Monthly Economic Review

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Contents **Page**

Contents	Page
Commentary on the economic situation	1
Research paper: Leading indicators vs. money	3

Will they ever learn?

Bank of England again fails to understand the role of financial sector money

Bank of England dismissal of relevance of financial sector money

"Broad money growth...in March reached its highest annual rate since July 1998...Many [non-bank] financial corporations such as securities' dealers use bank deposits solely for trading purposes: those deposits are therefore unlikely to be informative about the near-term outlook for nominal private sector demand. When [non-bank financial corporations'] deposits are excluded, the recent pickup in broad money growth has been less pronounced." This is the Bank of England's verdict in the latest *Inflation Report* (p. 12) on the return of a double-digit annual growth rate of the quantity of money. In the year to April M4 increased by 10.4 %.

Economy apparently split between an important "real" side and an ornamental "financial system"

The thinking here seems to be that money is of two kinds, one part which is held by persons and companies, and another part which is held in the financial sector. Non-financial money is relevant to the demand outlook because it is used for "spending on good and services". By contrast, money in the financial sector only facilitates the trading of securities. Such trading is of no relevance to "spending on goods and services", and is best seen as an ornament to the important forms of economic activity, i.e., those which take place in "shops", "factories" and such like. On this line of argument it doesn't matter to the future behaviour of the economy if financial sector money explodes at 20%, 30% or 40% a year, or contracts by 10% or 20% a year. The denial of a significant macroeconomic role for financial sector money has been characteristic of UK officialdom in the last 35 years, and goes a long way to explain the boom-bust cycles of the 1970s and 1980s. (The author can well remember an extremely senior Treasury official joking in late 1986, early in the disastrous Lawson boom, that the 30% - 40% annual growth rates of financial sector money then prevailing did not matter. His explanation was that "they could not be spent on groceries".)

But money circulates - and financial sector money influences asset prices

As every schoolboy knows, money has a distinctive characteristic. It circulates. Money that is held in the Prudential's bank balance on 1st May is "spent" on a rights issue by a housebuilding company on 15th June and the housebuilding company "spends" it on 18th July to cover sub-contractors' invoices and the sub-contractors (the bricklayers, the electricians, etc.) "spend it on groceries" in August. (And perhaps the grocery store manager invests in Prudential unit trusts on 18th September.) There is indeed some tendency for money to circulate within sectors for a time (i.e., technically, the growth rates of sectoral money holdings are serially correlated), but the Bank of England's comments on the irrelevance of financial sector money are poppycock. Money balances are restless without end. A repetitive feature of the cycles of the last 35 years is that rapid growth in financial sector money leads in the first instance to buoyant asset prices (and/or a weak exchange rate), then to above-trend demand growth and ultimately to more goods-and-services inflation. (The mechanisms were explained in some detail in the May 2004 issue of this *Review*.) In the three months to March the annualised growth rate of financial sector money was 23.4%.

Tim Congdon **29th May 2005**

Summary of paper on

'Leading indicators vs. money'

Purpose of the paper

Two approaches - the preparation of leading indicator indices and the tracking of money supply trends - are useful in assessing the macroeconomic outlook. But at present they give conflicting messages in the UK. Which will prove right?

Main points

- Growth of consumption has slowed in 2005, after a remarkable decade in which it consistently outpaced growth of output. (See p. 5.) Leading indicator indices - which typically include housing-related variables and business survey results - have turned down in recent months.

- But employment growth has been quite high (see p. 4), while business surveys for *services* have been better than those for *manufacturing* (see pp. 6 - 7). The immediate prospect is not too bad.

- Over the medium and long runs the similarity of growth rates of money and nominal spending has to be noted. In the year to March M4 increased by 10.4% and in the year to April also by 10.4%.

- In the period of macroeconomic stability from early 1993 until today the average annual growth rates of M4 and nominal GDP have been 7½ % and 5½ % respectively. On this basis the current rates of money supply growth are too high. (See p. 8.)

