# Monthly Economic Review

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# Is the Fed behind the curve?

## Or has Mr. Greenspan fallen asleep on the job?

**Clear return of inflationary forces in the USA**

Big prices increases in base metal prices and some other industrial costs, such as shipping freight rates, were a pronounced feature of the world economy in late 2003. The copper price continued to soar in January, partly because of supply disruptions in Indonesia. In the USA the impact on costs and prices in early 2004 will be exacerbated by the dollar's fall in November and December. Not surprisingly, the January survey from the US Institute of Supply Management reported that a positive balance of 51% of its respondents - which are predominantly manufacturing companies - expected to have to pay higher prices. This compares with a positive balance of only 17% in October 2003 and negative balances for much of 2002. The ISM translates its respondent values into a "prices index", which took a value of 75.5% last month, up from December 66.0%. According to its press release, the prices index has to fall below 46.9% to be "generally consistent with a decrease in the Bureau of Labor Statistics' index of manufactured prices". Plainly, the USA is a long way from deflation. In fact, the past record suggests that ISM prices index readings in the 70% vicinity are associated with factory-gate inflation of over 5%.

**Why did the Bureau of Labor Statistics delay the January producer price index?**

In this context the January value of the BLS's index of finished goods prices would be most valuable. It was due to be published on 19th February. However, on 17th February a press release was published with the producer price index release saying that the PPI numbers would be "delayed from the originally scheduled date". In its words, "The delay is caused by unexpected difficulties in the conversion of producer price index data from the Standard Industrial Classification system to the North American Industry Classification System." There may be nothing sinister in this announcement, but surely the statisticians have known for months about the differences between the classification systems. Why did "the unexpected difficulties" become so particularly unexpected and difficult a mere two days ahead of an official release date?

**US monetary policy will be biased towards case in 2004**

The suspicion has to be that statisticians in the American official agencies are again under pressure to massage data in a favourable way. There has been quite a history of this in the last decade, with - for example - the "hedonic" adjustment of computer industry output, the addition of software to estimates of corporate investment, and the downward Boskin Report changes to the consumer price index. A wider question is the Federal Reserve's reaction to the obvious return of inflation. Mr. Greenspan was heavily criticised by members of the Republican Party in 1993 for a tight monetary policy which was alleged to have caused the recession of late 1990 and early 1991, and then the defeat of the first President Bush in the 1992 election. A fair surmise is that Mr. Greenspan will not want to be similarly criticised in 2005 after the second President Bush's attempted re-election in November 2004. The bias in American monetary policy-making this year will be to find as many excuses as possible for deferring or avoiding interest rate increases.

**Professor Tim Congdon** **27th February, 2004**

**Summary of paper on**

# How high will inflation rise?

**Purpose of the paper**

The consensus view around the world is that inflation is "yesterday's problem". After examining several recent adverse developments in industrial costs, this research paper asks whether the consensus view is still correct. The conclusion reached is that it is not. Although there is spare capacity among the major industrial countries, emerging nations are putting greater demands on world resources. In the UK, inflation problems are brewing for late 2004 and 2005.

**Main points**

- There is some spare capacity in the major industrial nations suggesting that inflation pressures in 2004 should be limited. But the economic revival is strong, helped by exceptionally low interest rates.
- The emerging nations of China, India, Russia and others are growing fast and placing more demands on the world's resources. Commodity prices are rising steeply, metals prices have soared and shipping freight rates have spiralled higher.
- PPI inflation has already reached 4% in the US before all the damage to costs of higher metals and freight prices has been felt, and before the much weaker dollar has had its full impact.
- The UK's recent inflation performance has been good, but monitoring it has been complicated by the unnecessary change in the inflation target. Producer price inflation has risen noticeably in recent quarters and retail inflation could now push higher too.
- Although estimates differ, it seems clear that UK output is close to its trend level. Any above-trend growth would therefore lead to a positive output gap and rising inflation pressures.
- Yet that is exactly the prospect for 2004. Domestic demand remains robust, helped by still-low interest rates, while money growth is accelerating and external demand is picking up on the back of the global recovery.

This paper was written by Stewart Robertson.

# How high will inflation rise?

## CPI inflation could reach 2%, RPIX inflation 3%, by the end of 2004

**Inflation pressures in the UK will build in 2004 and 2005**

A research paper in March 2002 entitled "UK inflation outlook is deteriorating" concluded that RPIX (or underlying) inflation (then 2.2%) could exceed 3% by the end of that year. The consensus view, and one with which the Bank of England agreed, was that inflation would remain under control, staying comfortably below the 2.5% target throughout 2002 and 2003. In the event underlying inflation rose to 2.8% by November 2002 and reached 3% in February 2003 and stayed there for three months. Since then it has drifted lower, falling back below the old target in January this year. The inflation regime has now changed, with the Government adopting the alternative Consumer Price Index (CPI) as the official measure and setting a target of 2.0%. CPI inflation is currently (January 2004) just 1.4%. This paper re-examines the outlook for UK inflation and argues that inflation problems are brewing for late 2004 and 2005.

**Inflation is considered by many to be "yesterday's problem"**

Prevailing views about inflation have changed significantly over the last ten years or so across the world. It has largely come to be regarded as "yesterday's problem" by commentators and policy-makers. Japan's experience since 1990 has been held up as the example of what could happen if deflationary forces were allowed to take root. In 2002 and 2003 the Federal Reserve Bank in the US stressed that deflation was a real threat to the global economy. Most famously, Governor Ben Bernanke highlighted in a landmark speech to the National Economists Club in November 2002 (*Deflation: Making sure "it" doesn't happen here*) that the Fed would be vigilant, resourceful and pre-emptive in making sure that deflation was not allowed to take hold in the US. Specifically, "the US central bank, in cooperation with other parts of the government as needed, has sufficient policy instruments to ensure that any deflation that might occur would be both mild and brief." Bond markets around the world rallied over the next six months (helped by Iraq-related fears) as markets interpreted the debate as meaning that deflation could be the major macro-economic problem over the next few years. 10-year Treasury yields tumbled from 4¼% to just over 3%; long-dated gilts yields fell from 4¾% to less than 4¼%.

**Fears about deflation were prevalent in 2001 and 2002**

Deflation worries have diminished sharply since then as it became apparent that secular declines in prices in the major nations were not a realistic short or medium-term prospect, especially in the US. As evidence of the worthwhile global recovery mounted during the course of 2003, bond yields rose again. However, there seems to be little or no concern regarding higher inflation. According to *Consensus Forecasts*, US inflation is expected to reach 1.6% this year and 2.1% in 2005. Across the euro-zone it is forecast to be 1.7% in both years, while RPIX inflation is expected to be 2.5% this year and 2.4% next. Moderate deflation (around -0.2% to -0.3%) is projected for Japan, slightly higher than the experience of recent years.

**Short-term and medium-term analyses should proceed in different ways**

Forecasting inflation in the short term (say for periods up to a year) should proceed in a very different way from assessing prospects over the medium and long term (for periods of two to three years or longer). Prices and wages are set in goods markets and labour markets respectively, and in the first instance they depend on demand and supply in such markets. There is a mass of survey information available on both price and wage prospects, and on the balance between supply and demand in the various markets. An inflation forecast in the short run is most likely to be accurate if it is based on as much of this information as possible. But, over the medium term survey information gradually dwindles in its usefulness. Instead, two rules-of-thumb become useful as the forecasting horizon extends into the future.

