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Puzzling

No slowdown ahead at current interest rates

Central bank governors usually maintain silence on prices in asset markets

As a general rule central bank governors do not comment on the prices set in financial markets. If they are wrong, they are criticised; if they are right, no one thanks them because they ought to know everything anyway. Sir Edward George, the Governor of the Bank of England, therefore deserves some sort of bravery award for recent comments on the money market yield curve. In a speech to the Euromoney Bond Investors' Congress on 19th February he cautioned his audience on "placing too much weight on the steepness of the [sterling] interest rates futures curve as an indicator of the likely course of short-term interest rates". Taken in conjunction with other public statements, a fair interpretation is that the Governor believes the UK economy will slow down at interest rates similar to those now prevailing. He thinks financial markets are too pessimistic about UK interest rates.

But Sir Edward George has said that the interest rate futures curve is too pessimistic

The Bank of England has done a good job in the last few years, but that does not mean it knows how to forecast the economy. The Governor's remarks are puzzling. The remarkable feature of the British economy in late 2001 and early 2002 was the buoyancy of domestic demand against a difficult and gloomy international background. The international background is now improving, with the latest survey from the Confederation of British Industry showing a sharp jump in companies' output expectations between December (minus 28) and March (plus 2). (The CBI's manufacturing members are heavily involved in international trade.) A slowdown is in prospect therefore only if the growth of domestic demand moderates. But this is thoroughly implausible, with interest rates at their lowest level for almost 40 years and the Government committed to large increases in its own expenditure. Reliable advance indicators - such as mortgage approvals data, house price movements and car registrations - point to continued above-trend growth in household expenditure.

Sir Edward's remarks were puzzling and could well be wrong

The reasoning behind Bank of England policy moves is transparent by the standard of other central banks, but - quite rightly - this does not mean that all the thinking going on inside the institution is known to the outside world. Perhaps Sir Edrward has been told by his research staff that household debt is at its highest level relative to income ever and that consumers will retrench. This is an old mistake, which (along with the blunders in interpreting the money supply statistics) must carry a significant part of the blame for the Lawson boom. As explained in the February issue (on p. 5) of this *Review*, households' assets are eight times their debt and changes in the prices of these assets often overwhelm the effect on net wealth of the incurral or repayment of debt. Asset prices in turn are influenced by balance-sheet strength generally, including the adequacy of (broad) money holdings. Late 2001 and early 2002 has seen unusually high house price inflation and fairly stable equity markets after a rebound from the September 2001 lows. Households' net wealth is strong relative to their incomes at the same time that interest rates are at 40-year lows. This combination is a potent cocktail for buoyant spending. It was a puzzle that the Governor should say anything about the interest rate futures curve and even more of a puzzle that he should have made the remarks that he did.

Professor Tim Congdon **26th March 2002**

Summary of paper on

UK inflation outlook is deteriorating

Purpose of the paper

The consensus view is that rising inflation is not in prospect for 2002 and 2003. Most commentators, including the Bank of England, believe that UK inflation will remain comfortably below the 2.5% target over the next tewo years. The purpose of this paper, which follows the format of *Monthly Economic Reviews* in March 1992, June 1993, April 1994, March 1995, March 1996, March 1997, March 1998 and March 2000 is to put forward the opposing view.

Main points

* **The UK's inflation performance since 1993 has been excellent by the standards of the previous 30 years. The independent Bank of England has a good record so far.**

* **The continuing strength of the pound has kept goods price inflation subdued, but the inflationary risk of a steep fall in sterling remains a concern. Meanwhile, domestically-generated inflation pressures are rising.**

* **A number of adverse base effects, including higher petrol prices, Budget excise duty increases and large council tax hikes will impact on RPIX inflation in 2002. Underlying inflation could exceed 3% before the end of the 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 6.2%. But lending, the major determinant of money growth, is rising more quickly despite a brief hiatus in Q4. At current interest rates credit growth could run at double-digit rates in 2002.**

* **The level of output is close to or a shade above trend. Above-trend GDP growth would lead to a "positive output gap" (i.e., the excess of actual over potential output). In these circumstances, higher inflation in 2002 is likely as supply-side bottlenecks emerge.**

This paper was written by Martin McMahon and Stewart Robertson.

UK inflation outlook is deteriorating

Underlying inflation could exceed 3% by the end of 2002

Present analysis similar to previous ones

A research paper of March 2000 entitled "Inflation squall ahead?" concluded that RPIX inflation (i.e., the annual increase in the RPI excluding mortgage interest payments) would remain under control until at least the middle of 2001, but that there was a significant risk of it moving above target (2.5%) thereafter. In the event, RPIX inflation reached 2.6% in August 2001 and hit that level again in January 2002. It has since dipped a little and the broad consensus (and a view that is shared by the Bank of England) is that it will remain below target over the next two years.

Unfavourable influences on future inflation, especially from petrol prices

This optimism appears misplaced. A series of unfavourable base effects will hit the RPI index throughout 2002. The most significant is petrol prices, which fell steadily in 2001. Oil prices currently average between $24 and $25 a barrel compared with a recent low of $17 in late 2001. Pump prices have already drifted higher. If the oil price remains at least at current levels in 2002, further rises are possible. Even if petrol prices remained unchanged for the rest of the year, the base effect implies that RPIX inflation will be 0.5% higher by the end of the year. If excise duties rise in the April Budget, inflation will be boosted further.

"Core" inflation has risen steadily since the middle of 2000

The RPI index is always buffeted around by volatile influences such as petrol and foods prices, indirect taxes and interest rates. By excluding the most volatile components within the basket it is possible to construct a "core" index. One of the more worrying features of the last two years has been that the inflation rate of such a core index has risen from a little over 0.5% in mid-2000 to 2.5% in the year to February 2002. Retailers are now reporting that the strength of consumer spending is allowing them to push through increases in shops prices for the first time in over three years. With domestic demand likely to remain strong in 2002, this trend is set to continue.

