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What will happen when the Iraq distraction ends?

Uncertainty has made key decision-takers too cautious

Iraq is a pip-squeak nation

Iraq is an economic and military pip-squeak. Because its administration is in a shambles and its status is that of an international pariah, it is not included in the World Bank's list of the 2001 GDPs of 176 countries. (The range is from the USA with a GDP of \$10,171,400m. to Kiribati with \$40m.) But a fair estimate is that its GDP is about \$20b. - \$25b., above Luxembourg but somewhat less than Morocco. (Note that Iraq's GDP is less than that of most states in the American Union and of several UK counties.) Of course, even a pip-squeak nation can pose a threat to peace, if it is ruled by a madman who tries to develop chemical weapons and may support terrorism. But the problem of Saddam Hussein has been blown out of all proportion to his true significance for the international order. When "the war" is over, there will be problems about the attitude of world opinion towards civilian casualties and the installation of a new regime. But - by itself - the removal of Mr. Hussein is of little relevance to the long-run future of the world economy.

and Mr. Hussein is unimportant to the world economy

But managers and investors are postponing decisions,

Or, perhaps one should say, "the removal of Mr. Hussein *ought to be* of little relevance to the long-run future of the world economy". The trouble is that businessmen and investors read newspapers, and seem to think that "the war" matters. Business surveys show that companies are postponing investment because they are worried about "war", while investors are keeping cash on the sidelines for the same reason. As a result, a minor example of international policing is having a major effect on the world economy. This effect is undoubtedly a high multiple of Iraq's GDP and an enormous multiple of Mr. Hussein's crackpot expenditure on weapons of mass destruction. \$20b. is about half of 0.1% of world GDP, but - if the business surveys are right - the postponement of investment decisions may subtract 1/2% or more from world growth in 2003.

which will be a mistake

It is hard not to feel that an extraordinarily large number of people are being foolish about the supposed Iraqi "threat". Key questions for late 2003 and 2004 are "will there be a burst of catch-up investment spending to compensate for the delayed spending of late 2002 and early 2003?", and - more pointedly - "will many managements and investors look silly when Iraq is out of the headlines?". The exceptionally low level of interest rates at present creates many unusual investment opportunities. With the exception of Japan and Germany, most countries have banking systems which are able and willing to expand, and support reasonable rates of money supply growth. In USA M2 and M3 rose by about 6 1/2% last year. Meanwhile in the UK M4 growth in recent months has annualised at over 7 1/2%. (See the research paper on pp. 2 - 12 below.) This is not the monetary background to an intensifying recession. In fact, domestic demand seems likely to continue to expand faster than the UK's trend rate of output growth in 2003, for a remarkable eight year in a row. (Of course this cannot go on for ever, but the same thing was said here three years ago.)

Low interest rates spur rather high money growth in the UK

Summary of paper on 'Fairly high money growth ahead'

Purpose of the paper

Many forecasters, using models without money, are pessimistic about the UK demand outlook in 2003 and revenue forecasts in Mr. Gordon Brown's next Budget. This research paper asks whether money supply trends give a similar message.

Main points

- * **Bank credit to the private sector is nowadays the dominant influence on M4 growth. It increased at an annualised rate of 10.5% in the six months to December. Pointers to future credit demand - such as mortgage approvals - suggest no slowdown. (See the chart on p. 5.)**
- * **The public finances are deteriorating, while the Treasury and Debt Management Office seem unconcerned about the monetary effects of government borrowing from the banks.**
- * **In 2003 a positive public sector contribution to M4 growth (i.e., "under-funding") seems likely, as was recorded in 2001 and 2002. (This contrasts sharply with heavy over-funding in the five years to 2000. See the charts on pp. 6 - 7.)**
- * **M4 growth at an annual rate of between 7 1/2% and 10% looks plausible in 2003, which will help balance sheets and support at least trend growth of domestic demand. In that sense the mainstream forecasts for the economy - or at any rate domestic demand - are too pessimistic about 2003.**
- * **Households have increased their money balances faster than aggregate M4 since 1999, exerting downward pressure on the money balances of other agents, notably financial institutions. (See the charts on pp. 8 - 9.)**
- * **The squeeze on financial sector money has been the monetary background to stock market weakness since 2000. (See the charts on pp. 10 -11.) But bond issuance by companies has been at record levels.**
- * **Companies' liquidity ratio (i.e., their M4 money holdings divided by their M4 borrowings) has been and remains close to long-run averages. Companies may have too much debt, but their liquidity position is comfortable. (See p. 12.)**

This research paper was written by Tim Congdon.

Fairly high money growth ahead

Money trends favour above-trend growth of UK domestic demand in 2003

Pessimism about 2003 from forecasters who neglect money

A pre-Budget debate has started about the outlook for the UK economy this year and in early 2004. The prevailing view among forecasters is that the Treasury forecast of growth is too high. (See the front page story by Ed Crooks in the *Financial Times* of 31st January.) It follows that Mr. Gordon Brown will be disappointed by lower-than-expected tax revenues and a higher-than-expected budget deficit, and that higher taxes may be needed to ensure that the public finances obey the Government's fiscal rules. The purpose of this research paper is to see whether current monetary trends have anything to contribute to the debate. A relationship between money and nominal GDP will undoubtedly persist into the opening decades of the 21st century.

Rather high money growth - of, say, 7 1/2%-10% - likely in 2003

The central point is that money growth has accelerated in recent months and seems likely to remain rather high in 2003. To be more precise, a reasonable estimate is that M4 will expand at an annual rate somewhere within the band of 7 1/2% - 10%. The key parts of the analysis behind this conclusion are set out on pp. 5 - 7. The dominant influence on money supply growth is the extension of bank credit, as new bank assets are matched on the liabilities side of the balance sheet by extra deposits. (Most of the newly-created deposits can be used to make payments and so are money.)