- Prognoses based on leading indicator work are therefore at variance with those based on money. This sort of conflict is unusual and makes the debate about the outlook for the UK economy in late 2005 particularly interesting.

- In the last few months rather high money growth has been associated with a surge in financial sector money, dismissed by the Bank of England as of little importance. (See p. 1.) However, similar surges occurred in the early phases of previous cyclical booms. (See p. 9.)

- UK banks are remarkably profitable and well-capitalised at present. In the five years to end-2004 their "capital and other funds" increased at a compound annual rate of 21%. Over the medium and long runs banks' capital and assets tend to grow at similar rates. (See p.p. 10 -11.)

- The bouyancy of bank profits and signs of a revival in mortgage credit (see p. 12) argue in favour of expecting above-trend demand growth in late 2005 and, at unchanged interest rates, in early 2006 as well.

This paper was written by Tim Congdon

Leading indicators vs. money

An interesting debate about the outlook for the UK economy in late 2005

Value of leading indicator indices, which combine information about future deliveries, etc.

Early 2005 has seen an unusual conflict between two types of advance indicator to economic activity. One way of judging the economic prospect is to compile information about future spending on big-ticket items of expenditure (such as that on houses and durable goods by the personal sector, and on buildings, plant and equipment by companies). A great deal of such information is available (mortgage commitments, car registrations, construction orders, investment intentions in business surveys, answers to questions on orders and output again in business surveys) and can be synthesized in "leading indicator indices".

and also useful is analysis of money growth, because of long-run link with nominal GDP

An alternative approach tries to exploit the undoubted similarity of the growth rates of money and nominal spending, which is a feature of nearly all economies. If it is assumed (quite reasonably in most circumstances) that the current growth rate of money will persist if interest rates are unchanged, the current growth rate of money ought to be associated over the medium term (i.e., the next two or three years) with a similar growth rate of nominal spending and GDP unless monetary policy is altered. By combining these two lines of analysis - leading indicator work and the tracking of money supply developments - an analyst ought to assemble a fairly good prognosis of the economic outlook over the next few quarters.

But - in UK at present - the two approaches give conflicting messages

The trouble at present is that, as far as the UK economy is concerned, the two approaches are in open conflict. Most leading indicator indices - including those prepared by Lombard Street Research - are going sideways or have weakened a little in recent months. The deterioration is readily explained by the adverse impact of higher interest rates on housing-related variables and the knock-on effect of the Eurozone slowdown on UK industry. (The Eurozone has suffered from the withdrawal of spending power by the oil price rise and the appreciation of the euro against the dollar.) If the leading indicator indices are right, the outlook for demand in the second half of 2005 is mediocre and early 2006 isn't likely to be much better. This somewhat negative verdict is reinforced by the latest information on retail sales and the housing market, which has been bleak. (However, when one says "retail sales", one should really say "retail sales ex-Tesco"!)