**Two rules-of-thumb are important**

First, the direction of inflation is fundamentally influenced by the output gap, the level of actual GDP relative to trend or potential. Inflation will rise (fall) if output is above (below) its trend level. Secondly, the behaviour of demand and output is strongly influenced by the rate of monetary growth. To spell out the second rule-of-thumb in more detail: if the rate of growth of real (i.e., inflation-adjusted) money is significantly above (beneath) the trend rate of growth of real output, then demand and output will be likely to increase at an above-trend (beneath-trend) rate. Sustained periods of above-trend (beneath-trend) growth must of course eventually push output above (beneath) its trend level, with inflationary consequences.

**Global inflation outlook should be benign after the major downturn**

After the major global economic downturn of 2001/02 world output dipped significantly below its trend level. In early 2003 the global negative output gap was estimated to have approached 1½% of world GDP. This was similar to the size of gap reached in 1992/93 after the deep global recession of the early 1990s. In 1993 world demand revived under stimulatory monetary policies (low interest rates) and there were fears that inflation would rise again. But the significant amount of spare capacity that existed at the time (because of the earlier recession) meant that there were no inflationary pressures. Lombard Street Research estimates show that world GDP (actually just the OECD main countries) was below its trend level between mid-1991 and mid-1997. Inflation in the G7 nations was 4.0% in August 1991 and this fell to 2.7% in August 1993. The resumption of above-trend growth in 1993 did not prevent inflation falling further over the subsequent four years because world output remained below trend over this period.

**But growth is already reviving strongly...**

The significant negative output gap in the middle of last year should mean that the prognosis for global inflationary pressure over the next few years is similar to that of a decade ago. But there are two important differences. First, interest rates are much lower now than they were ten years ago. The strong revival in US growth in the second half of last year (annualised GDP increases of 8.2% and 4.0% in Q3 and Q4 respectively) indicates that expansionary policy is having the desired impact. But it also implies that the negative output gap is being reduced quite rapidly. Secondly, the world is changing. It used to be the case that an analysis of the prospects for the

**...and the world is changing**

G7 nations was quite sufficient to produce an outlook for the global economy. In the 1980s these seven countries accounted for more than two-thirds of world GDP. By 2002 that proportion had dropped to just less than half as other nations have grown in importance. The major one is obviously China, but India, Brazil, Russia and others are becoming more important world players. These four account for about 9% of world GDP today at current exchange rates, but around 22% at purchasing power parity (PPP) exchange rates. In 20 years they could account for almost one-third of world GDP, only slightly less than the G7 by that time.

**Great demands are being made on world resources**

The key point is that the rapid growth of these nations is placing more demands on world resources and that is leading to inflationary pressures. Commodity prices are currently 10% or 20% higher than a year ago, the oil price has stayed stubbornly above $30 a barrel, some metals prices have doubled over the last year and shipping freight rates have soared higher in 2003 and early 2004. So although output gap analysis in the major nations may indicate a relatively benign inflation outlook, the rest of the world cannot be ignored. Moreover, inflation in the US is already rising. Producer price inflation has reached 4% even before the full impact of higher commodity prices and freight rates, and the dollar weakness of November and December, has been felt. The rise in inflation has happened at a surprisingly early stage of the US recovery.

**Inflation in the UK is not dead, merely dormant...**

In the UK, inflation has been fairly well-behaved in recent years. But, as the MPC admits, there is very little spare capacity in the British economy at present. With growth set to remain at an above-trend rate in 2004, supply-side bottlenecks could emerge later in the year. The Bank of England has implicitly recognised this by acknowledging that inflation is set to be on a gently-rising trend over the next two years. But are they being too sanguine about inflation prospects in the UK? Producer price inflation is already rising and the labour market is tight. Unemployment recently fell to a 30-year low. It is possible that wage pressures have been hidden because employers have offered higher pension fund contributions rather than salary increases. But even so, settlements have inched higher and some skills shortages are becoming apparent in particular sectors.

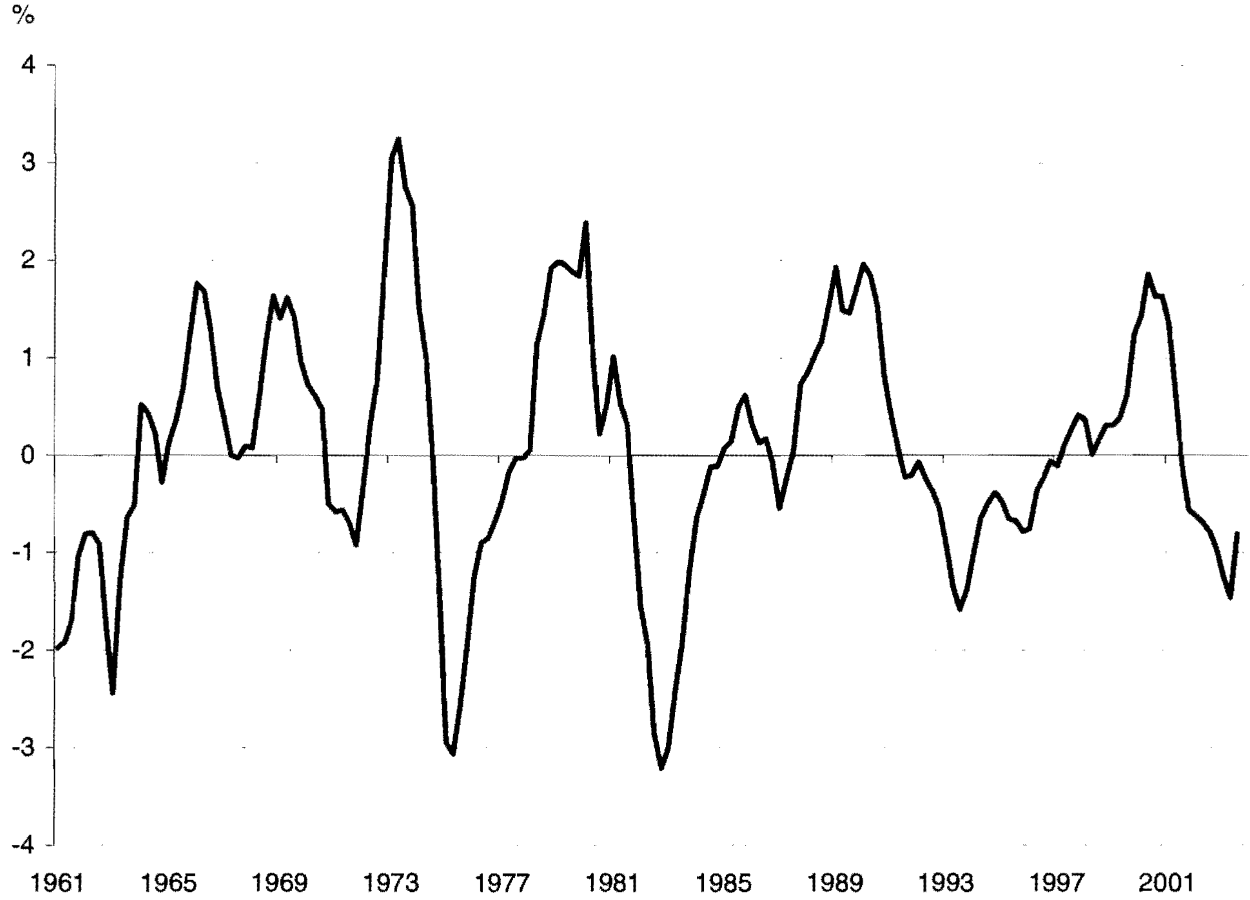
**...and it could return in late 2004 and 2005**

Perhaps most fundamentally, money growth in the UK is too high to be consistent with a 2% or 2½% inflation target over the medium term. Low interest rates have stimulated rapid credit growth, while an increased budget deficit may have to be financed largely by the banks. A return to the high inflation rates of the 1980s and early 1990s is implausible. But the UK looks set to experience inflationary problems in late 2004 and in 2005 as a result of a - hopefully mild - bout of overheating.