High money growth due partly to buoyancy of credit demand

Nowadays the overwhelming preponderance of new bank credit is to the private sector. The chart on p. 5 makes two points. The first is that over the last 40 years the growth of bank credit to the private sector and the change in M4 have indeed been related. The second is that, in real terms, bank lending to the private sector was typically much higher in the 1980s and 1990s than in the 1960s and the 1970s. The explanation here is that, as British banks shed their claims on the public sector over the post-war decades, the business of banking became essentially that of judging credit risks in the private sector. The worrying development for future monetary control is that bank lending, again in real terms, has been buoyant in recent years. In 2002 it was stimulated by low interest rates, with mortgage lending being particularly strong. The annualised growth rate of M4 lending in the six months to December was 10.5%, while pointers to future credit growth - such as mortgage approvals - remain extremely high.

Role of debt management in monetary control

If banks can expand their principal asset by 10% a year, the task of keeping the growth of their deposits down to nearer 5% a year is likely to be difficult. For much of the post-war period policy-makers responded to this problem by deliberately reducing the banks' claims on the public sector. Policy-makers tried both to limit the budget deficit and to sell public sector debt at the long end ("funding") where it would be unattractive to the banks. The chart on p. 6 shows the effect of such operations, as measured by the PSBR/PSNCR minus official debt sales to non-banks and the external sector ("the public sector contribution to M4 growth") since 1981. (Again, the chart is in real terms.)

Credit counterparts to the Lawson boom

In the early 1980s over-funding was used actively to neutralise the monetary effects of rapid growth of bank credit to the private sector. This sensible policy was stopped by the “full funding rule” between 1985 and 1992. Between 1985 and 1989 an explosion in bank credit to the private sector (see chart on p. 5) was associated with excessive growth rates of M4, which led to the Lawson boom and rising inflation. The growth of bank credit then collapsed in the early 1990s, after 15% base rates in 1990 wiped out billions of pounds of housing equity and inflicted heavy loan losses on the banks.

By accident, debt management consistent with stable monetary policy, 1992-2000,

From 1992 funding policy (or “debt management”) was no longer regarded officially as part of monetary policy. Ironically, it was conducted in a largely benign fashion - from the standpoint of monetary control - until 2000. While bank credit to the private sector was weak between 1992 and 1995, the Government again borrowed from the banks and this increased M4 growth. When credit to the private sector started to boom again in 1996, over-funding resumed. In fact, as the chart on p. 6 shows, over-funding in the five years to 2000 was higher in real terms than in the five years to 1985. This was an entirely appropriate response to the credit boom and dampened M4 growth. (Over the five-year period M4 growth was on average about 1% a year lower than if the PSBR/PSNCR had been fully funded.)

but positive public sector contribution to money growth in 2001 and 2002, and probably 2003

However, there is no doubt that policy-makers (in the Treasury, the Debt Management Office and the Bank of England) did not take the key decisions for monetary control reasons. Instead they had a variety of other motives, including that of supplying the long-term savings institutions - notably the pension funds subject to the Minimum Funding Requirement - with appropriately long-term gilt-edged securities. Their indifference to the monetary effects of debt management decisions was demonstrated in 2001 and 2002, when the Government reduced its claims on the banks (by making net payments to the private sector from a government deposit built up in 2000) and so added to M4 deposits when private sector credit growth was high. (See the last two bars of the charts on pp. 6 - 7.)

In the event the world economy was so weak in 2001 and 2002 that the persistence of moderately high UK money growth may have been a blessing. The problem is what happens from here. If bank credit to the private sector keeps on growing at 10% a year, and if the public sector contribution to M4 growth is positive (as seems possible), it is simply a matter of arithmetic that M4 growth will stay rather high. (The banks may borrow to some extent from abroad, rather than incurring deposit liabilities to UK residents. But such external financing - the monetary symptom of a current account deficit - may be turned off by shocks to the international banking system and, in any event, is finite.)

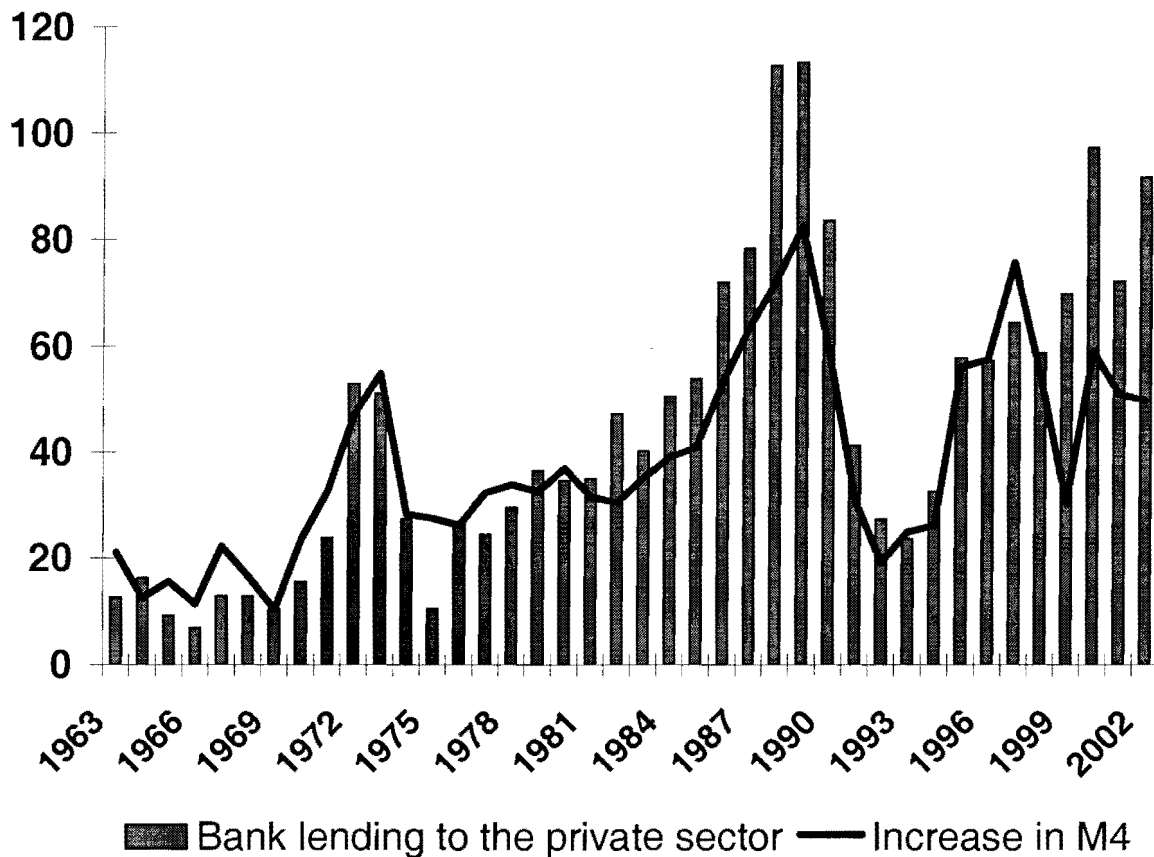
Money growth of 10% a year could not be reconciled indefinitely with 2 1/2% inflation