UK economy close to trend, implying that rapid GDP growth will lead to higher inflation

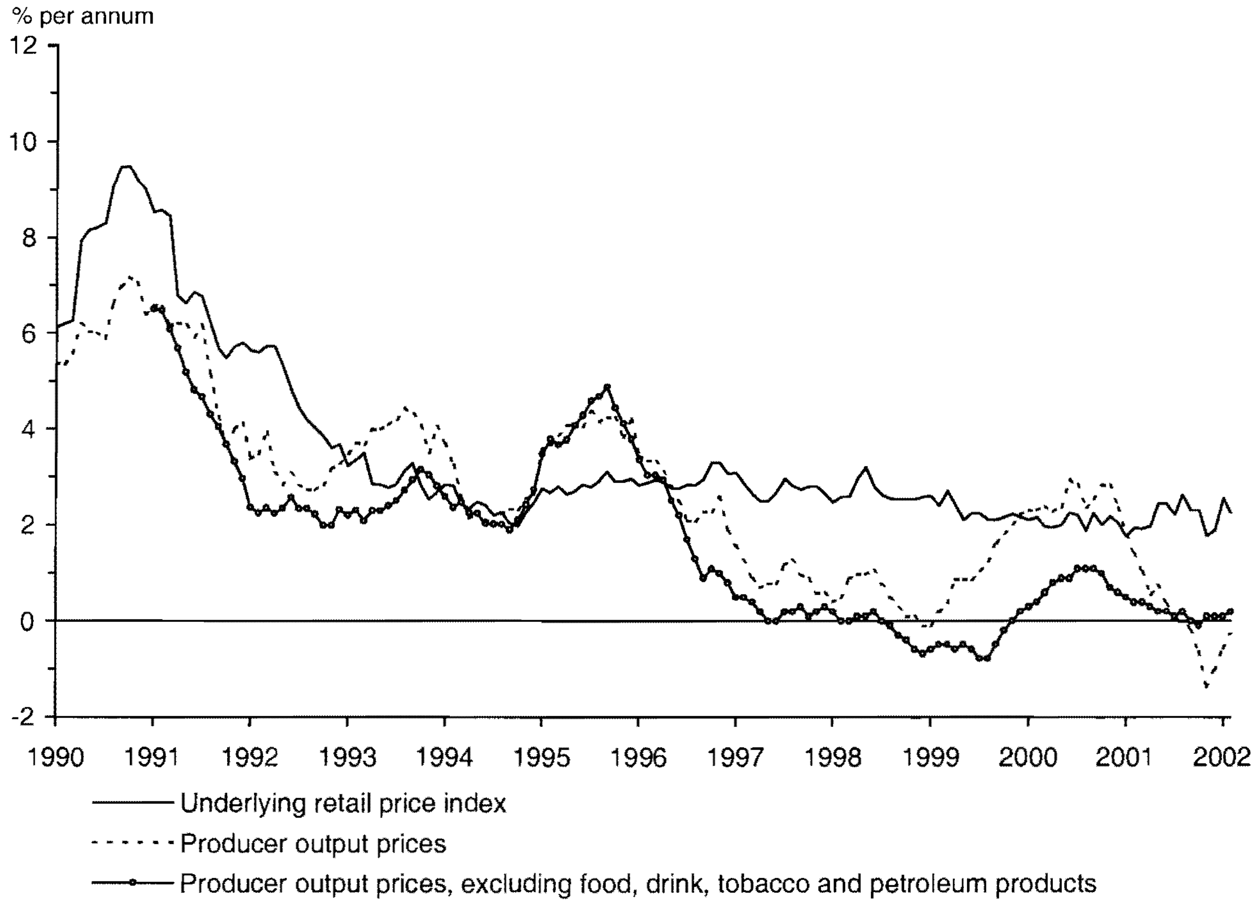
More fundamentally, UK output is probably at around its trend level at present. Unless growth in 2002 is constrained to the trend rate (usually considered to be 2.25% to 2.5% a year), inflationary pressures will begin to emerge more widely. Consensus opinion is indeed that GDP will grow by just 2% in 2002 and that inflation will be contained. But the lowest interest rates since the 1960s have fuelled a mortgage and housing boom, while rather high money growth (which could pick up further this year) argues for stronger - not weaker - GDP increases. Furthermore, the additional stimulus from higher public spending growth, which is already putting significant pressure on the labout market, is set to continue in 2002 and 2003.

RPIX inflation set to exceed 3% before the end of 2002

The most reasonable judgement is that annual RPIX inflation may remain satisfactory (i.e., close to target) until mid-year, but could be rising strongly in the second half of 2002. It could breach 3% before the end of the year and is unlikely to fall back until the economy is slowed through higher interest rates. The Bank of England's complacency over this inflation threat is unfortunate and will mar their otherwise good record in their first five years of operational independence.

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.

