average by 2.55% a year, while its consumption has increased by 2.61% a year. (See the chart on p. 6.) But since the end of 1995 consumption has grown by about a quarter whereas output is up by only 16%. How has the UK managed to have such a spectacular consumption boom against the backdrop of rather indifferent output growth? If there was a miracle in the late 1990s, it was that the British people were able to increase spending on themselves so much more than they increased their production. Why was so special about the late 1990s that this became possible? Why have the six years since 1995 been so different from the preceding 45 years?

Big jump in imports explains discrepancy between consumption and output growth

The gap between consumption and output was filled mostly by imports. If one way of measuring exports and imports is adopted, imports advanced in real terms by 9.7% a year from 1995 to 2000, outpacing exports which increased by 7.0% a year. Indeed, according to this method - which uses national accounts data and presents them in constant prices - the consumption boom was made possible by a plunge into the red on the UK's external accounts. The excess of imports over exports increased from under 1/2% of GDPin 1995 to roughly 5% of GDP in 2001. This change in net exports goes far to match the divergence between consumption and output.

On one measure UK's external deficit now is highest, relative to GDP, in post-war history

Unfortunately, the implication is that the UK's external payments are in trouble. The charts on p. 8 and p. 9 appear to show a horror story. They demonstrate that the excess of imports over exports in 2001 (again, on a constant price national accounts basis) was the highest as a share of GDP in the post-war period. The slide into deficit may have slowed a little in recent quarters, but it has certainly not reversed. The events of 11th September are likely to aggravate the deterioration in the export/import outlook. As the UK is a large and important exporter of aerospace products, it will be hit disproportionately by the slump in air travel.

But there are problems of measurement

How much should UK policy-makers worry about the scale of the deficit which has now emerged? The answer, as so often in economics, is that it largely depends on definitions. The analytical difficulty is that there is more than one way to measure the external deficit and assess international payments. The current account of the UK's balance of payments is perhaps the most familiar indicator of the external position. It is also one of the most useful because it corresponds to the net increase in the UK's external indebtedness. But it differs from the net export balance in the national accounts - which has been the focus of the discussion so far - in two significant ways.

Need to allow for investment income

First, the current account is defined as the sum of the trade gap in goods and services, the balance on investment income and net transfers. Investment income is included in the current account, but does not affect net exports in the national accounts. As it happens, the UK has been blessed in recent years by strong investment returns on its overseas assets. In fact, these returns have been so good that the UK receives substantial net amounts of investment income even though its external liabilities are greater than its external assets!

and, more important, for improvement in the terms of trade,

Secondly, and more important, the trade gap registered in the current account reflects actual prices and payments. Unlike the export and import figures that appear in the national accounts, they are not doctored to be made consistent with "income equals output equals expenditure" identities and with a particular price basis. In the late 1990s the trade gap in the current account could therefore be much narrower than the net export imbalance "in constant 1995 prices", if the price of exports had risen relative to the price of imports since 1995 or - in economists' jargon - if "the terms of trade had improved". Some crucial information on this topic is set out on pp. 10 - 11. The chart on p. 10 compares the balance of trade, as measured in the current account, with the net export balance (i.e., exports minus imports) in constant 1995 prices, as measured in the national accounts. Both are shown as a %age share of GDP. The two series do move together, as they ought to do, but from time to time there are quite marked divergences. The divergences are mostly attributable to terms-of-trade changes. The chart on p. 11 describes these divergences and delivers an obvious message. Whereas movements in the terms of trade were relatively unimportant in the 15 years to 1970 and in the 15 years to 1995, they were significantly adverse in the mid-1970s and highly favourable in the late 1990s.

which was marked in the late 1990s

Better terms of trade partly due to lower commodity prices in weak world economy

The explanation for the drastic deterioration in the terms of trade between 1972 and 1974 was simple. The world boom at that time drove up the price of the commodities that the UK imported, particularly oil. The UK had to transfer resources into the balance of payments in order to pay for much more expensive energy imports. Consumption was lower in 1977 than in 1973, enabling the resource transfer to take place. The explanation for the striking improvement in the terms of trade between 1995 and 2000 is less clear. One hypothesis might be that the sluggish world economy in the late 1990s cut the price of the commodities that the UK imports. Consumption could be much higher in 2001 than in 1995, without endangering international solvency.

but may also be due to upgrading of UK *goods* exports

This may be much of the story, but it cannot be all of it. The world economy had phases of quite high growth in the late 1990s, with the American economy in particular characterised by boom conditions until the second half of 2000. Official estimates of the UK's terms of trade *in goods* are derived from balance-of-payment statistics, separately from the export and import data in the national accounts. Again, a comparison of balance-of-payment statistics and national accounts data is interesting. The official terms of trade series *for goods* did improve between 1995 and 2000, but far less than implied by the difference between the nominal and constant 1995 price export and import series in the national accounts. One possibility here is that the "quality" of UK exports has risen. Quality is not to be understood merely in terms of more refined and elaborate products, but also as a move away from bulk commodities (plastic, steel, aluminium) towards specialised, high-value-added products with distinctive brand names (mobile phones, aero-engines).