The message has to be that monetary trends point to 2003 being yet another year of resilient demand. The charts on pp. 8 - 12 show aspects of the relationship between agents' M4 holdings and their spending, and demonstrate the long-run stability of their monetary behaviour. The Government and the Bank of England would be naive to imagine that 10% M4 growth can be reconciled with 2 1/2% inflation in the medium term.

The inseparable twins, bank credit and money

Analysis of the determination of the money supply 1.

Chart compares new bank and building society to the private sector with increase in M4, in £b. of constant 1995 prices. (Chart relates to annual values. Both series have been deflated by the GDP deflator.)



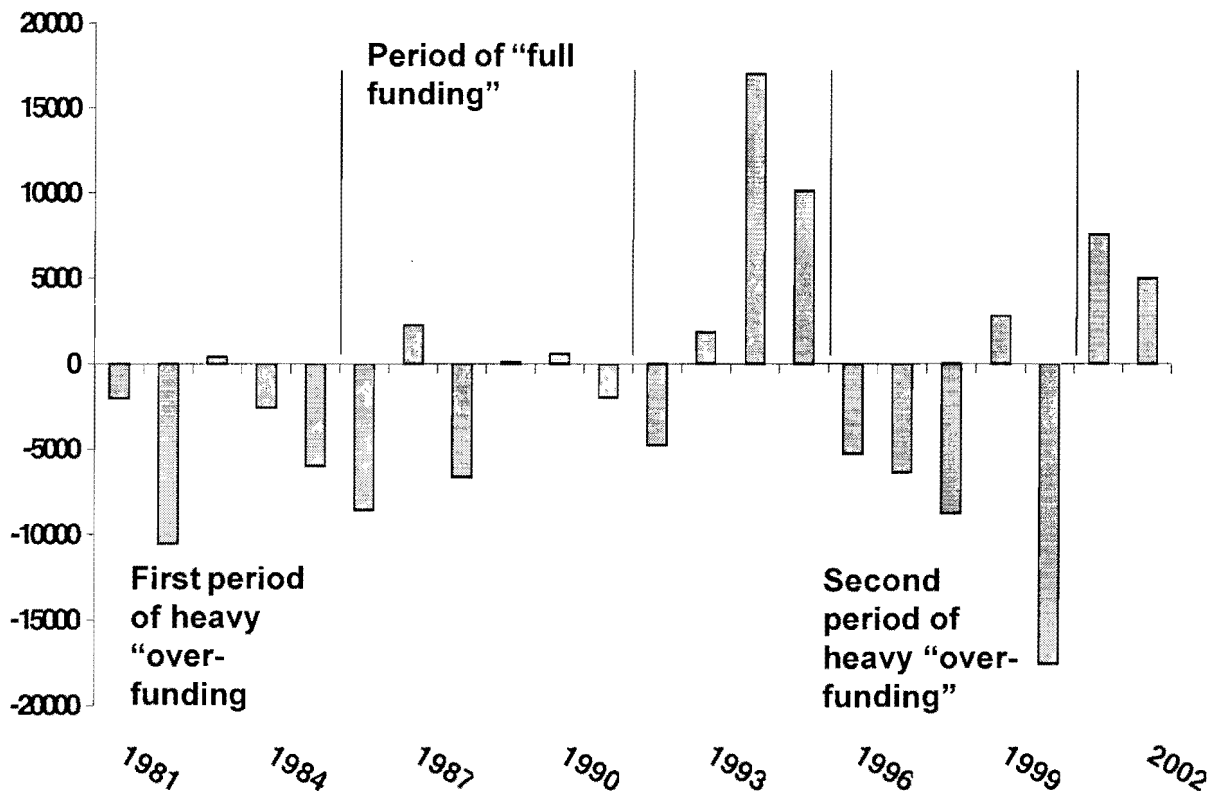
Source: Bank of England and Lombard Street Research estimates

When a bank makes a new loan to the private sector, it creates a new bank deposit. The new deposit is part of the M4 measure of the money supply. For most of the 1950s and 1960s the banks were subject to quantitative credit restrictions, because otherwise the growth rates of bank credit and the money supply would have been too high to be compatible with the pound's fixed exchange rate with the dollar. A big credit boom followed the relaxation of restrictions in September 1971, but the chart shows vividly that in real terms credit growth in 1987 and 1988 was by far the highest in the post-war period. The banks took heavy loan losses and suffered severe capital depletion in the subsequent slump of the early 1990s, but recovered in 1993 and 1994. Another upturn in credit growth began in 1995. The last three years have seen buoyant bank credit, most of it to finance house purchase. There is little sign that the mortgage boom is about to finish. Banks' unused credit facilities (largely to companies) at the end of 2002 were £225.3b., £18.1b. higher than a year earlier.

Carry on over-funding

Analysis of the determinants of the money supply 2.

Chart shows “the public sector contribution to M4 growth”, which is broadly equivalent to “the PSBR/PSNCR minus the net financing of the public sector from domestic non-banks and the external sector”. It therefore amounts to “the public sector borrowing from the banking system (or repayment of debt owed to it)”. In the chart it is in constant 1995 prices in £m., with the GDP deflator used to adjust the nominal values.