# The output gap is the main influence on inflation

## Global output gap is negative, but closing fast

*Chart shows the deviation of actual GDP from trend or potential GDP, as a proportion of potential GDP, for the major industrial nations. This concept is known as the output gap.*




*Sources: OECD and Lombard Street Research calculations.*

The level of actual output or GDP relative to trend (or potential) is the fundamental influence on the direction of inflation. If GDP is above its trend level (in other words there is a positive output gap), inflation will tend to rise. Conversely, if there is a negative output gap, inflation will tend to fall. The "major nations" output gap was negative between 1991 and 1997. Inflation in the G7 economies fell from 4.0% in mid-1991 to 2.7% in mid-1993. At that point growth began to revive and the negative output gap started to close. But inflation continued to fall because output was still below its trend level. The four-year period between mid-1993 and mid-1997 saw the economic nirvana of above-trend growth and low or falling inflation. The same favourable combination of macroeconomic outcomes seemed plausible from the middle of 2003. But the economic revival has been marked, while the rest of the world (i.e., the non-G7 world) is having a significant impact on the global inflation outlook.

# The world is changing

## Emerging nations becoming more important

*Table shows the estimated share of global GDP accounted for by particular nations, calculated at current exchange rates.*

| | **1981** | **2001** | **2021 (projected)** |
|---|---|---|---|
| United States | 30.0 | 32.3 | 32.4 |
| Japan | 11.6 | 13.3 | 9.0 |
| Germany | 6.7 | 5.9 | 4.0 |
| United Kingdom | 5.1 | 4.6 | 3.8 |
| France | 5.8 | 4.2 | 3.5 |
| China | n/a | 3.7 | 8.0 |
| Mexico | n/a | 2.0 | 2.9 |
| India | n/a | 1.6 | 3.3 |
| Brazil | n/a | 1.5 | 2.4 |

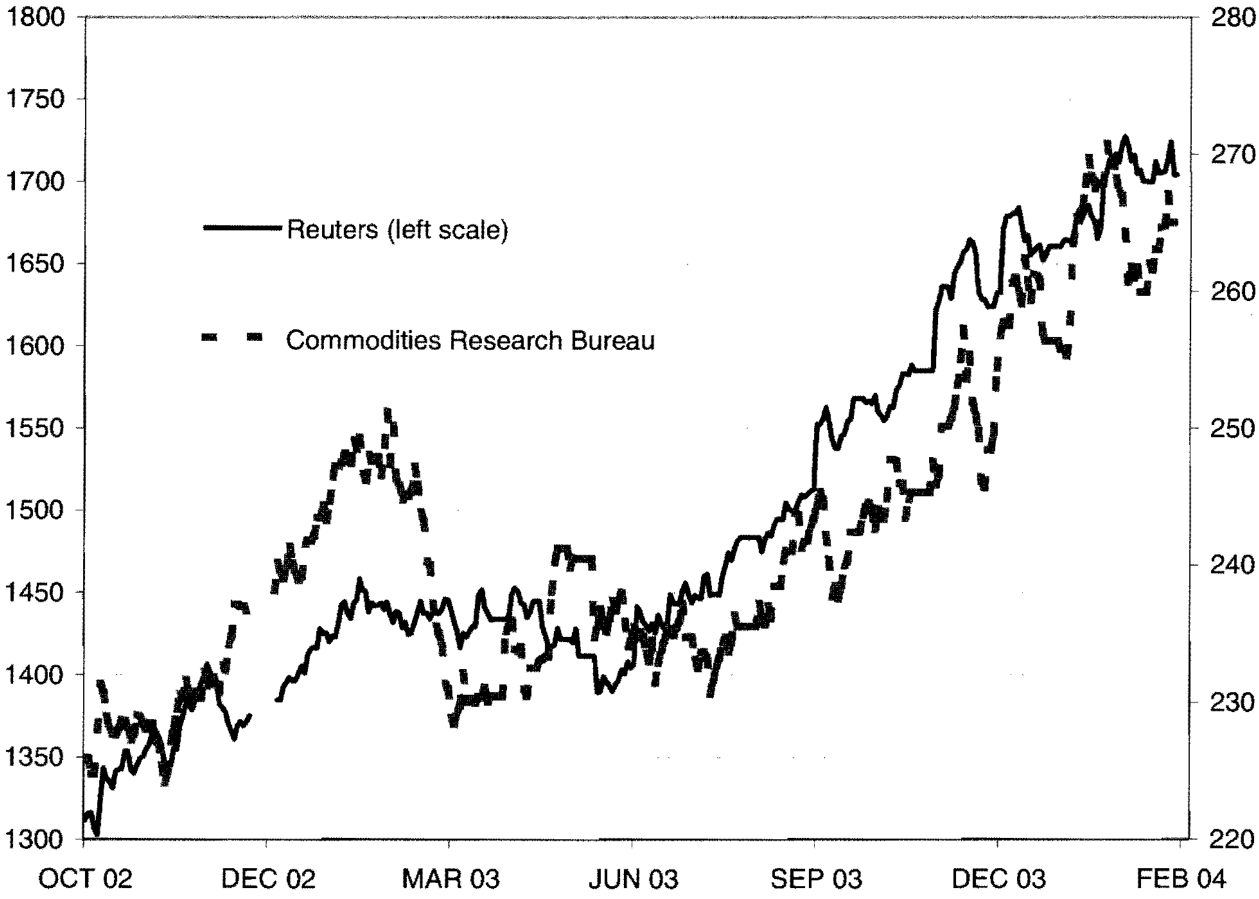
*Sources: OECD, World Bank and Lombard Street Research calculations.*

In the 1970s and 1980s it was reasonable to reach an assessment about the global growth and inflation outlook simply by looking at the G7 nations. Together, these countries accounted for between two-thirds and three-quarters of world output. Global inflationary pressures were therefore largely determined by trends in these economies. During the 1990s the situation changed as developing economies started to have more of an impact on the world stage. The emergence of vast low-cost manufacturing bases in China, India and elsewhere had a massive deflationary effect on the global prices for traded goods. These trends remain, but more recently the rapid growth and industrialisation within such nations has put greater demands on world resources. For example China is now the world's largest consumer of copper. Over the last year, metals prices and shipping freight rates have soared as a result. These trends cast an inflationary pall over an otherwise benign world outlook.