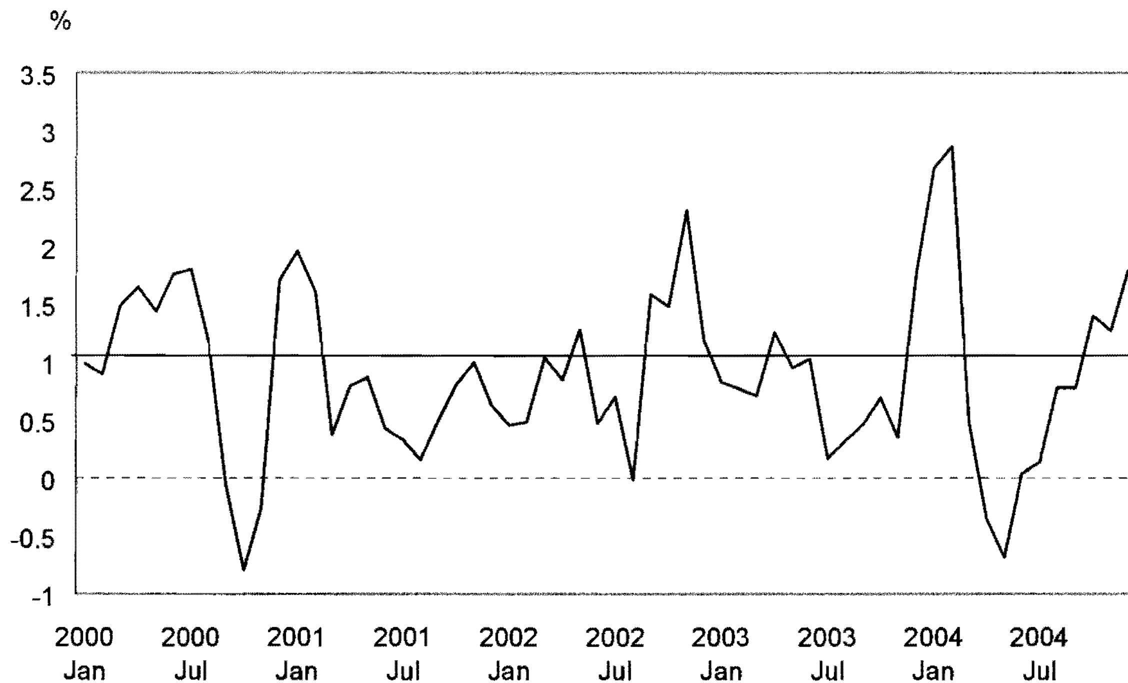
Rapid money growth implies *above-trend* demand growth in late 2005

By contrast, the monetary data give an up-beat message for demand in coming quarters. In the year to March M4 advanced by 10.4%, the first double-digit growth rate since early 1998. Company liquidity has been increasing steadily, while financial corporations' money climbed by 16.9% in the twelve months to March and at an annualised rate of in the three months to March of 23.4%. These are classic advance indicators of liquid balance sheets, buoyant asset prices and above-trend demand growth. The monetary data suggest above-trend growth of domestic demand. Late 2005 will be an interesting test of different economic theories. The following pages survey the competing evidence.