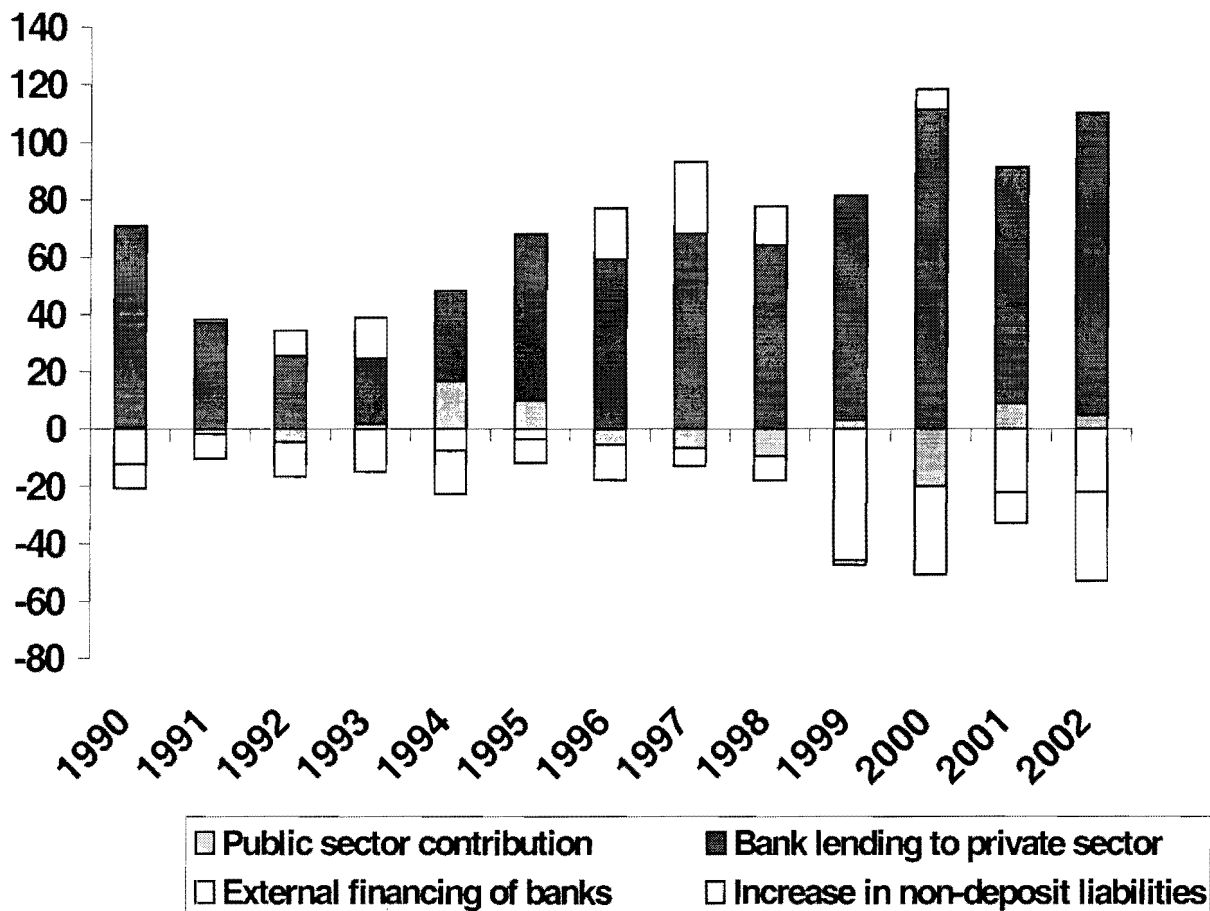
Source: Bank of England and Lombard Street Research estimates.

The role of debt management in monetary policy has been a difficult subject. The full funding rule introduced in 1985 was supposed to prevent debt management having any effect on the broad measures of money, ending a period of heavy over-funding in the early 1980s. Since 1992 the official purpose of debt management has been to minimize the costs of servicing the national debt, but in practice the Treasury and the Debt Management Office have also tried to accommodate financial institutions’ asset preferences. So long-dated gilts were sold on a large scale in the late 1990s, even though the budget was in surplus for much of the time. Over-funding was higher in real terms in the five years to 2000 than in the five years to 1985. The monetary effects were benign, with some neutralisation of the monetary expansion associated with another phase of strong bank credit. But - with the public finances again moving into deficit - the Government may in 2003 borrow from the banks, while bank credit to the private sector remains rather buoyant.

Money growth to rebound?

Analysis of the determination of the money supply 3.

Chart shows credit counterparts to M4 growth in £b., at current prices. The figures for 2002 are estimated by extrapolating from the first three quarters.