and boom in internationally-traded *services*

The national accounts figures also show exports and imports *of services* in both nominal and constant 1995 prices. The data for recent years are fascinating and prompt a number of questions. Exports of services are estimated to have risen, in terms of money value, by 55.2% between 1995 and 2000 and, in terms of 1995 prices, by 49.5%. Evidently, their price *increased*. By contrast, imports of services are estimated to have risen, in terms of money value, by 52.0% between 1995 and 2000 and, in terms of 1995 prices, by 61.5%. So their price *fell*. This relative price movement - which is understandable given the extraordinary boom in bankers', lawyers' and accountants' incomes from international business in the late 1990s - amounted to about 10% on roughly 6% of GDP. It may have added about 1/2% - 3/4% to the UK's spending power.

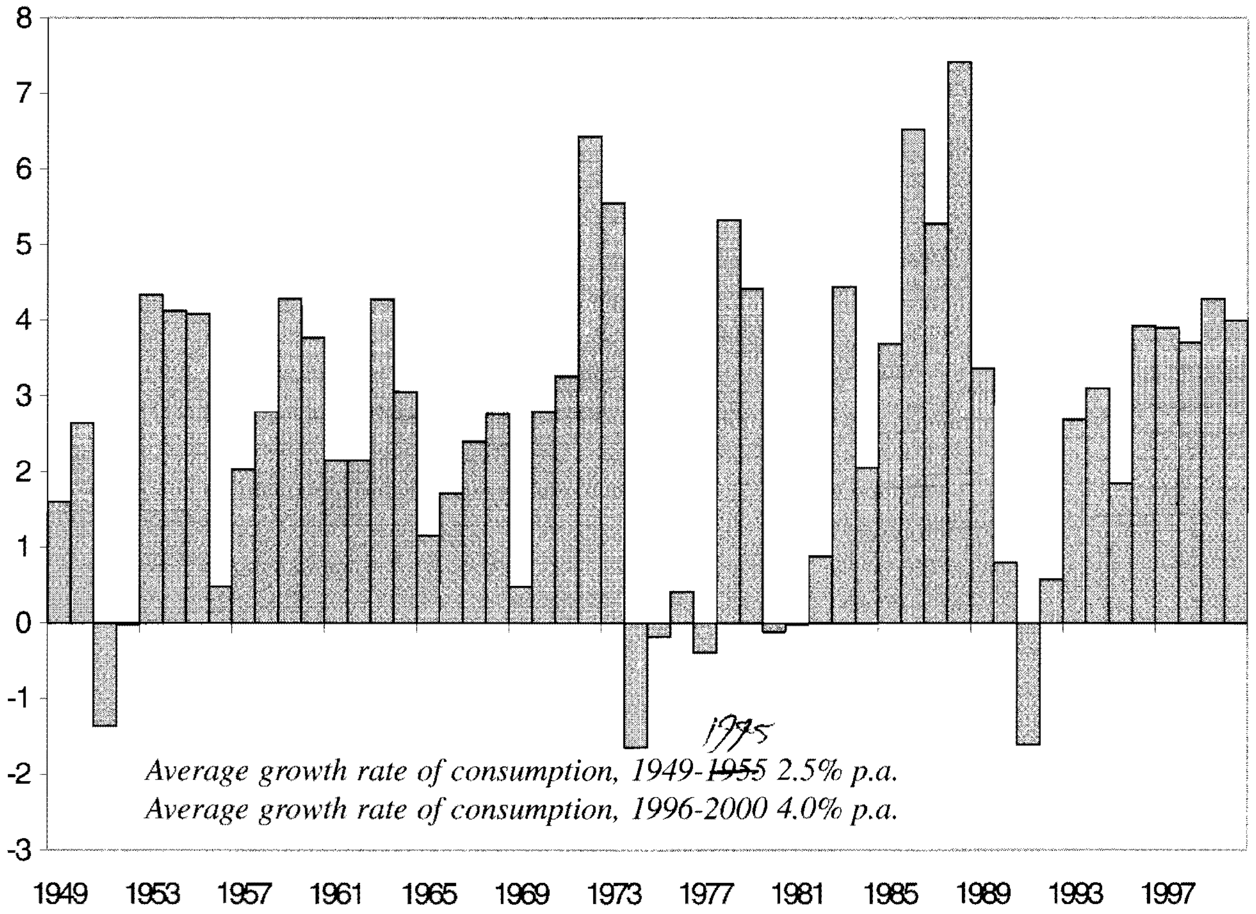
But terms-of-trade improvement may reverse, requiring consumption to grow more slowly than output

Neither the buoyancy of investment income nor the shift towards high-value-added products and services are certain to persist in future. As already discussed, the historical experience is that periods of favourable terms-of-trade developments are followed by periods in which the terms of trade move adversely. In the very long run the growth of consumption is extremely close to the growth of output. The conclusion must be that over the next few years UK consumption will grow more slowly than national output. The consumption boom of the 1995 -2001 period cannot last. The timing of the slowdown is uncertain, but it will probably coincide with a weakening of the pound on the foreign exchanges.