# Commodity prices up steeply over last year

## Metals prices and shipping freight rates have soared

*Chart shows two of the major commodity price indices since late 2002*



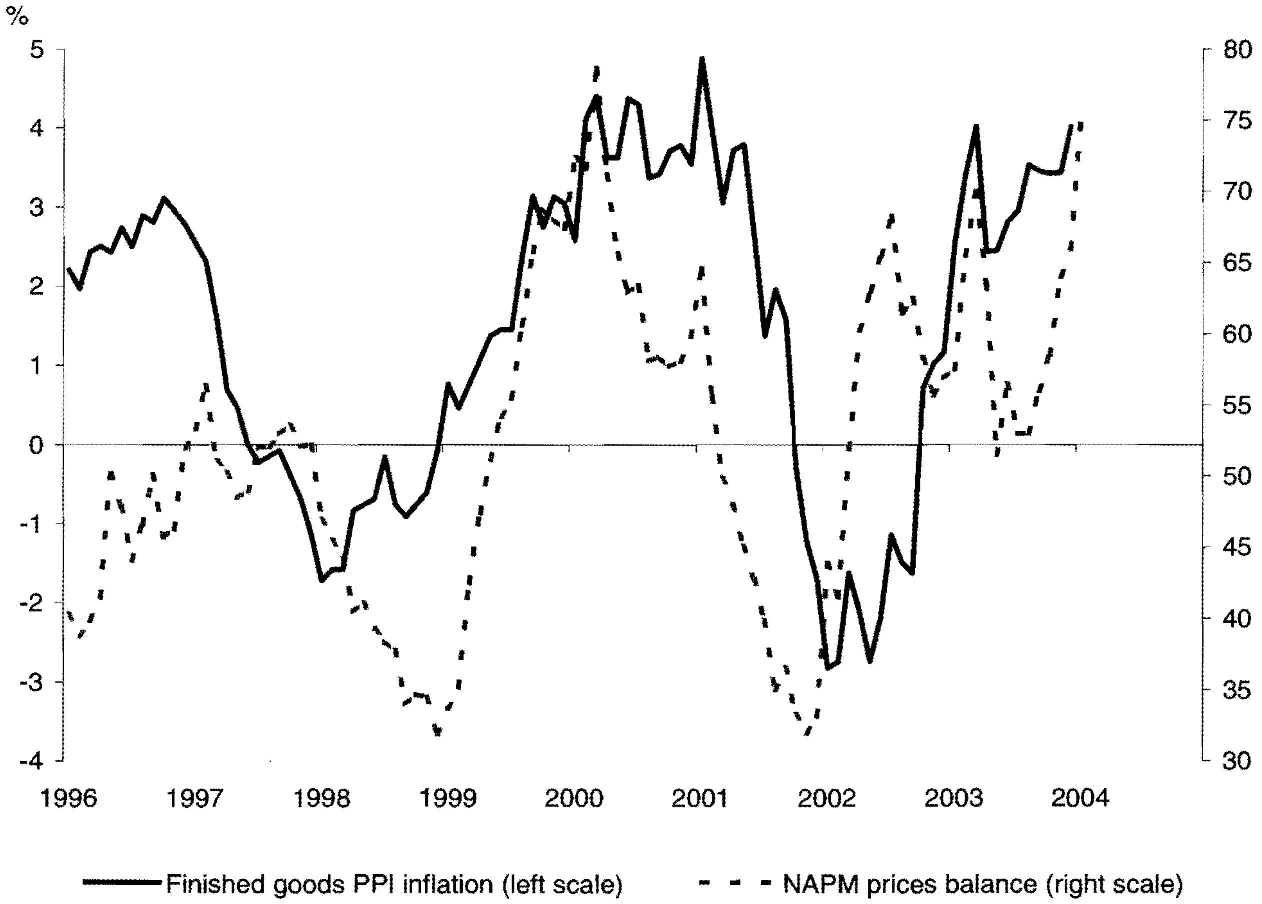

*Sources: Reuters, Commodity Research Bureau*

According to the Commodity Research Bureau (CRB) world commodity prices have risen by 8% over the last year. The underlying rate of increase of non-oil commodities is higher, since the CRB index includes oil. Twelve months ago oil prices spiked higher because of supply interruptions in Venezuela and Nigeria. The price of Brent crude was over $33 a barrel in February and March last year, compared to around $30 today. The Reuters index of commodities, which excludes oil prices, is currently 19% higher than a year ago. These trends are worrying since there appears to be little concern about global inflation prospects. The consensus is that inflation will stay low across the world for the foreseeable future. Yet any inflationary uptick is bound to be seen first at the early stage of the supply chain, where supply inelasticities in the short-run are marked.Much higher metals prices and a doubling of world shipping freight rates over the last twelve months are indicative of the re-emergence of mild inflation pressures.

# Inflation pressures growing in the US

## PPI inflation to rise above 5% later in 2004

*Chart shows annual % change in US finished goods producer price inflation and the reported prices paid balance from the monthly purchasing managers' survey.*



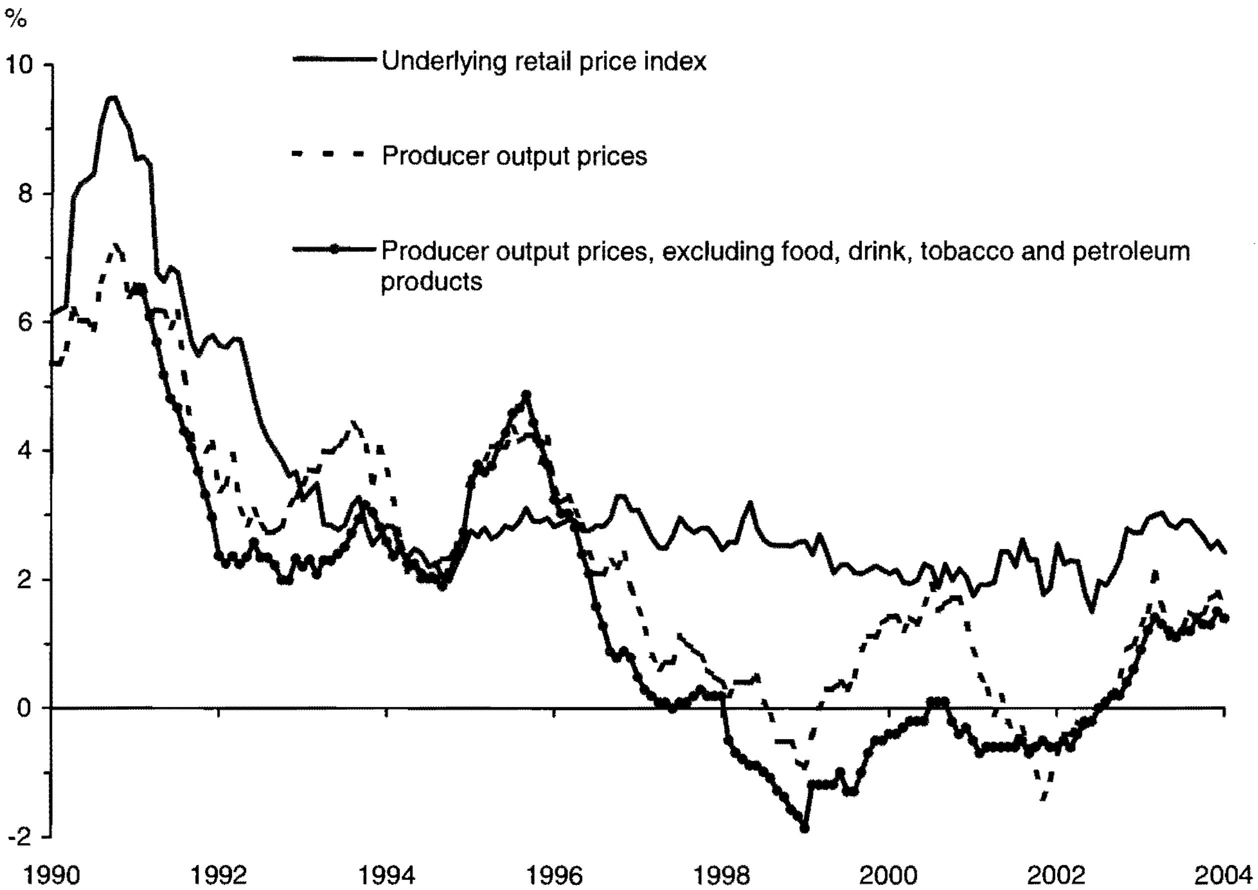

*Sources: Bureau of Labor Statistics, National Association of Purchasing Managers*