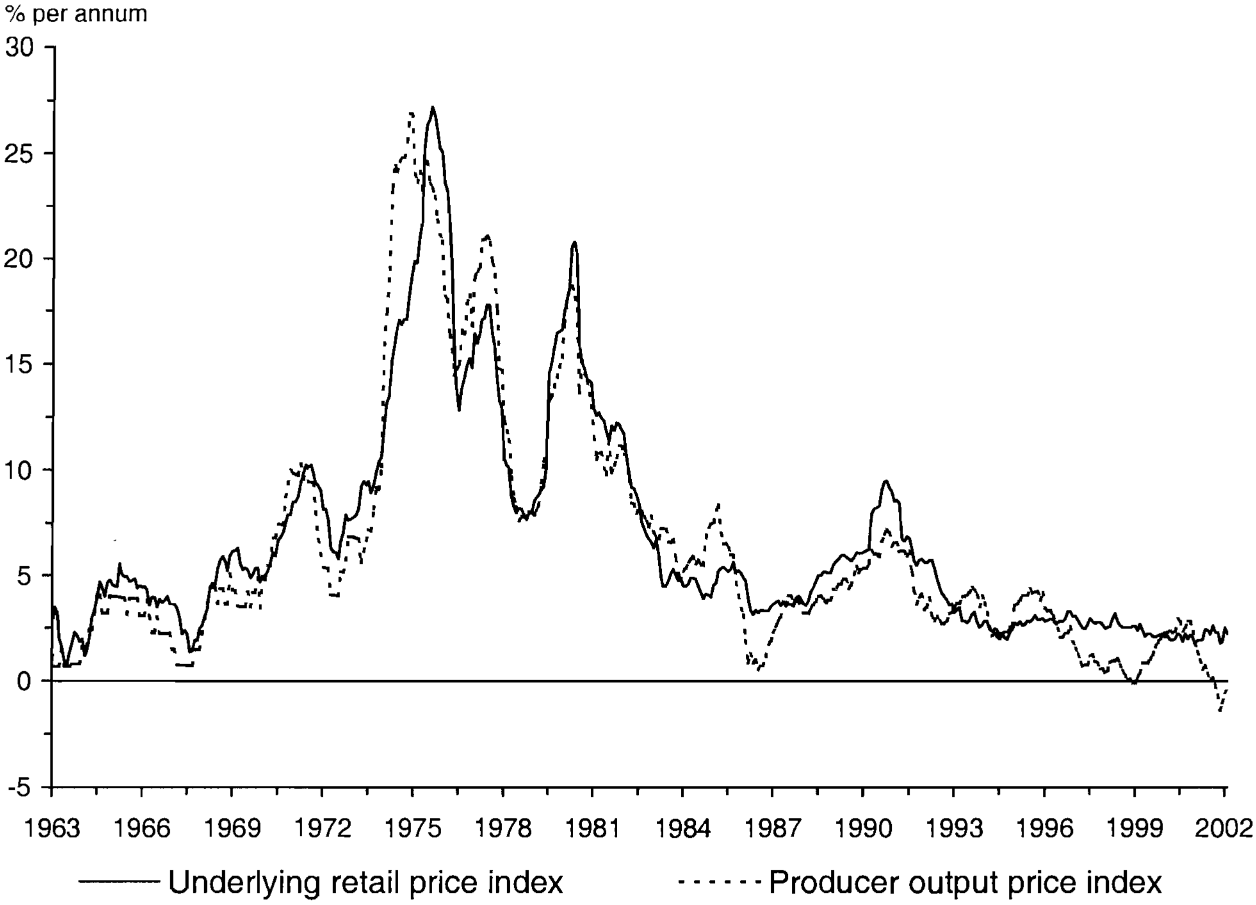


Source: ONS Economic Trends.

The Monetary Policy Committee (MPC) at the Bank of England does not believe that rising inflation is a threat over the next two years. The February *Inflation Report* projected that RPIX inflation (i.e., the annual increase in the retail price index excluding mortgage interest payments) would remain well below the 2.5% target between now and early 2004. But plummeting petrol prices have reduced inflation by 0.5% points over the last year. If fuel prices now stay constant, that will be added back to annual inflation by the end of 2002. Moreover, if the Chancellor does raise excise duties in next month's Budget, as seems likely, the inflation rate will receive a further boost. Further, the benefit from falling producer prices, which has been highly significant over the last two years, seems to be coming to an end. Both oil and other commodity prices have risen in early 2002, a trend that can only be supported by even a mild recovery in world growth.

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.