Consumption growth

The long-run picture

Chart is of annual data in constant 1995 prices. It shows % growth rate of "consumption by households" from 1949 to 2000.

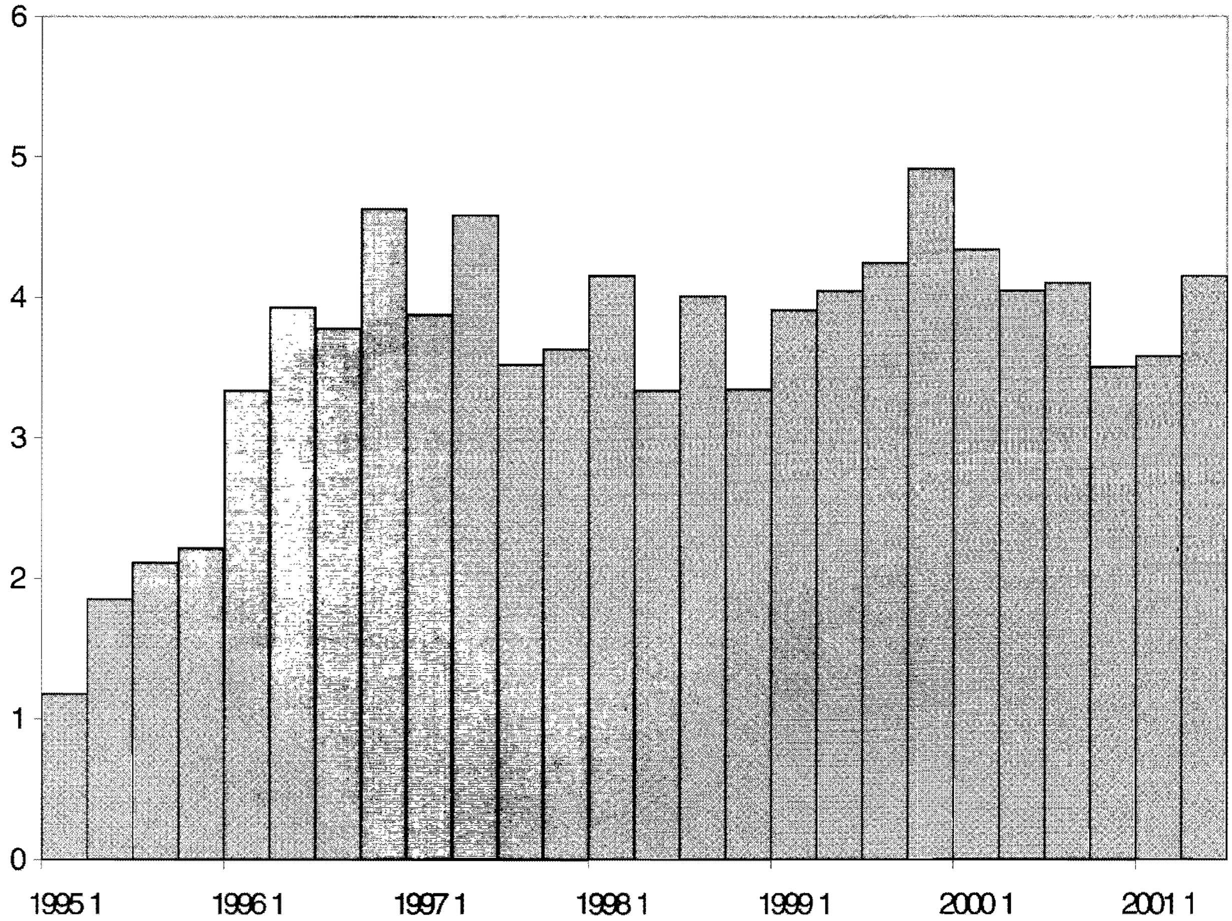


Source: National Statistics

In the very long run the growth of consumption ought to be related to the growth of output. Admittedly, this relationship might not hold in an economy subject to major structural change because of demographic or technological upheaval, but over the last 50 years the UK has been a very stable society. It is therefore reassuring that the average annual growth rate of consumption in the 52 years 1949 to 2000 inclusive was 2.61%, virtually identical with the average annual growth rate of output which was 2.55%. (The figures have to be expressed to two decimal places to differentiate them.) However, quite long sequences of above- and beneath-normal consumption growth have been recorded. Logically, a few years of above-normal consumption growth - as in the early 1970s and late 1980s - are followed by a few years of beneath-normal consumption growth - as in the mid-1970s and the early 1990s. Also logically, the average annual consumption increase of 4.0% in the five years 1996 - 2000 ought to give way to several years of low consumption growth.

Consumption still buoyant in recent quarters

Chart is of quarterly data in constant 1995 prices. It shows % growth rate of household consumption compared with the same quarter in the previous year, from Q1 1995 to Q2 2001.