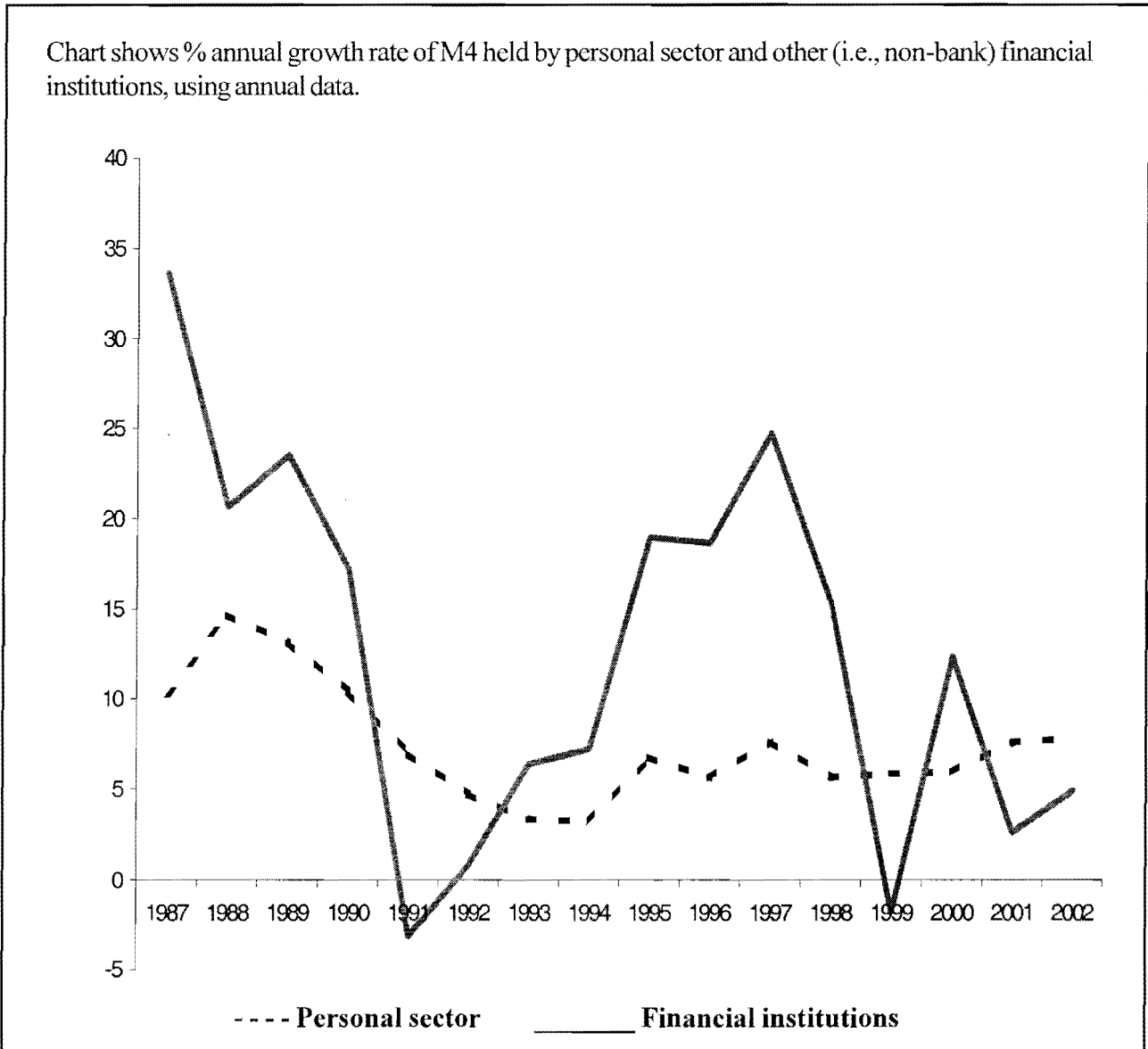


Source: Bank of England and Lombard Street Research estimates

M4 growth in the year to December 2002 was 6.9%, compared with twelve-month M4 growth rates more typically under 6% for most of 2002. The three-month annualised growth rate was consistently between 7% and 8% in late 2002. M4 growth rates of 7% or more probably cannot be reconciled with 2 1/2% inflation in the long run. The chart here shows the asset counterparts to the M4 increase. Bank lending to the private sector was only a shade lower than the all-time record in 2000, when the M4 increase in the year to December was 8.3%. The major differences between the two years are in the other counterparts. The public sector contribution to M4 growth was heavily negative in 2000, as the phone companies paid for their 3G licenses, but was positive in 2002. On the other hand, the external counterparts lowered M4 growth last year, whereas they increased it in 2000. If the budget deficit continues to widen in 2003/04, and if the public sector contribution is again positive, credit growth at about 9% - 10% a year almost certainly implies rather high M4 growth of 7% or more.

The sectoral split of money holdings

Analysis of the demand to hold money 1.