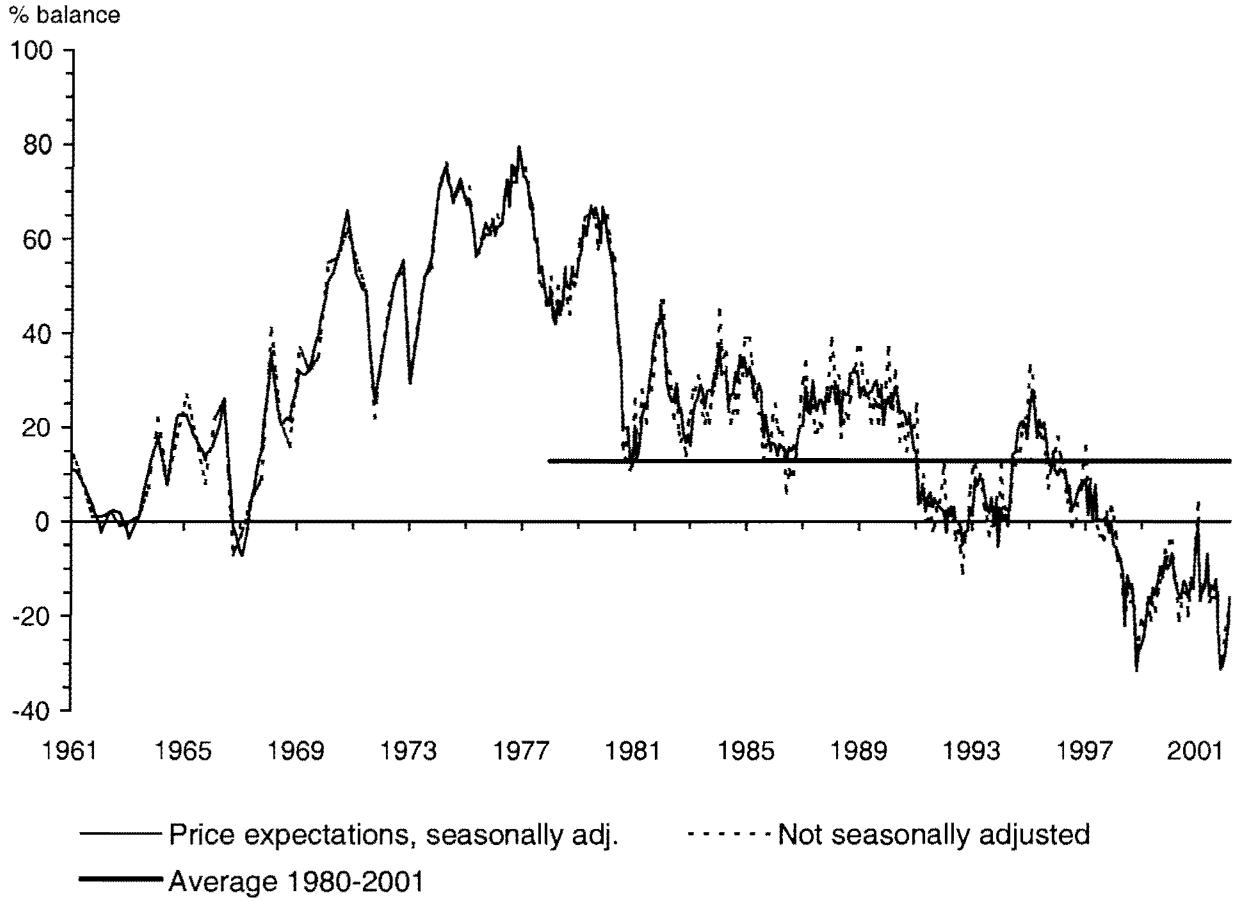


Source: ONS Economic Trends.

By the standards of the last 40 years, the UK's macro-economic performance over the last decade has been exceptionally good. National output has grown by 3% a year on average, while underlying inflation has remained between 1.8% and 3.5% (i.e., within the current guidelines of 1.5% to 3.5%). But 3% a year growth was only sustainable over such a long period because output in 1993 was well below trend. Almost all commentators would agree that, despite some imbalances, the UK economy is currently operating close to its trend level. A continuation of 3% annual growth in 2002 and beyond would therefore now begin to result in supply-side bottlenecks and rising inflationary pressure. Yet that is exactly what may be expected at current interest rates. A series of unfavourable base effects along with the likelihood of above trend domestic demand growth this year suggest that RPIX inflation could touch 3% later in 2002.

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.

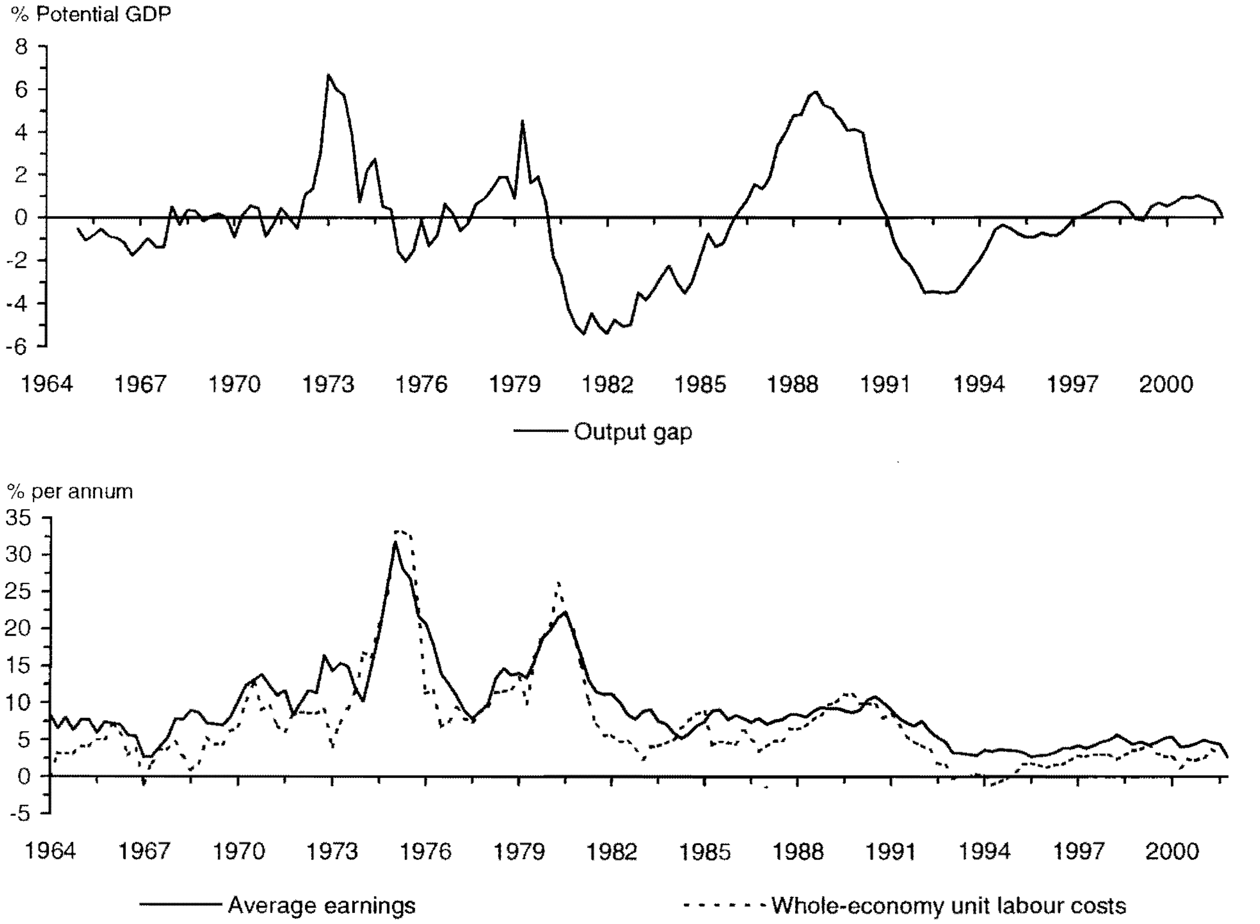


Source: CBI Monthly Trends Enquiry.

The divergence in inflation trends between traded goods and (generally non-traded) services in the UK continues. In the year to February goods prices rose by just 0.1%, while the average price of services increased by 4.5%. Since the pound's sharp appreciation in the second half of 1996 the pricing power of the UK manufacturing sector has been extremely limited. The message from the CBI's regular monthly survey is that there is little sign of this trend changing soon. The balance of firms intending to raise prices is still heavily negative, as it has been since late 1996, although it has recovered a little in recent months. Nevertheless, the inflationary risk from a significant fall in the value of sterling remains. Meanwhile, the sharp rise in services price inflation (from under 3% a year ago), arguably a better indication of domestically-generated inflationary pressures, is worrying.