Almost unnoticed, and more or less ignored by most commentators, factory-gate inflation in the US has risen steeply over the last twelve months. In the year to December, PPI inflation for finished goods reached 4.0%, the highest since the peak of the boom in 2000. Part of the explanation for the recent rise has been higher prices for food and oil. "Core" PPI inflation, which excludes both, is lower. But there has to be some scepticism regarding the use of indices that exclude items where prices are going up. Americans are not suddenly going to stop eating or driving cars. The last time that PPI inflation was this high, CPI inflation rose too, exceeding 3.5% in late 2000 and early 2001. Moreover, PPI inflation is probably heading higher. The latest figures do not incorporate fully recent rises in metals prices and shipping rates and they pre-date much of the steep fall in the dollar. It is worth noting that import prices rose by 1.3% in January alone. PPI inflation will move above 5% in 2004.

# UK inflation performance over the last decade

## Retail inflation has been well-behaved

*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.*



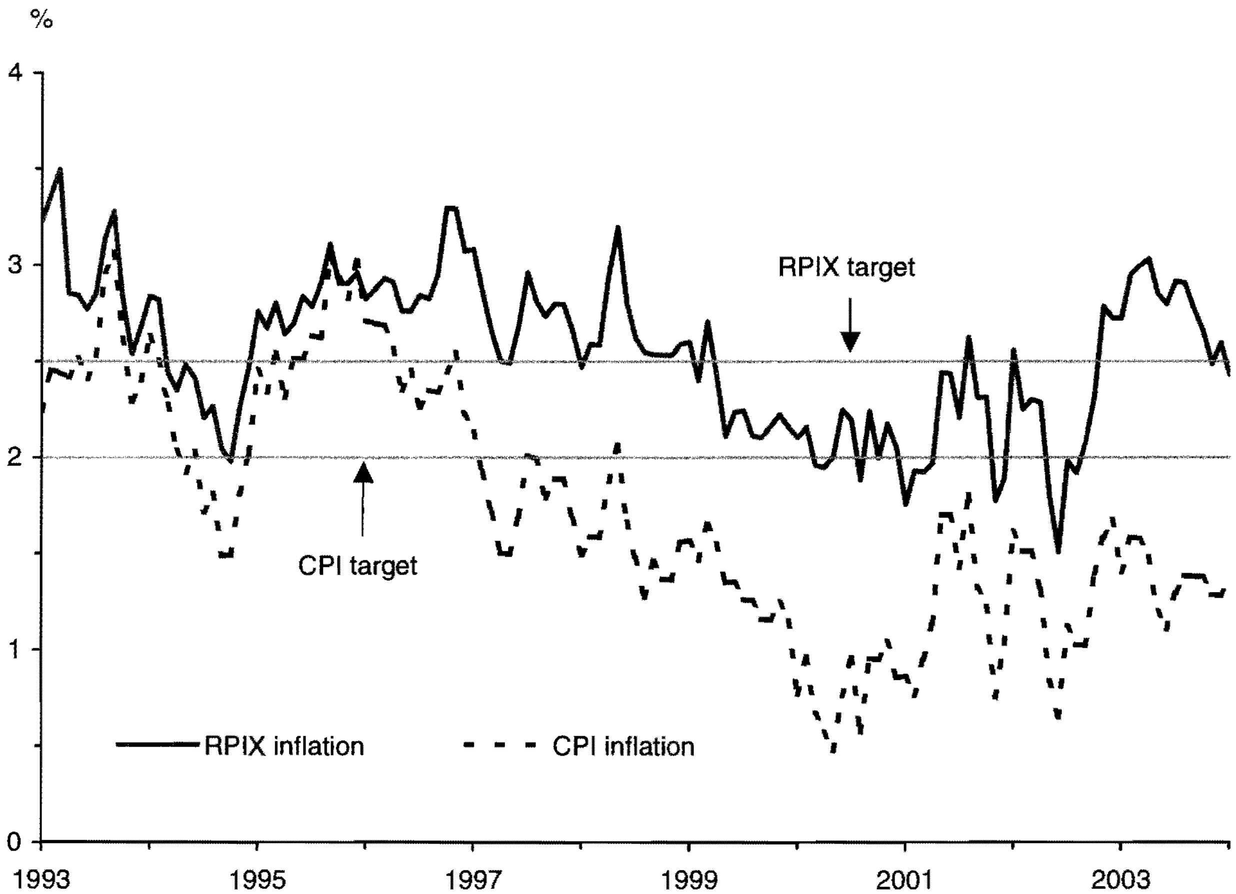

*Source: ONS* Economic Trends.

Underlying retail inflation on the RPIX measure has drifted lower in recent months, reaching 2.4% in January, below the old 2.5% target, having been as high as 3% in early 2003. The main reason is that services price inflation has collapsed from well over 5% to less than 3%. Within this category, the entire fall has been within leisure services and within that, it has been the price of foreign holidays, the annual inflation rate of which has plummeted from 10% to –1% over the last year. This pattern is somewhat at odds with other data sources, such as ABTA, and may be related to the National Statistics Office using new figures from online bookings and budget airlines. While doing so is entirely appropriate, there is a risk that in transition phases, official data can be misleading. More fundamentally, PPI inflation in the UK has picked up quite noticeably over the last few years, indicating modest inflation pressures in the pipeline.

# The inflation target - old and new

## CPI inflation is below target, but set to rise this year

*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 consumer prices (the CPI or old HICP).*