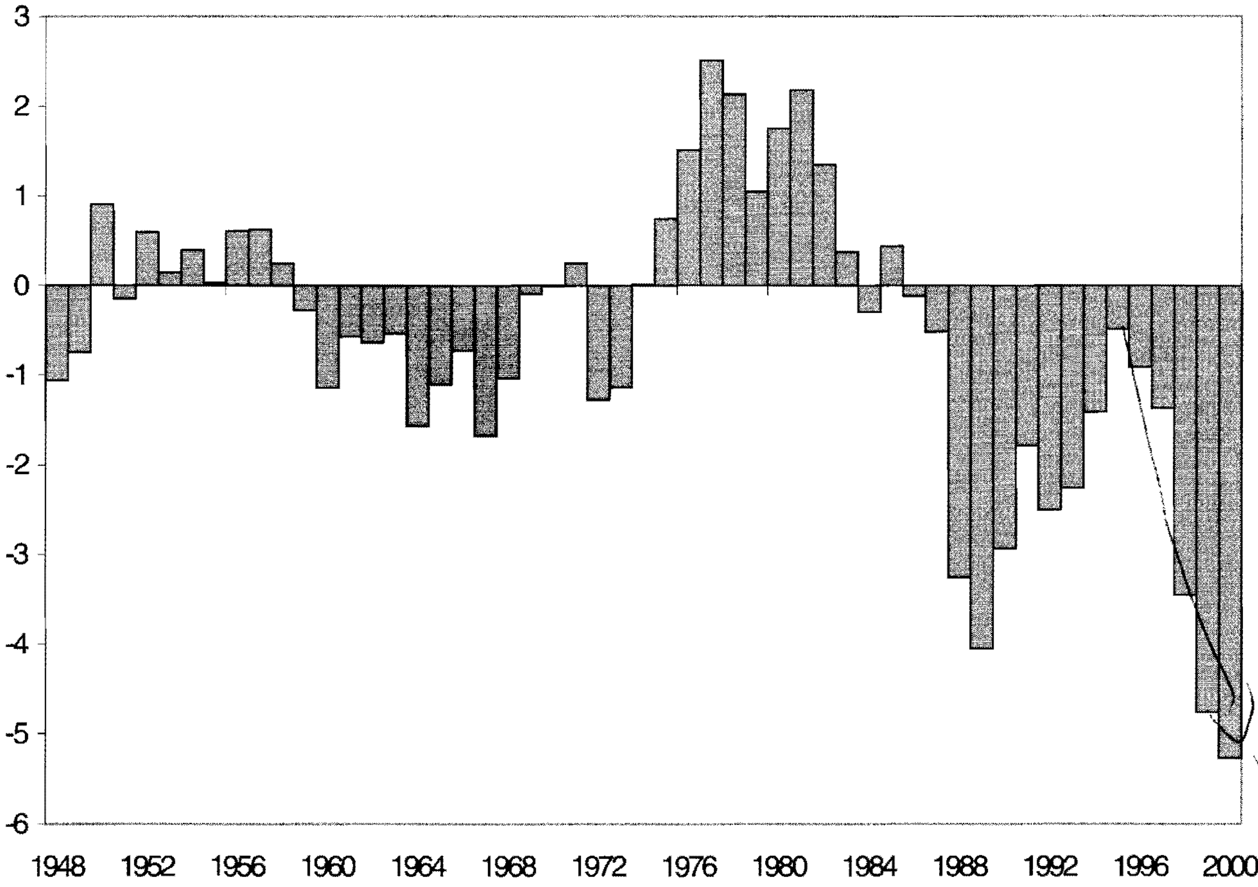
Source: National Statistics

A reasonable expectation after the consumption buoyancy of 1996 - 2000 might be a year of retrenchment in 2001. But nothing of the sort has been happening. It seems likely that the volume of consumption will again grow by about 4% this year. The strength of retail spending challenges the view that the plight of manufacturing, badly hit by the over-valued pound and the weak world economy, justifies a fall in interest rates. A salient feature is that non-food consumption is more volatile than food consumption. As a result, the buoyancy of consumption overall in the last six years has been associated with exceptional rises in non-food consumption. In fact, over the six years to September 2001 the volume of non-food retail sales grew at a compound annual rate of 5.7%. (Food retail sales grew at a compound annual rate of 2.7%.) This 5.7% figure is remarkable, probably unmatched over any other six-year period in British history.

The UK's export/import balance

Exports and imports grew together for most of post-war period ....

Charts show exports minus imports (i.e., "net exports") expressed as a % share of GDP. National accounts concepts of exports and imports of goods and services are used. Data are annual and in constant 1995 prices.