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.

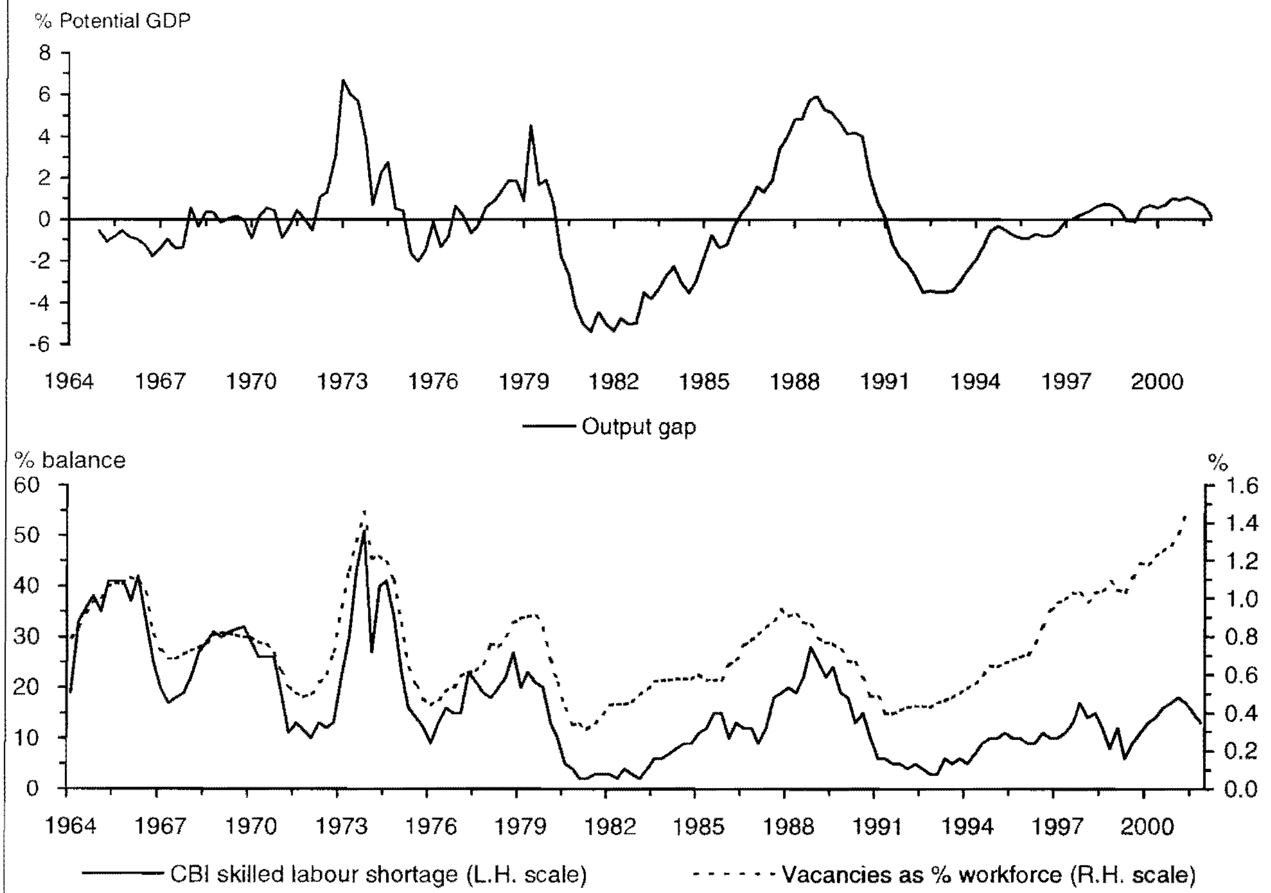


Sources: ONS Economic Trends *and Lombard Street Research calculations.*

Headline average earnings growth dropped to 2.7% in January, its lowest level since May 1995. True, this largely reflected slumping City bonus payments. But annual wage growth excluding bonuses also moderated, slipping from over 5% in much of 2001 to 4.2% by January 2002. Moreover, pay settlements data from the important New Year pay round suggest that wage pressures will remain subdued for some time. Both Industrial Relations Services (IRS) and Incomes Data Services (IDS) reported that headline basic settlement levels dropped sharply to 2.5% in early 2002. Low headline inflation numbers and seemingly endless stories of imminent recession appear to have affected wage-bargainers. But with claimant count unemployment hovering near 26-year lows, the labour market is still extremely tight by historical standards. The risk must be that current rapid rates of public sector wage inflation ultimately feed through into the private sector.

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.