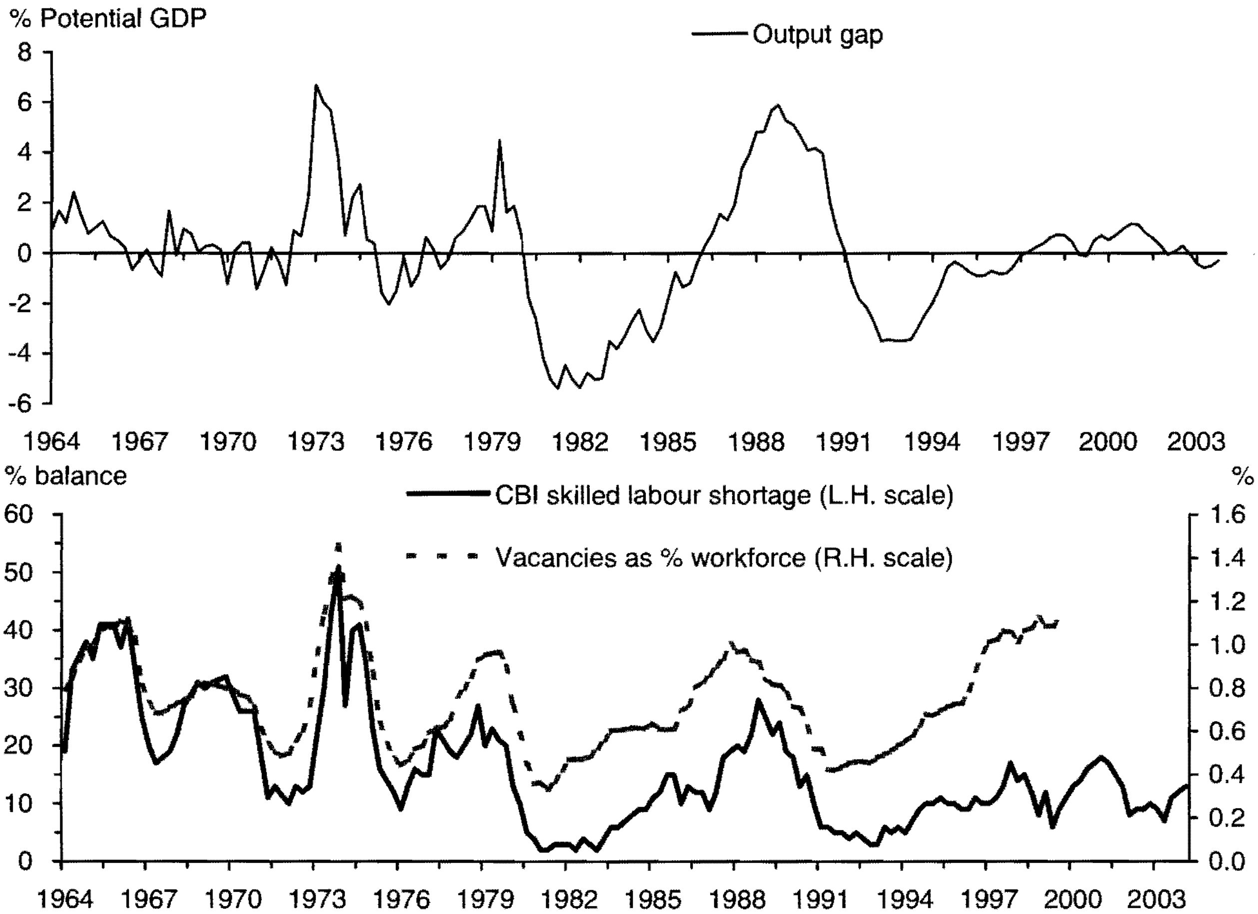

*Source: ONS* Economic Trends.

One of the difficulties facing the MPC is that whereas inflation at the end of 2003 was above target on the RPIX measure, it was – and still is – below target on the new CPI index. Part of the explanation is that the CPI does not include house prices. If house prices hadn't risen over the last year, RPIX inflation would have been 0.5% lower. But the Governor of the Bank made it quite clear at the press conference accompanying the release of the February *Inflation Report* that below-target inflation would not stop interest rates going up. Indeed, the profile of the official CPI inflation projection showed it rising steeply at the end of the two-year forecasting horizon. Moving the projection on three months would presumably show it well above target. The Bank also forecast GDP growth of 3.4% this year and 3.1% in 2005. That can only be achieved without adverse inflation consequences if there is significant spare capacity in the economy. But the Bank doesn't think that is the case.

# Two measures of labour market slack

## The labour market is tight, even in the manufacturing sector

*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.*



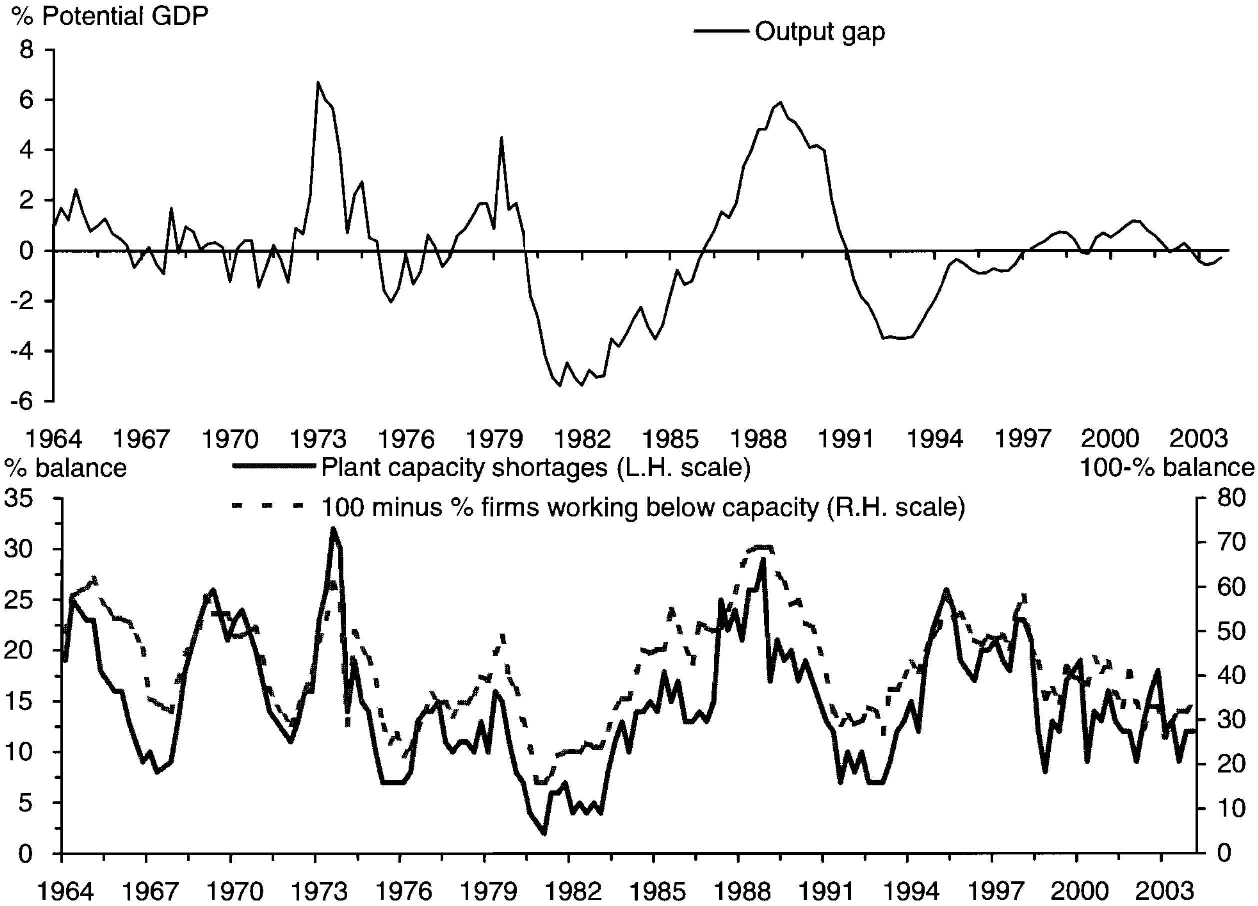

*Sources: ONS* Economic Trends, *CBI* Quarterly Industrial Trends Survey *and Lombard Street Research calculations.*

The ultimate constraint on increasing output is labour input. Capital can always be imported. According to Lombard Street Research, there is currently a very small negative output gap in the UK at present, perhaps of the order of ½% of trend GDP. But that will be swiftly eroded if the above-trend rates of growth recorded in recent quarters are repeated in early 2004. Over the last decade, the Bank has been successful in keeping UK output close to trend and thereby avoiding major inflationary or recessionary swings. In the 1970s, 1980s and early 1990s this was not the case. The three unsustainable booms were all associated with acute labour shortages, while in the two significant slumps no such problems were reported. Vacancy rates told a similar story. The official vacancies series was suspended in 2001 because the coverage was becoming wider and wider, making historical comparisons invalid. The message today is that skills shortages are in-line with long-run norms.