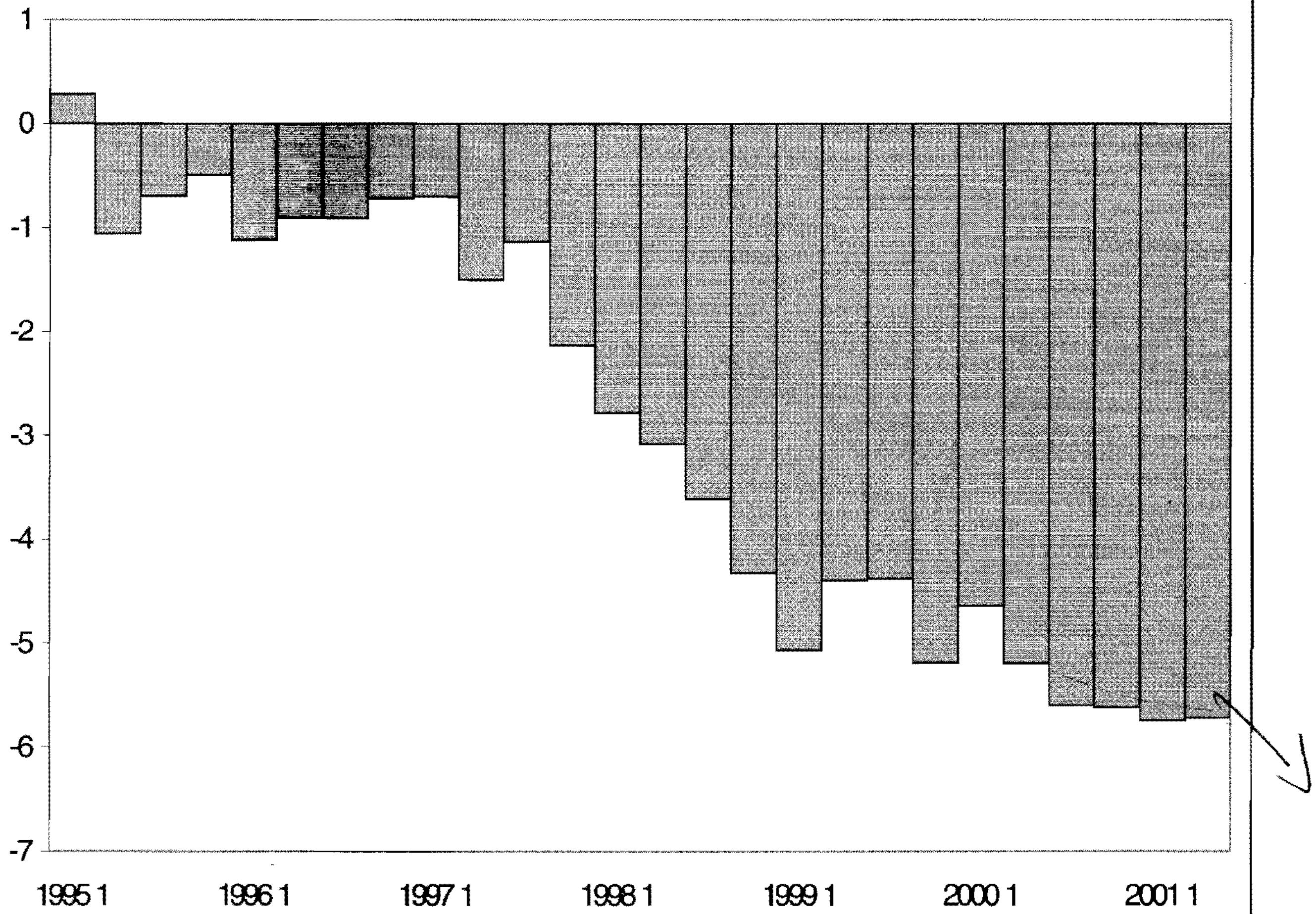


Source: National Statistics

At first glance, the chart on this page is a horror story. It appears to show that the imbalance between the UK's exports and imports is greater than at any time in the post-war period, implying that the UK is "living beyond its means". But the statistics need a little explanation (see the main text), as they can be put together in several ways. The numbers must not be confused with the current account, which is also influenced by investment income. As they stand, the figures show that in the period of almost 50 years from the late 1940s until the mid-1990s exports and imports grew at roughly the same rate. There were extended periods when imports outpaced exports and when exports outpaced imports, but in the very long run these cancelled out. To be precise, in the 47 years to 1995 the volume of exports of goods and services expanded at a compound annual rate of 4.4% and that of imports increased at a compound annual rate of 4.3%. Further, periods of net export contraction (the 1960s) were followed by periods of net export improvement (the mid- and late 1970s).

.... but imports have outpaced exports since 1995

Chart shows net exports as a % share of GDP. As on p. 8, data are in constant 1995 prices and relate to Q1 1995 to Q2 2001. But - unlike those on p. 8 - the data are quarterly.