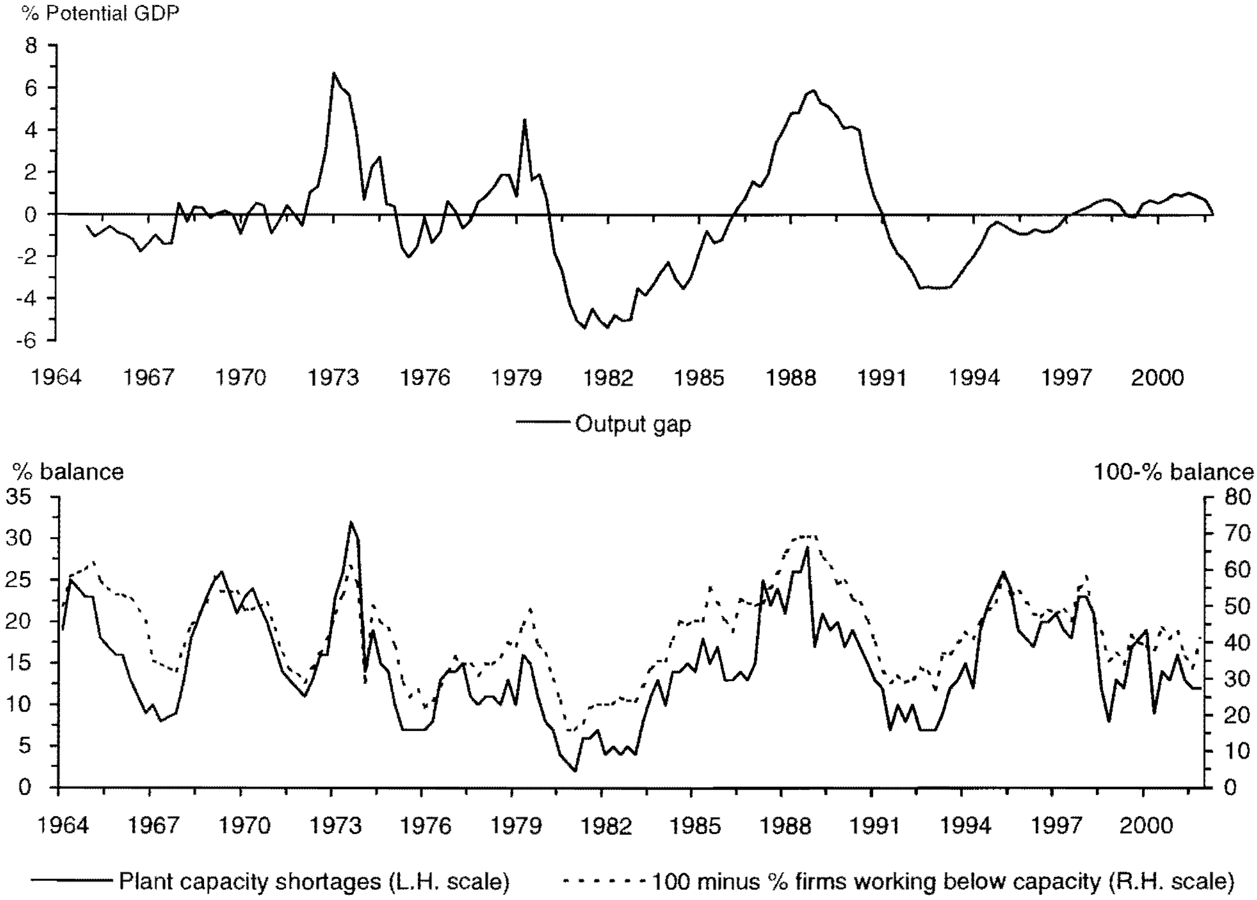


Sources: ONS Economic Trends, *CBI* Quarterly Industrial Trends Survey *and Lombard Street Research calculations.*

The CBI balance of manufacturers expecting skilled labour shortages to limit production in coming months has fallen consistently since the start of 2001. This is unsurprising given the troubles of the export-dependent sector last year. Workforce Jobs data show that 145,000 manufacturing jobs were shed in 2001 alone. But manufacturing's importance in the overall economy has declined over time. Unfortunately, recent movements in the broader vacancies-to-wokforce ratio can not be tracked as Jobcentre vacancies data were suspended in April 2001. However, last Spring the measure had reached its highest level since 1973, confirming that the labour market was stretched. Indeed, overall Workforce Jobs numbers rose for the eighth year running in 2001, with jobs growth driven by buoyant domestic-based sectors. Construction jobs jumped by 123,000 with those in the public sector rising by 103,000. The Government's focus on public services will help to support demand for labour in 2002 and beyond.

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.