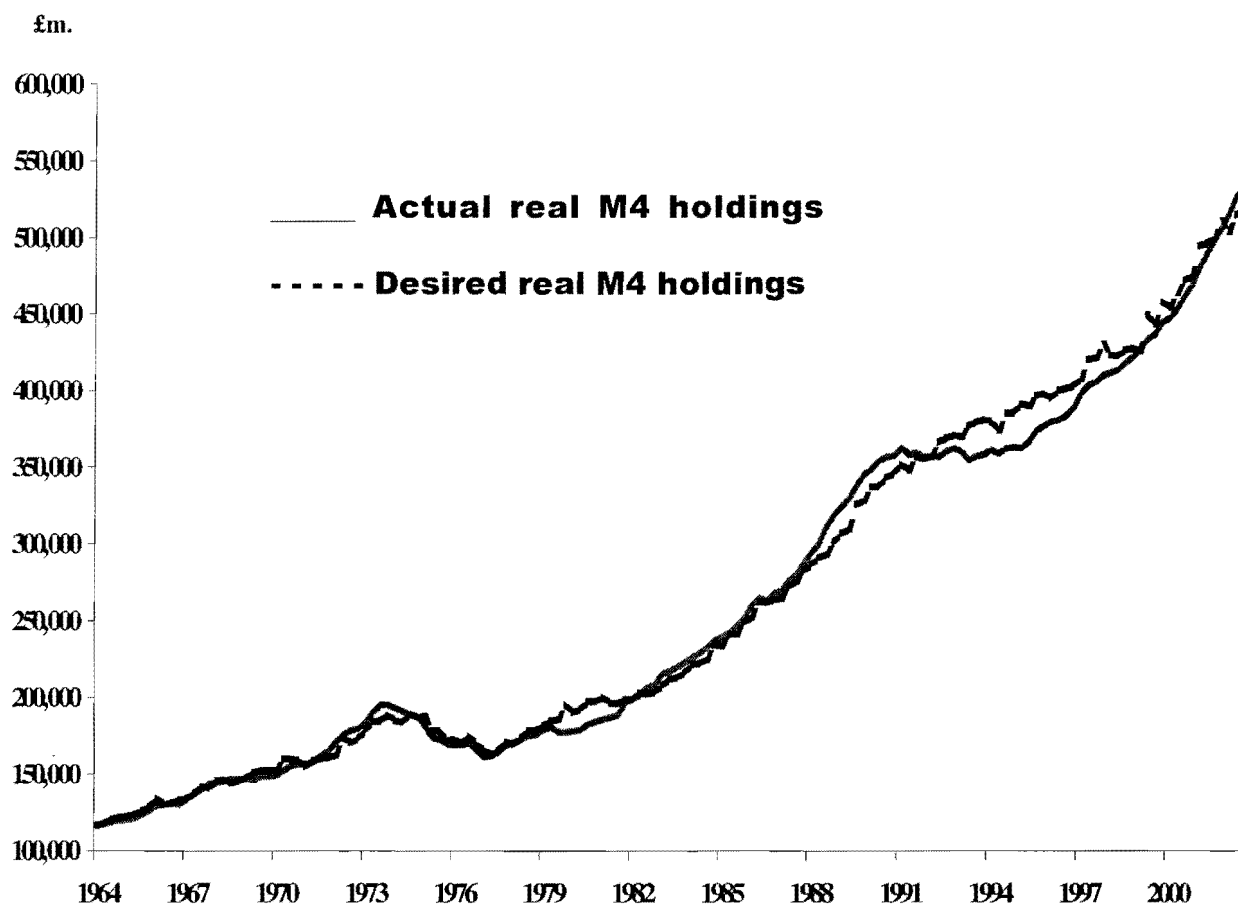


The chart on p. 7 showed extremely weak bank credit to the private sector in the 1991 - 4 period, reflecting the banks' shortage of capital associated with the 1989 - 93 slump in house prices. M4 growth in these years was the lowest since the 1950s, creating the monetary background to the low inflation of the 1990s. When credit growth revived in 1995 and 1996, so also did M4 growth. M4 money balances are held by three types of private sector agent - persons, companies and financial institutions. The personal sector's demand for money balances is quite stable, as shown on the opposite page. It follows that changes in M4 growth are accompanied by larger swings in the money holdings of companies and financial institutions, which then have major effects on asset prices and spending behaviour. Financial sector money soared in the 1995 - 98 period, boosting asset prices, but fell back in the 1999 - 2002 period. Excess money was no longer helping asset prices. (But there is no mechanical year-by-year link between financial institutions' liquidity and, say, equity prices. The relationship is medium-term and rather loose.)

Households' money demand remains stable

Analysis of the demand to hold money 2.

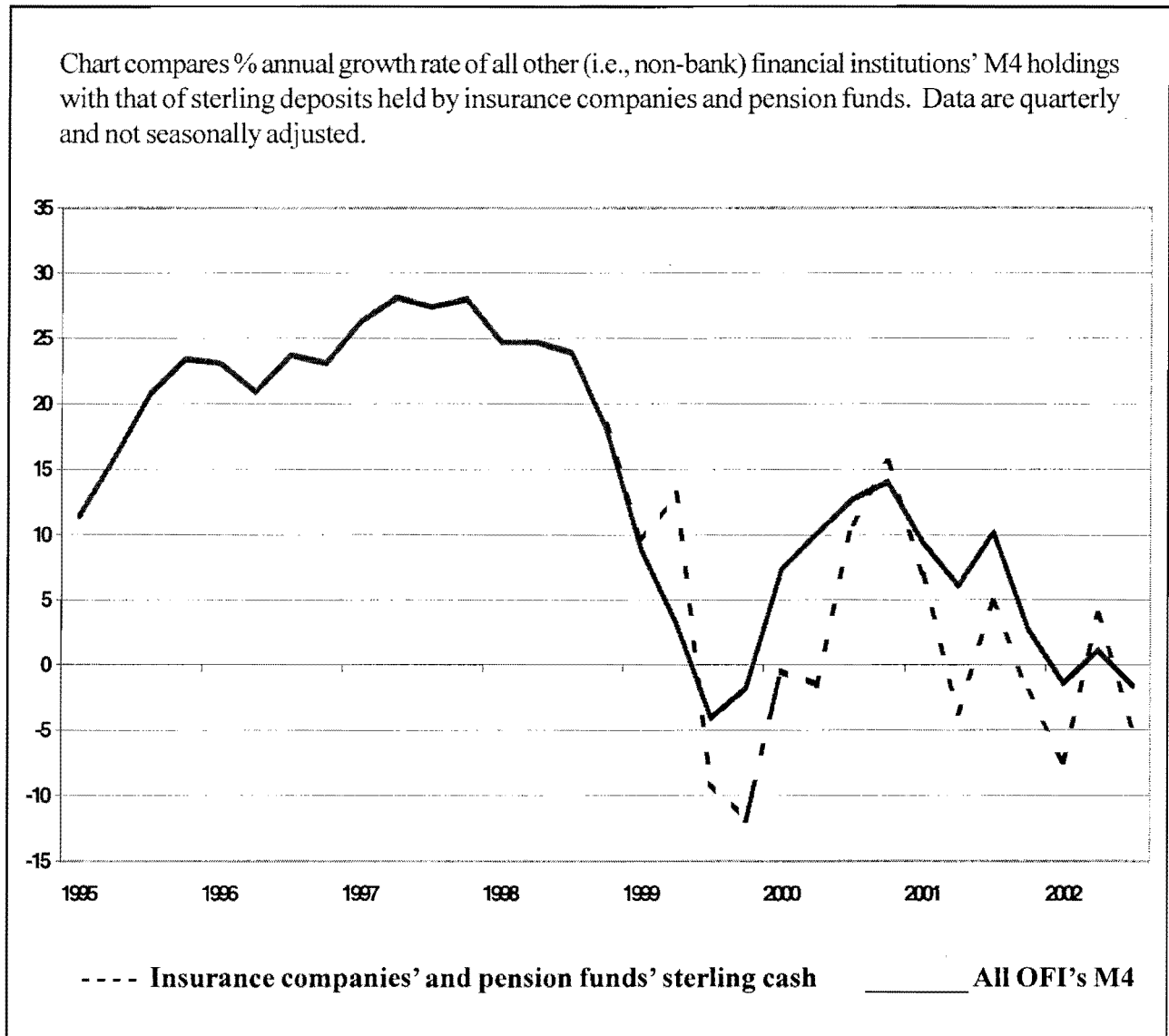
Chart compares personal sector's actual M4 holdings with the long-run desired level, as estimated by an econometric equation. (The equation is available from Mr. Stewart Robertson of Lombard Street Research on 020 7382 5912 or stewart.robertson@lombardstreetreseach.com.) Nominal data are deflated by the consumer expenditure deflator, to obtain the series in real terms.