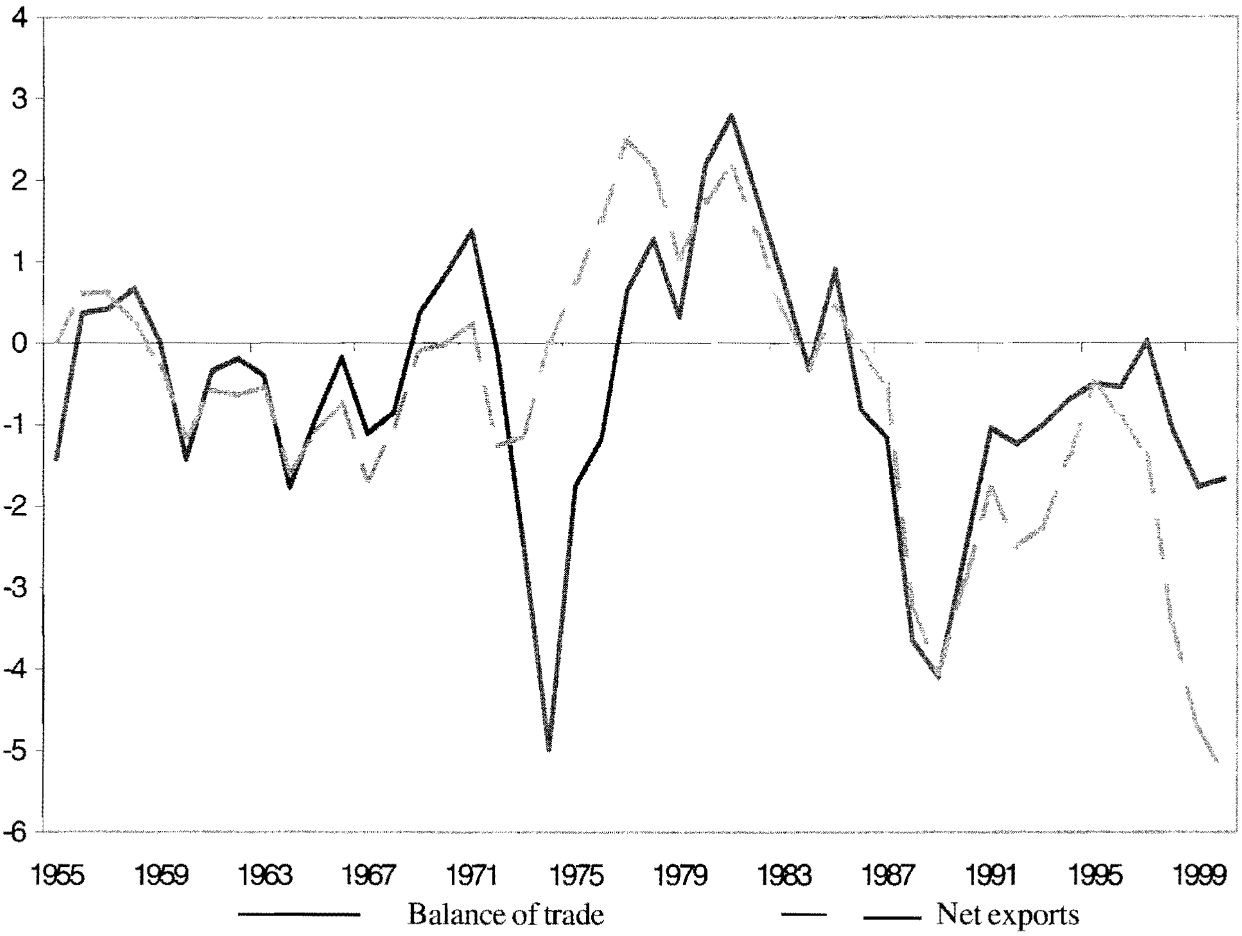
Source: National Statistics

From 1995 to 2000 the volume of exports rose at a compound annual rate of 7.0%, while the volume of imports soared at a compound annual rate of 9.7%. The growth rates of both trade measures and the extent of the divergence between them are unprecedented. The UK has participated fully in the process of globalisation, while its external payments have lurched into the red. Undoubtedly important here was the sharp appreciation of sterling in late 1996. The effective exchange rate index (calculated by the Bank of England, 1990 = 100) rose from a low of 82.9 in December 1995 to 84 - 86 in the spring of 1996, and then soared from 84.7 in August 1996 to 104.5 in July 1997. It has fluctuated since then, but on average stayed close to its mid-1997 level. In effect, a revaluation of 20% - 25% has been sustained, dampening inflation and allowing domestic demand to rise faster than output, but also hurting exports. If the revaluation of late 1996 and early 1997 were reversed, domestic demand would have to rise more slowly than output, while exports motored ahead strongly.

Two names for the same thing?

Big divergencs between balance-of-payments concepts

Chart shows 1. Balance of trade in goods and services as % of nominal GDP in market prices, where the balance of trade is measured on a balance-of-payments basis, and 2. Net exports as % of GDP in constant 1995 prices, on a national accounts basis.