The present situation

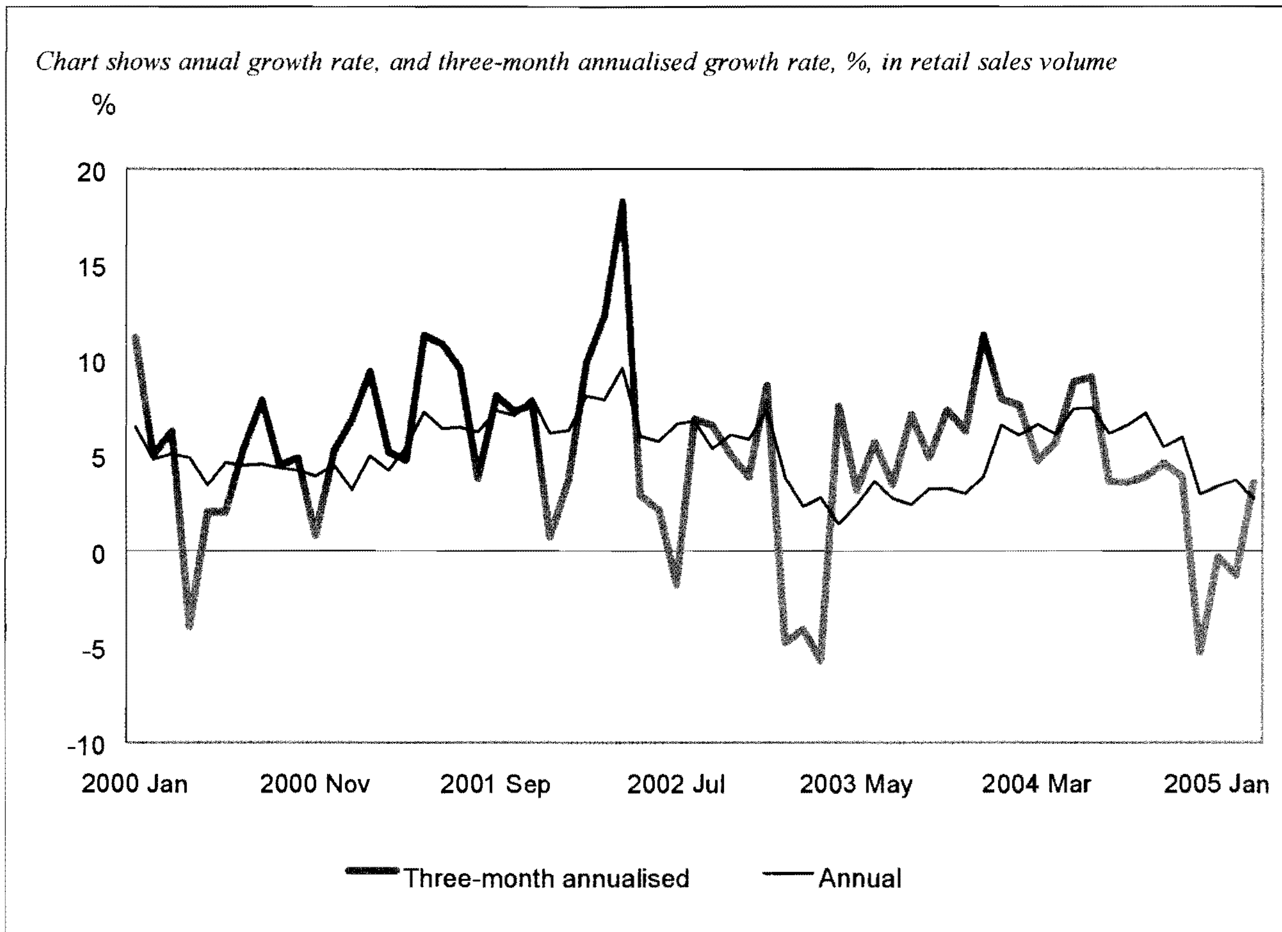
Employment growing quite strongly

Chart shows annualised growth rate of employment in last three month period, using monthly data and based on Labour Force Survey. Straight line shows average such growth in 1993 - 2004 period of macroeconomic stability.



Employment is generally recognised as one of the best coincident measures of output. On this basis the latest numbers are not consistent with the impression of economic weakness conveyed by the housing market and newspaper reports. According to the *Labour market statistics* release of 18th May employment rose by 87,000 between the quarter to December 2004 and the quarter to March 2005. While the sampling error in the relevant survey is enormous, the increase in employment is so substantial (at an annual rate of over 300,000, equivalent to over 1% of the number of people in work) that the broad conclusion cannot be avoided. Recruitment continues to run at buoyant levels, which makes sense only if the economy as a whole is doing well. Unemployment has edged up a bit in recent months, but the level of claimant-count unemployment was only 2.7% in March and April, which indicates a very tight labour market.