Of the three sectors (personal, corporate and financial) holding M4 balances, the personal sector is much the largest. (It holds almost two-thirds of the total.) Lombard Street Research has an equation for the personal sector's M4 balances estimated over data back to 1964. Despite the massive institutional changes in this almost 40-year period, it identifies a stable relationship which meets all the usual significance tests. The key point for the future is that - whereas persons' actual M4 holdings were slightly beneath the desired long-run level in the mid-1990s - they appear to be above the desired long-run level today. If aggregate M4 growth stays rather high, it seems unlikely that the personal sector's M4 holdings will keep on growing at the approximate 8% annual rate seen in 2001 and 2002. If in 2003 aggregate M4 growth were to run at, say, 9% and personal sector M4 growth at 7%, the combined money balances of companies and financial institutions would increase by 12%. This would be markedly higher than in 2002 and so would imply stronger balance sheets throughout the economy.

Money and asset prices

Analysis of the demand to hold money 3.

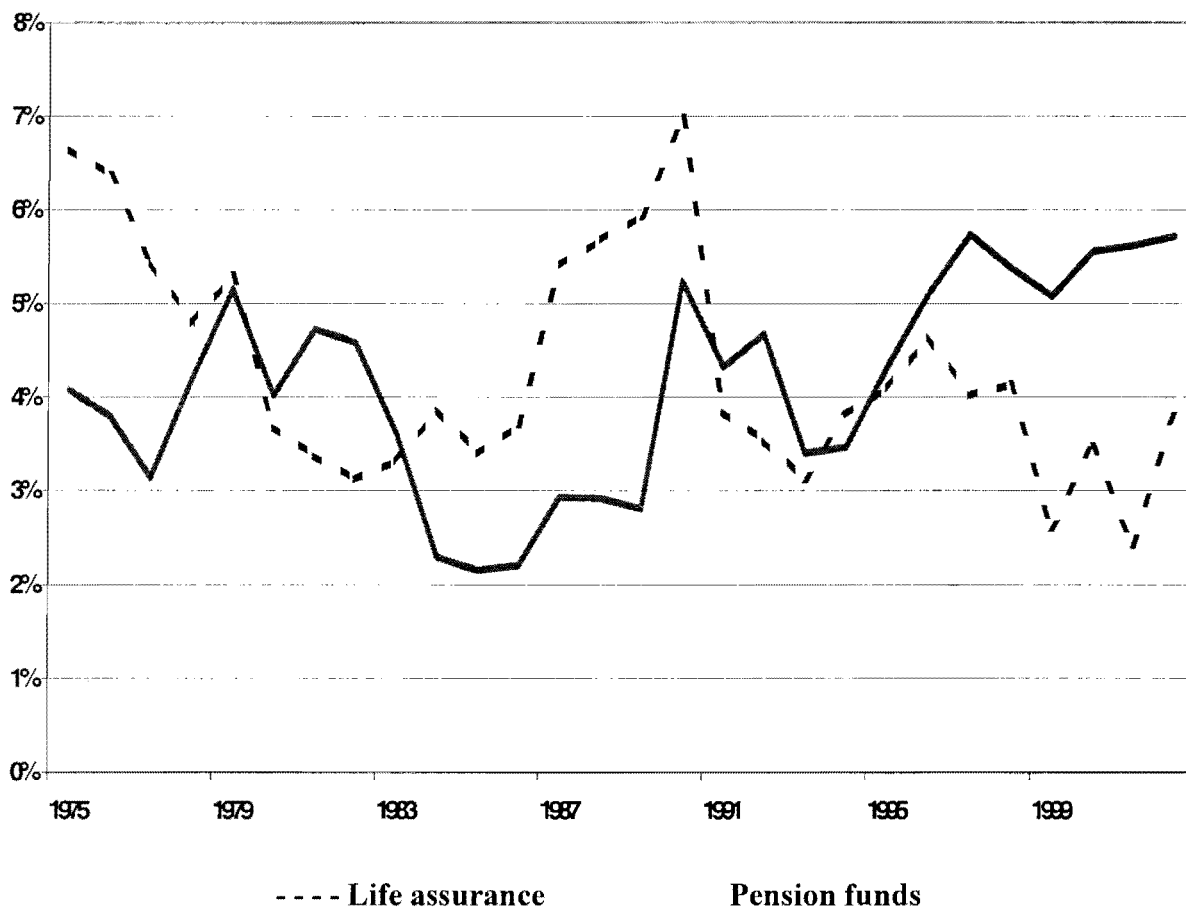


A new statistical series, an “industrial analysis of bank deposits”, was started by the Bank of England in December 1997. (See an article on ‘The new industrial analysis of bank deposits and lending’, by Karen Westley, in the January 1999 issue of the Bank’s *Monetary and Financial Statistics*.) Since then it has been possible to monitor the deposits, in sterling and foreign currencies, of the category “insurance companies & pension funds” [ICPFs] as well as of many other types of financial intermediary. At the end of the third quarter 2002 the sterling deposits of insurance companies and pension funds amounted to £49.8b., compared with M4 holdings of £219.8b. for the financial sector as a whole. Although only a quarter of total financial sector money, the chart suggests that ICPFs’ money balances change in much the same way as those of all intermediaries. The squeeze on financial sector money since late 1999 has been accompanied by a squeeze on ICPFs’ money, a key part of the background to asset price weakness.

Stability of institutions' liquidity preferences

Analysis of the demand to hold money 4.

Chart shows ratio of "cash" (mostly sterling deposits included in M4) to total assets, as %, for life assurance companies and pension funds. Data are from National Statistics, not Bank of England, and may not be entirely comparable with the Bank's monetary statistics.