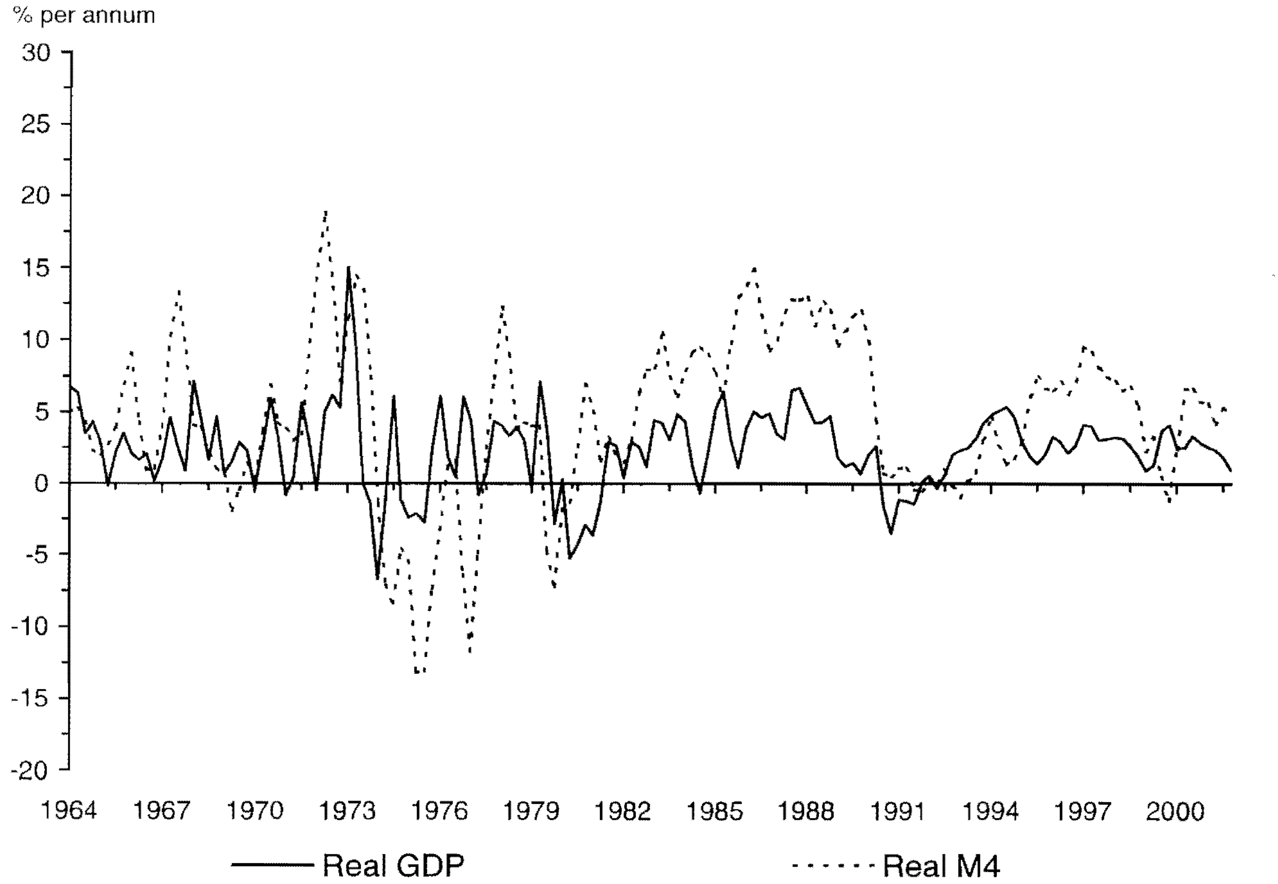


Source: CBI Quarterly Industrial Trends Survey *and Lombard Street Research calculations.*

Our estimate of the output gap (i.e., deviation of output from trend) is small but positive. This implies upward pressure on prices, as the economy operates above its trend level. As such, it is consistent with the rise in our "core" measure of inflation from below 1% in 2000 to over 2.5% by early-2002. (This "core" measure strips out the effects of various highly volatile components such as petrol and oil prices, council taxes and duties.) Measures of capacity utilisation in the manufacturing sector, on the other hand, confirm that economic activity and potential price pressures in the beleaguered sector remain weak. The number of firms working below capacity jumped to +66% in January 2002 compared to a 35-year average of +57%, with plant capacity shortages also falling. Manufacturing production tumbled by 2.3% in 2001, shaving about 0.5% from GDP. Prospects of global economic recovery in 2002 should help manufacturing to edge out of recession and could allow manufacturers to attempt to rebuild profit margins.

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.

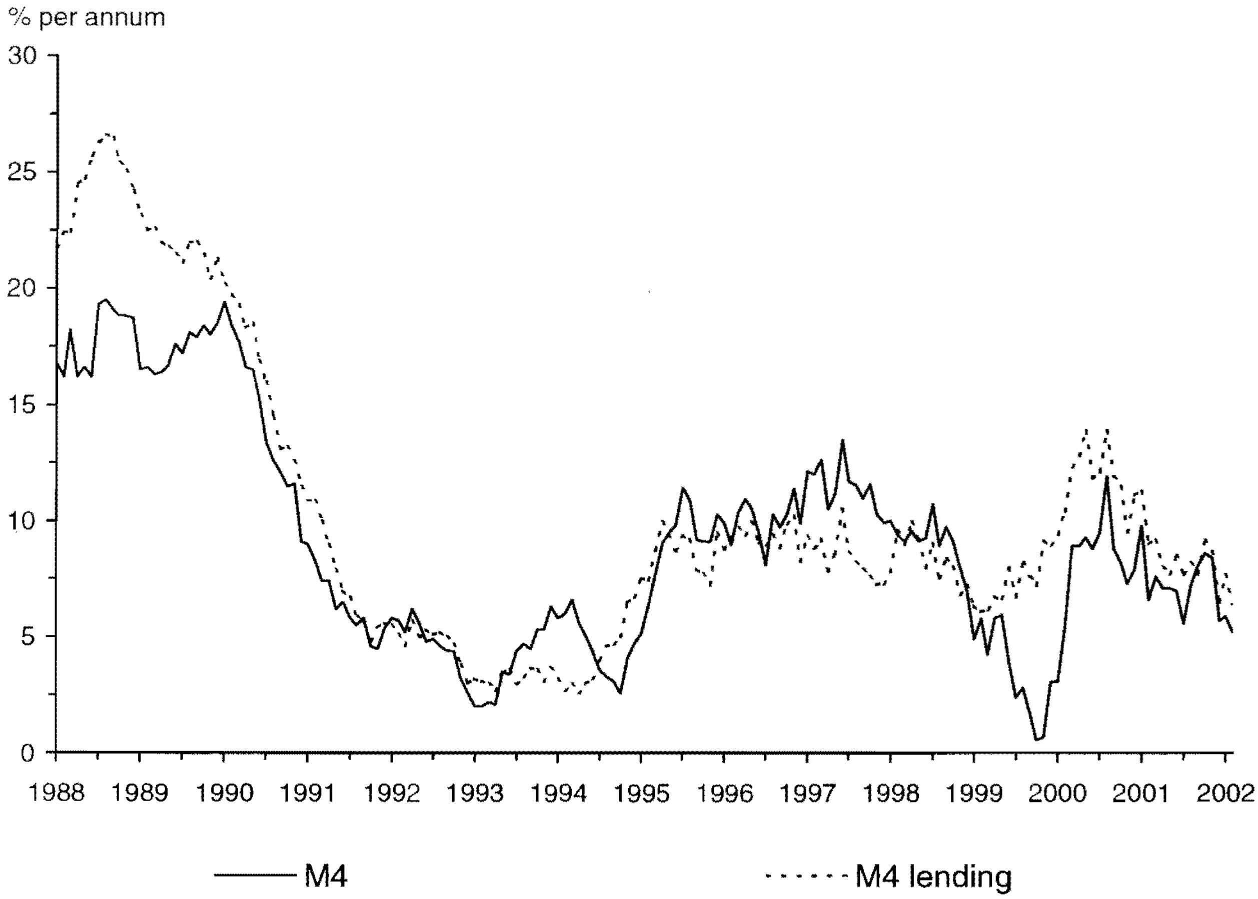


Sources: ONS Economic Trends *and Bank of England* Monetary Statistics.