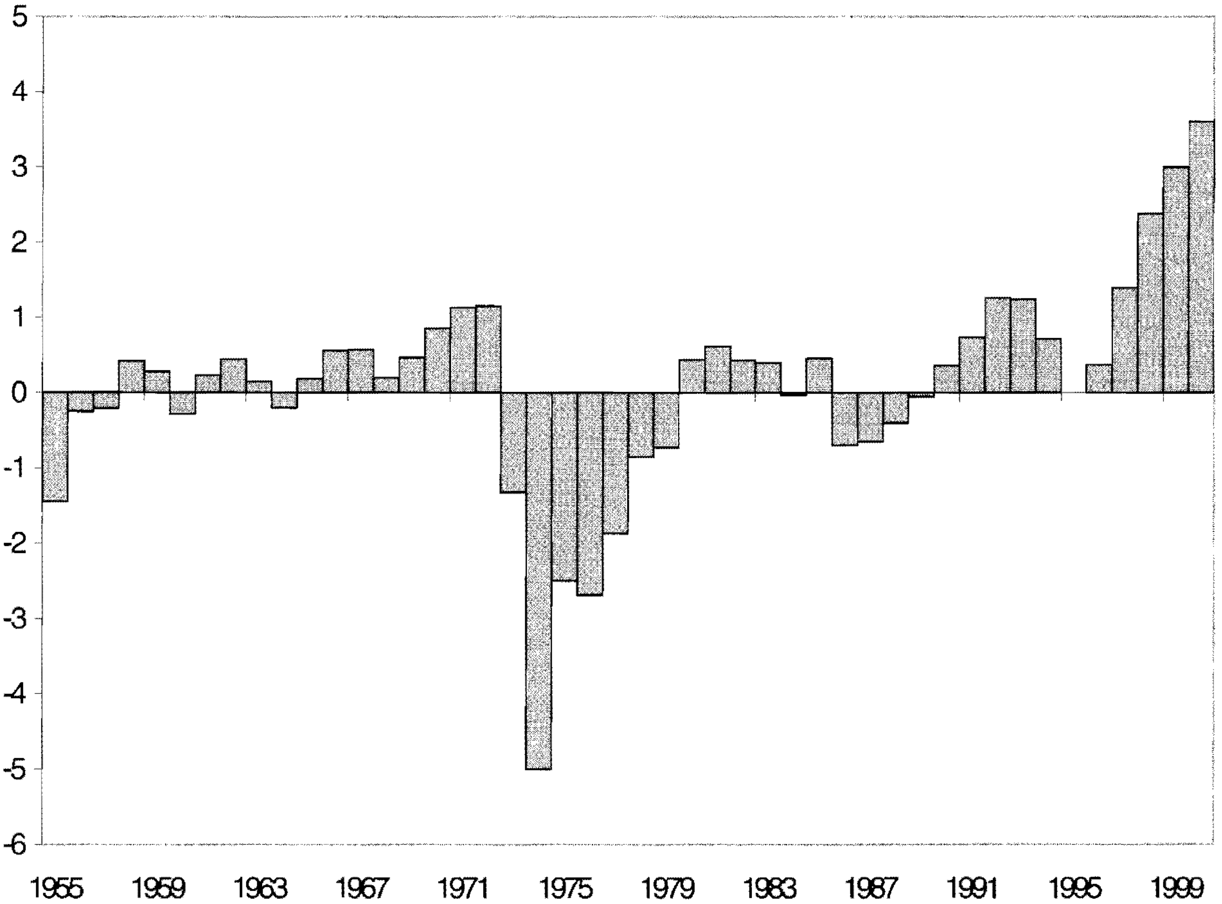


Ostensibly this chart is puzzling. Both lines relate to essentially the same variable, the trade gap in goods and services as a proportion of GDP. But the concepts are not identical. The darker line refers to the difference between exports and imports "on a balance-of-payments basis", which corresponds closely to actual payments for goods and services. One function of this trade gap measure is to reconcile official estimates of the current account and capital account balances. The lighter line refers to exports and imports "on a national accounts basis". Exports and imports are of course part of GDP, and the relevant information has to be processed so that the figures for exports and imports in the national accounts are estimated in the same way as other components, such as consumption and capital formation. The two concepts ought to move together and they do. In fact, the average divergence between them over the whole period of almost half a century is negligible. But in particular years the divergence can be quite big.

Lucky New Labour

UK blessed by favourable terms of trade in late 1990s

Chart shows difference between balance of trade in goods and services as % of nominal GDP and net exports as % of GDP, in constant 1995 prices. Difference between two series largely reflects relative prices of exports and imports.