Marked recent weakness in retail sales

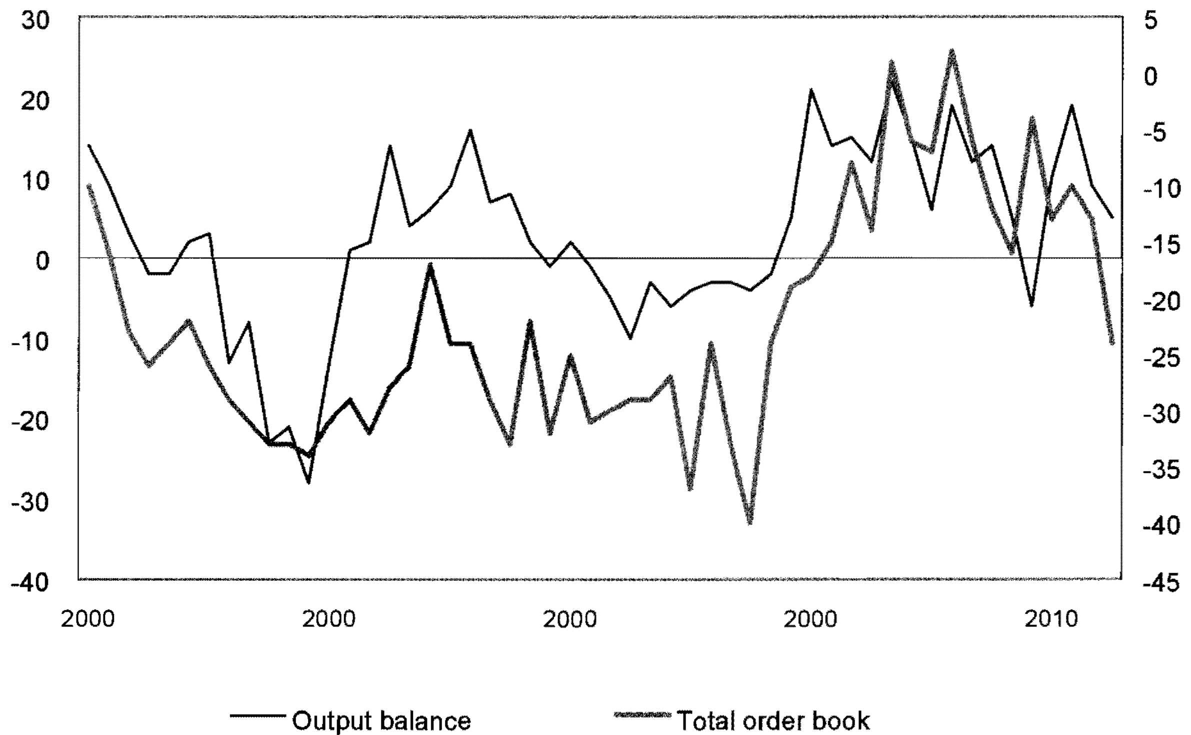


The nine years from 1996 to 2004 inclusive were a remarkable period for the UK economy, with the growth of consumption exceeding that of national output in every year. 2005 looks as if it will be different, with consumption growth perhaps ½% behind output growth. In resource terms, the justification is simple, that the UK needs to shift some output into net exports and corporate capital spending (notably a recovery in telecommunication investment) to re-balance the economy. In terms of the key influences on agents' decisions, the rise in interest rates from base rates of 3½% in late 2003 to 4¾% in August 2004 was fundamental. That rise checked house price inflation and deterred mortgage borrowing. As the chart of p. 12 shows, the *number* of mortgage approvals collapsed from over 125,000 a month in late 2003 to 80,000 a month by the end of 2004. However, the figure has now crept back towards 95,000, not far from the typical value in the 1990s.

The immediate prospect

Recent CBI survey results show some deterioration

Chart shows % balance of companies planning to raise output in next three months and regarding total order books as above or beneath normal



As the CBI survey dates back to the early 1960s, it is one of the most long-lived business surveys available and serves as a reasonably good guide to conditions in the manufacturing sector. Although now less than a fifth of the economy, manufacturing output is more volatile than output in general and so needs to be tracked in an assessment of the economic outlook. The message from the chart is straightforward: rather muted conditions in 2002 and early 2003 were followed by a demand surge in late 2003 and stabilisation at the higher level in 2004. The last few months have seen some deterioration, perhaps largely because of a slowing of demand in the UK's European neighbours. (The Eurozone has suffered from the rise in the oil price and the appreciation of the euro.) But the deterioration is far from dramatic and does not yet justify a radical change of view on the macroeconomic prospect.