# Two measures of capacity utilisation

## Capacity utilisation is in line with historical norms

*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.*



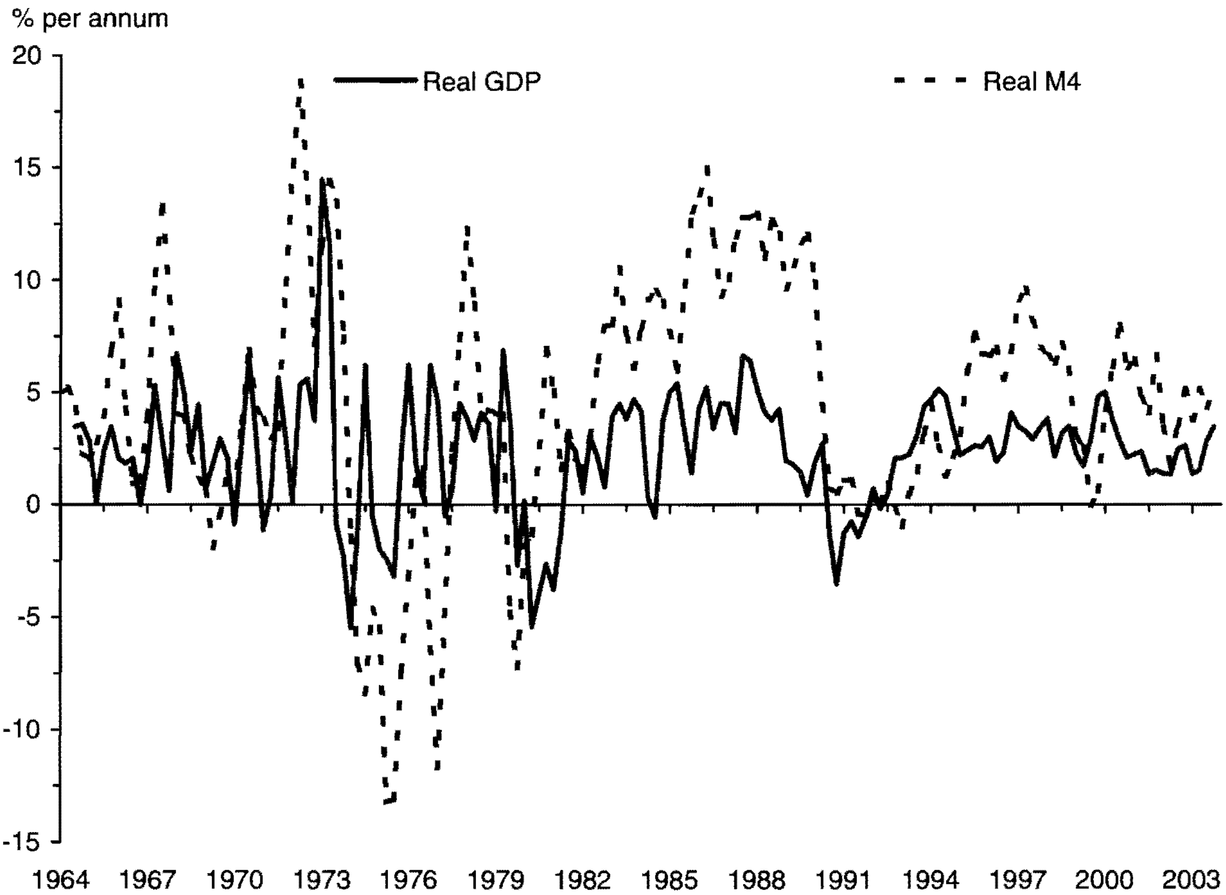

*Source: CBI* Quarterly Industrial Trends Survey *and Lombard Street Research calculations.*

Between the early 1960s and the early 1990s, the CBI's monthly survey of capacity utilisation in the UK manufacturing sector gave a useful guide to supply-side pressures within the economy as a whole. Manufacturing is now only around 18% of the total economy (perhaps even less) compared with between 25% and 30% in the 1960s and 1970s, meaning that the message from the survey today does not necessarily reflect overall trends. Having said that, the readings from recent surveys, both in terms of utilisation rates and in the numbers of firms reporting plant capacity shortages, do not indicate that there is plenty of spare capacity even in the relatively-depressed manufacturing sector. Both series are in line with their averages over the last twenty years and have risen over the last six months. Manufacturing production is now rising again on an underlying basis, in large part because of the worthwhile recovery in global demand, and surveys point to further increases in 2004.