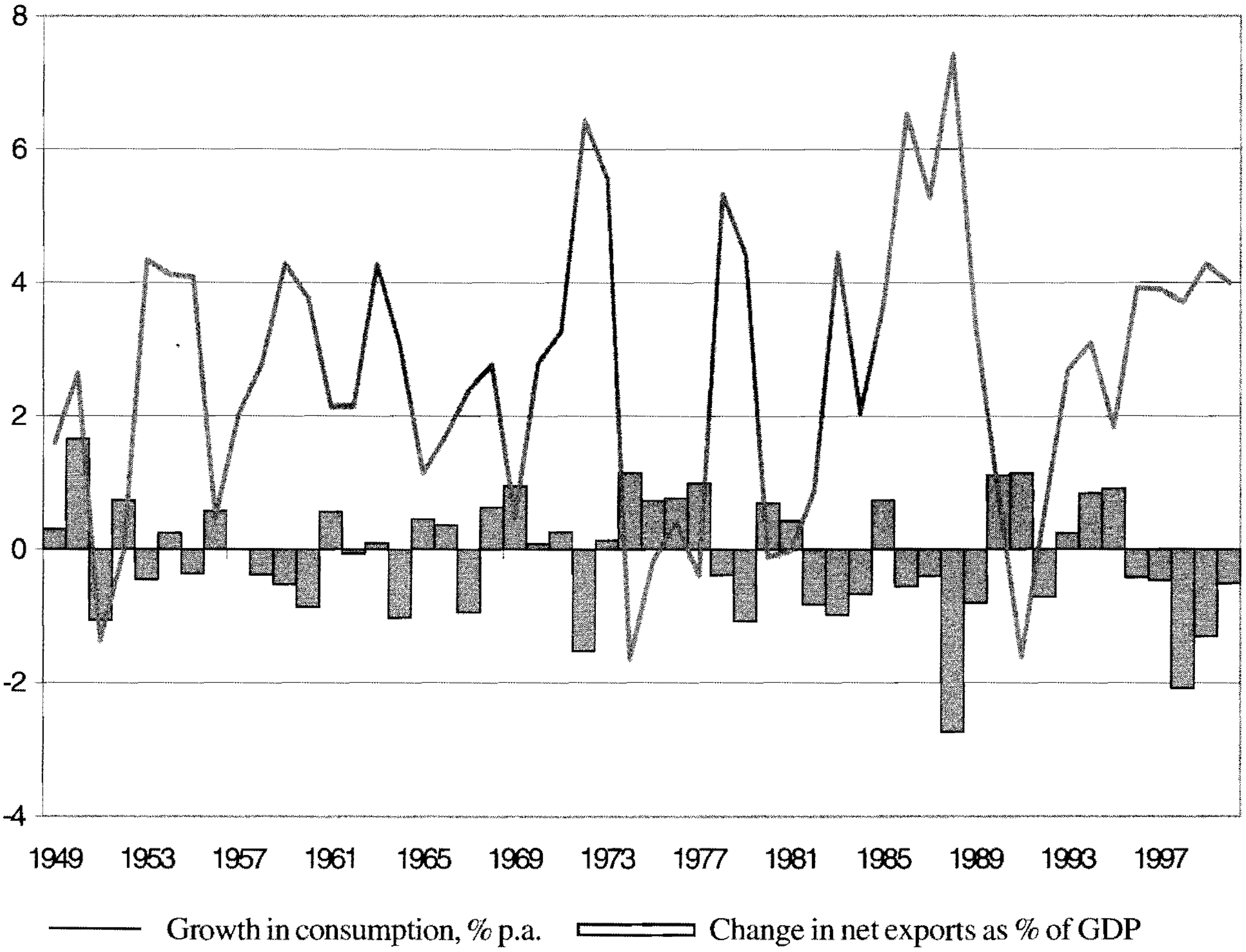


The chart shows the divergences between the two payments deficit concepts presented on p. 10. Broadly speaking, a move from a negative to a positive divergence is due to a favourable movement in the UK's terms of trade, with the price level of exports rising faster than that of imports. The central point of the chart is clear. Whereas the oil price increases and sterling devaluations of 1972 - 74 caused an adverse shift in the terms of the trade in the 1970s, movements in world commodity prices and the sterling revaluation of mid-1996 to mid-1997 have resulted in a favourable swing in the late 1990s. At present the UK's living standards are helped to a quite exceptional extent by these developments in its external economic relations. This bonus is important in understanding the popularity of Mr. Blair's Government. (Note that the improvement of the terms of trade in goods, as measured by balance-of-payments data, between 1995 and 2000 was half that implied by price indices of exports and imports in the national accounts.)

How much must consumption be restrained?

Consumption may keep on growing, but at under 2% a year

Chart shows change in net exports as % of GDP and in consumption, both on a national accounts basis and in constant 1995 prices, from 1949 to 2000. The two variables are *inversely* related.



History shows that favourable terms-of-trade swings are offset by later unfavourable movements. If the pattern is repeated in the next few years, the UK would have to boost its exports sharply and to constrain its imports. The implied jump in net exports would almost certainly be associated with beneath-trend growth in consumption. The chart shows that years of positive net exports tended to be years of slow consumption growth and vice versa. If it is assumed (reasonably) that the UK's "underlying external deficit" is 3% of GDP and (also reasonably) that it needs to be reduced to 1% of GDP, the 2% change in net exports (as a share of GDP) might be associated with a period in which consumption grows 2% - 3% less than the long-run trend of about 2 1/2%. If the period lasted two years, that would signal consumption growth of 1% - 1 1/4% a year; in the period lasted three years, the annual consumption growth would be 1 1/2% - 1 3/4%. These numbers are guesses and timing is uncertain, but the coming phase of austerity would resemble previous periods of consumption restraint.