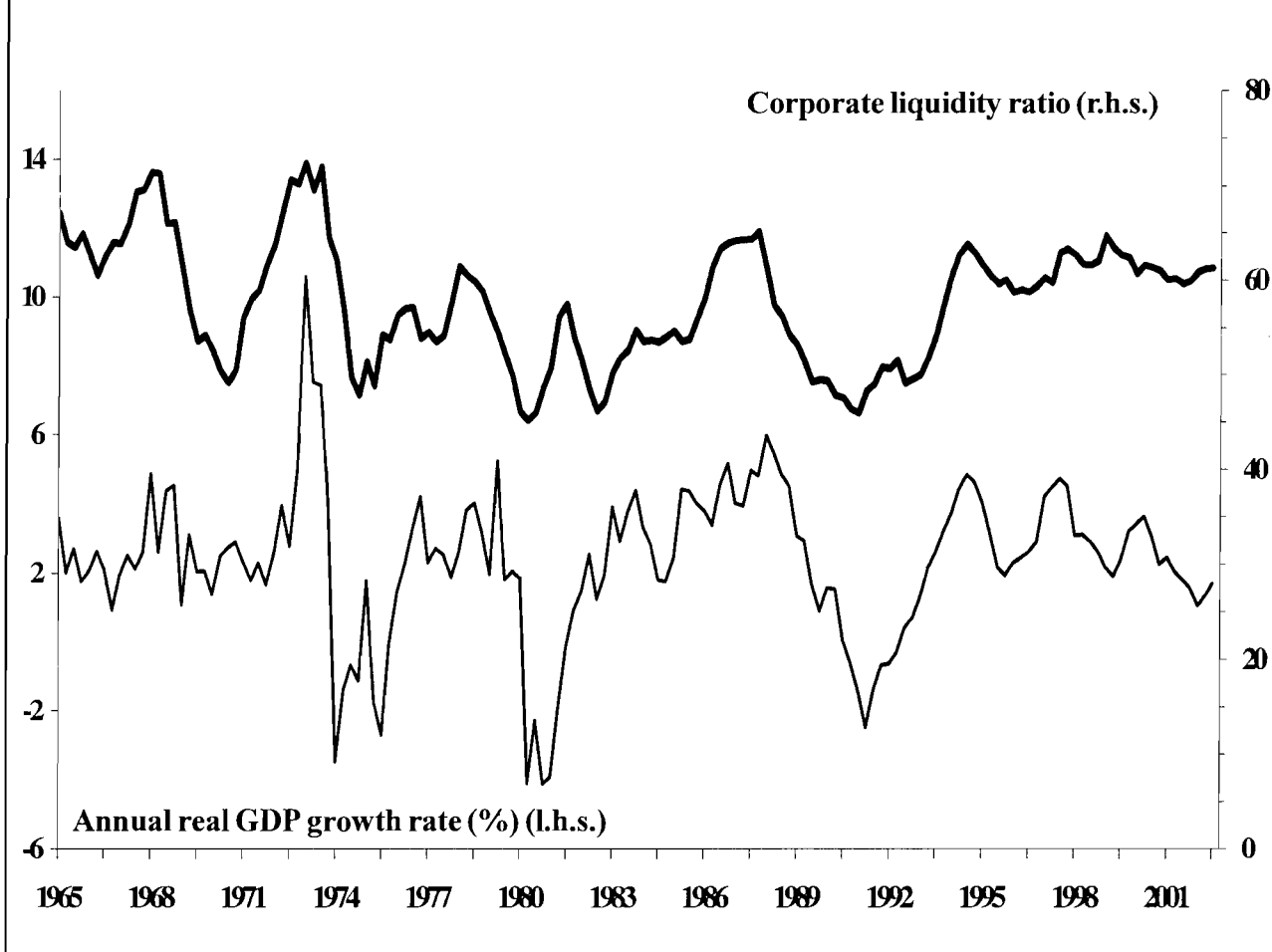


The chart on p. 10 showed the Bank of England's estimate of deposits held by the UK's ICPFs, which play a vital role in the determination of certain key asset prices. (For example, at the end of 2001 insurance companies and pension funds held equities to the value of £310.6b. and £250.0b. respectively. The total value of all UK equities was £1,554.0b.) The value of all the assets they hold can be regarded as the product of their "cash" (i.e., their bank deposits) and the inverse of the "liquidity ratio" (i.e., the ratio of cash to all assets). This chart shows - despite marked occasional fluctuations (as the institutions' mood swings from bullishness to bearishness, and vice versa) - the ratio of ICPFs' short-term assets to their total assets has been within a band of 3% to 6% for nearly all the 27 years from the end of 1975. The implied stability in liquidity preferences suggests that the stagnation of ICPFs' money holdings since 1999 ought to have hit asset prices, as indeed it did.

Stability of the corporate liquidity ratio

Analysis of the demand to hold money 5.

Chart shows companies' "liquidity ratio", where "companies" are private, non-financial corporations in Bank of England's financial data, and liquidity ratio is ratio of M4 holdings to M4 borrowings. The ratio is compared with growth rate of real GDP. Data series are quarterly and seasonally adjusted.



This chart is one of the best illustrations of the transmission mechanism from money to economic activity. Large movements in the corporate liquidity ratio (i.e., M4 deposits divided by M4 borrowings) tend to precede or coincide with large movements in GDP relative to trend. In essence, when companies have ample "cash" (i.e., bank deposits) compared with their bank borrowings, they feel financially comfortable, and so are more inclined to expand by acquiring other companies, by investing in plant and equipment, and by recruiting extra staff. So a high liquidity ratio is associated with above-trend growth in demand and output (and a low liquidity ratio is associated with beneath-trend growth). The argument of the charts on pp. 7 - 9 was that the rather high money growth to be expected in 2003 could lead to increases in corporate sector M4 in the low double digits (at a % annual rate). As the chart shows that the liquidity ratio is now about average, low-double-digit growth in companies' M4 would mean a rise in the ratio to above-average levels.