# Real broad money and the business cycle

## Real M4 and GDP have moved together over the last 40 years

*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.*



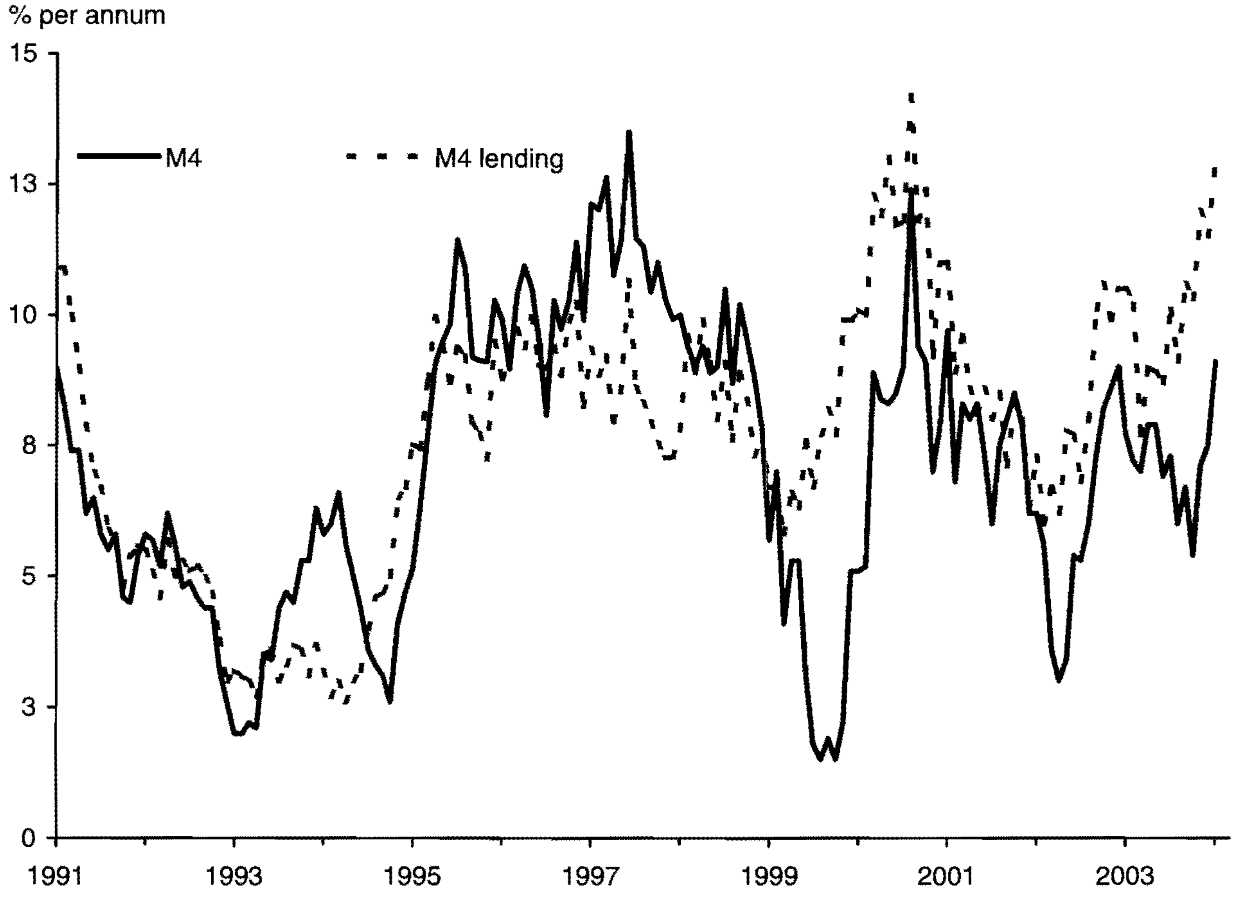

*Sources: ONS* Economic Trends *and Bank of England* Monetary Statistics.

If it is true that there is only very limited capacity in the UK economy in early 2004, then above-trend growth in the first half of this year will lead to the emergence of a positive output gap and mild inflationary pressure. The message from the recent pace of monetary growth is that is exactly what will happen this year. Although the relationship is far from perfect, there is a clear correlation between the expansion of real money and the rate of change of real GDP. As a rule, real money trends tend to lead economic growth by about six months to a year. The firm rate of real M4 growth seen over the last year or so (and it picked up sharply again in January) argues for continued rapid growth of domestic demand in at least the first half of 2004 and probably longer. The MPC has expressed itself "surprised" that domestic demand has not slowed more in recent quarters. Yet the message from monetary trends was, and still is, fairly clear.

# Recent monetary trends

## Rapid credit growth is boosting the money supply

*Chart shows the six-month annualised percentage change in nominal M4 and M4 lending since 1991. Seasonally-adjusted monthly data.*



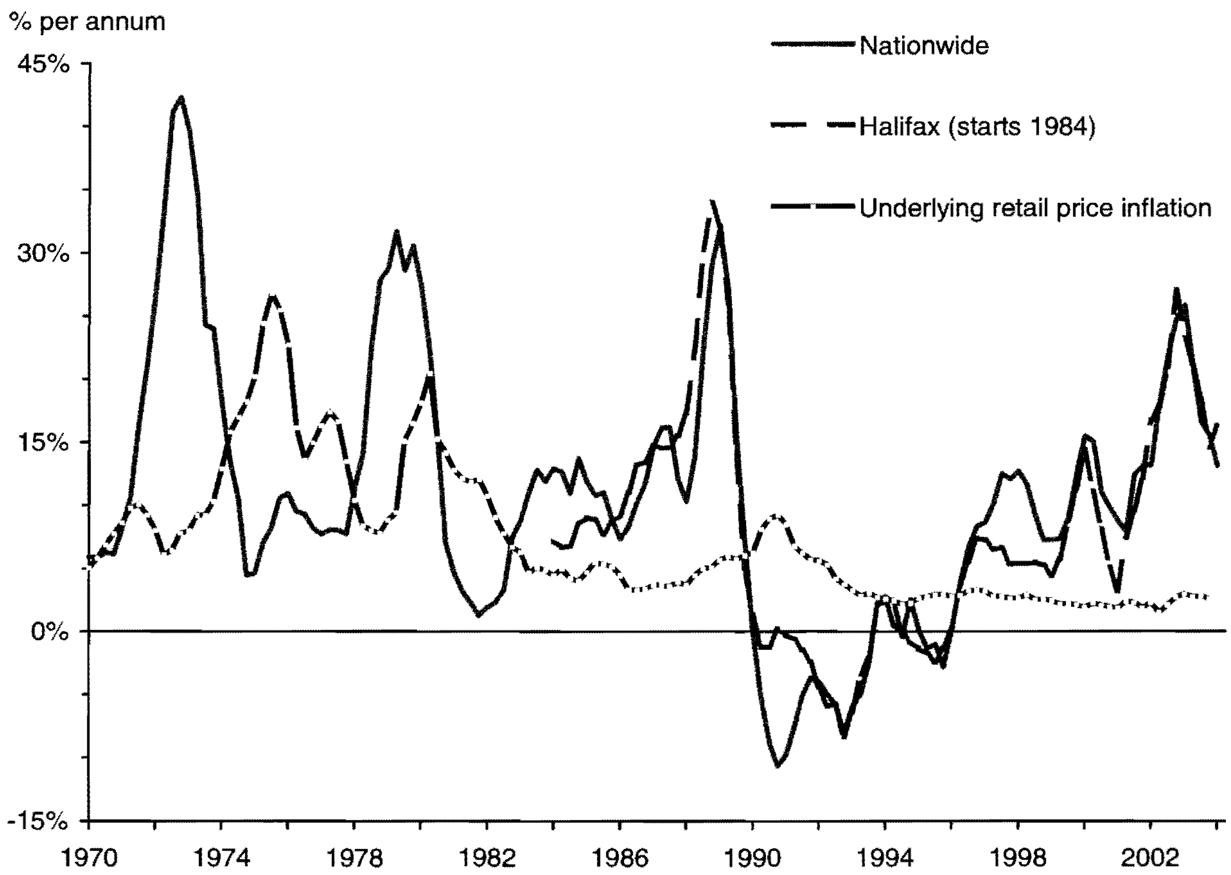

*Source: Bank of England* Statistical Abstract.

The annual rate of monetary growth has picked up recently, primarily because of renewed momentum in credit growth. According to Bank of England figures, M4 rose by 8.4% in the year to January, but by 13.4% in the last three months at an annualised rate. Lending to the UK private sector has risen by 11.3% over the last year and appears to be accelerating. These figures suggest that the November rate rise has had no impact on borrowing. Mortgage approvals data may now be stabilising, but they are doing so at a very high level, suggesting that mortgage demand will stay strong for a while yet. Moreover, evidence is growing that corporate loan demand is reviving. With public borrowing set to stay high for some time, the public sector could also boost money growth through "monetisation" of debt. The overall message is that money growth will stay high in 2004, arguing for robust domestic demand but inflation problems later in the year and in 2005.

# House price inflation and retail price inflation

## Previous house price bursts have been followed by higher retail 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).*




*Source: Nationwide, Halifax and ONS* Economic Trends

The three previous bouts of rapid house price inflation (early 1970s, late 1970s and late 1980s) were all followed – with a lag of up to two years – by significant upturns in retail price inflation. One explanation is that booming house values imply a beneficial wealth effect to households that stimulates consumption, often funded by equity withdrawal (MEW). Bank of England research has shown that changes in housing wealth have a more direct and larger impact on spending than movements in financial wealth. MEW reached a new peak in Q3 last year of 7% of disposable income. There are at least seven major house price indices to choose from now, but the overall conclusion must be that house prices are still rising at double-digit annual rates. Approvals and supply shortages suggest rates could pick up further this year. A correction to UK house prices is inevitable at some time, but it does not look likely this year. In the meantime, households will be happy to carry on spending.