While policy-makers appear to pay little attention to monetary trends, a medium-term relationship between the rates of expansion of real money and real GDP is fairly reliable. Changes in real M4 growth tend to lead those in real GDP by about six months to a year. As such, firm real broad money growth throughout much of last year correctly indicated ongoing robust domestic demand growth. GDP expanded by 2.5% in 2001, with domestic demand rising by 3.2% over the same period. It was the buoyancy of the domestic economy which helped the UK to outperform all other G7 economies last year. While rates of real M4 growth have moderated in recent months, this slowdown will probably be only temporary. (See p.11.) In any case, current rates of real money growth do not point to any dramatic slowdown in economic activity in 2002 as seems to be envisaged by various MPC members. The message from the monetary data must be that 2002 will be another year of trend growth at least.

Recent monetary trends

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

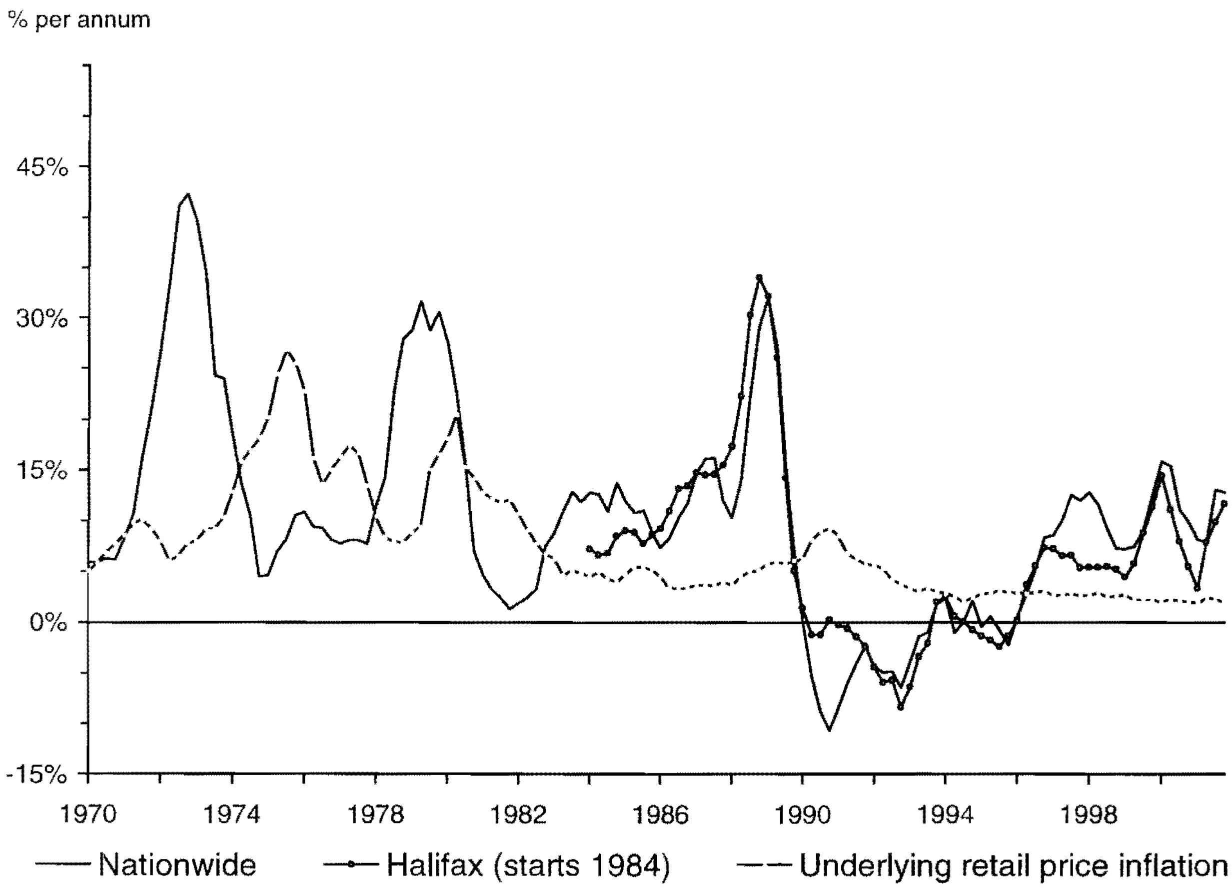


Source: Bank of England Statistical Abstract.

Somewhat surprisingly, M4 growth has moderated in recent months. Broad money grew by 6.2% in the twelve months to February, a rate of expansion which, if maintained, would be broadly consistent with the 2 1/2% inflation target. But an acceleration seems likely in 2002. Generation-low interest rates should continue to stimulate lending growth, the dominant credit counterpart to money growth. Mortgage lending surged to another record monthly high of £5.3b. in January, while robust mortage approvals point to more strong lending ahead. True, corporate and non-bank financial sector loan demand was broadly static in late-2001, a key reason for the slowdown in M4 growth. But any revival of lending to these sectors could push M4 growth back up to double-digit rates. Meanwhile, the Government's return to deficits implies an increasingly positive public sector contribution to M4 growth in 2002. Attempts to run down the Government's cash balance will similarly transfer cash to the private sector, increasing M4.

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

Over the past 30 years annual house price inflation has on average exceeded underlying inflation by 3%. But, at present, the housing market is booming in the wake of 40-year low mortgage rates. Both Nationwide and HBOS measures of house price inflation are running at 15%+ three-month annualised rates. Moreover, there seems little reason why there should be any imminent moderation. The number of loans approved for house purchase jumped to a new record high of 113,000 in January, suggesting that the lure of cheap credit is proving hard to resist. Meanwhile, GFK's headline consumer confidence measure has rebounded after its post-11th September slump. Interestingly, fewer people now expect unemployment to rise than at any time since 11th September, tending to confirm that conditions for a strong housing market remain in place. With surging house prices boosting tangible wealth and stimulating mortgage equity withdrawal, the High Street boom should continue throughout much of 2002.