But a broader survey more positive

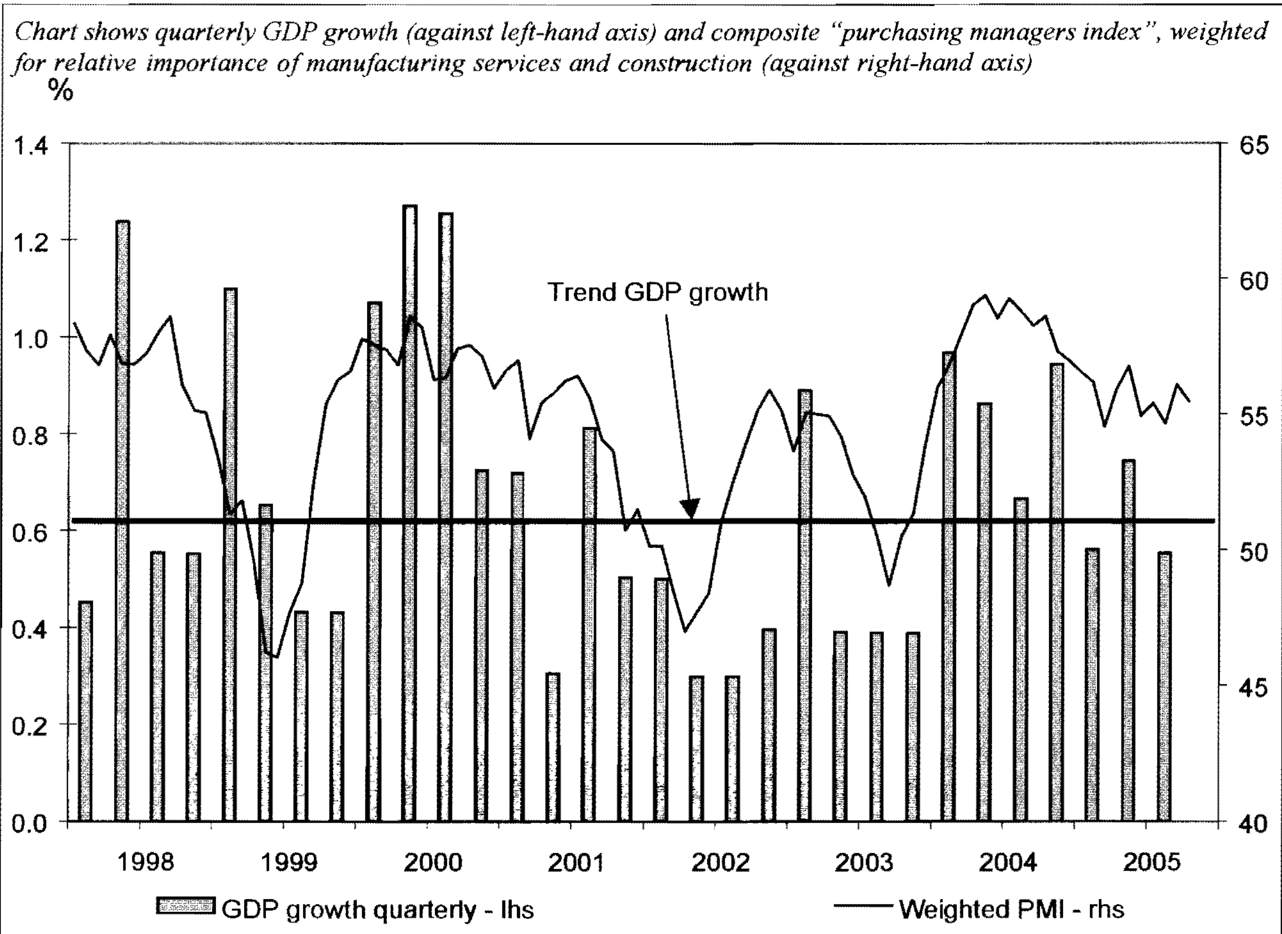
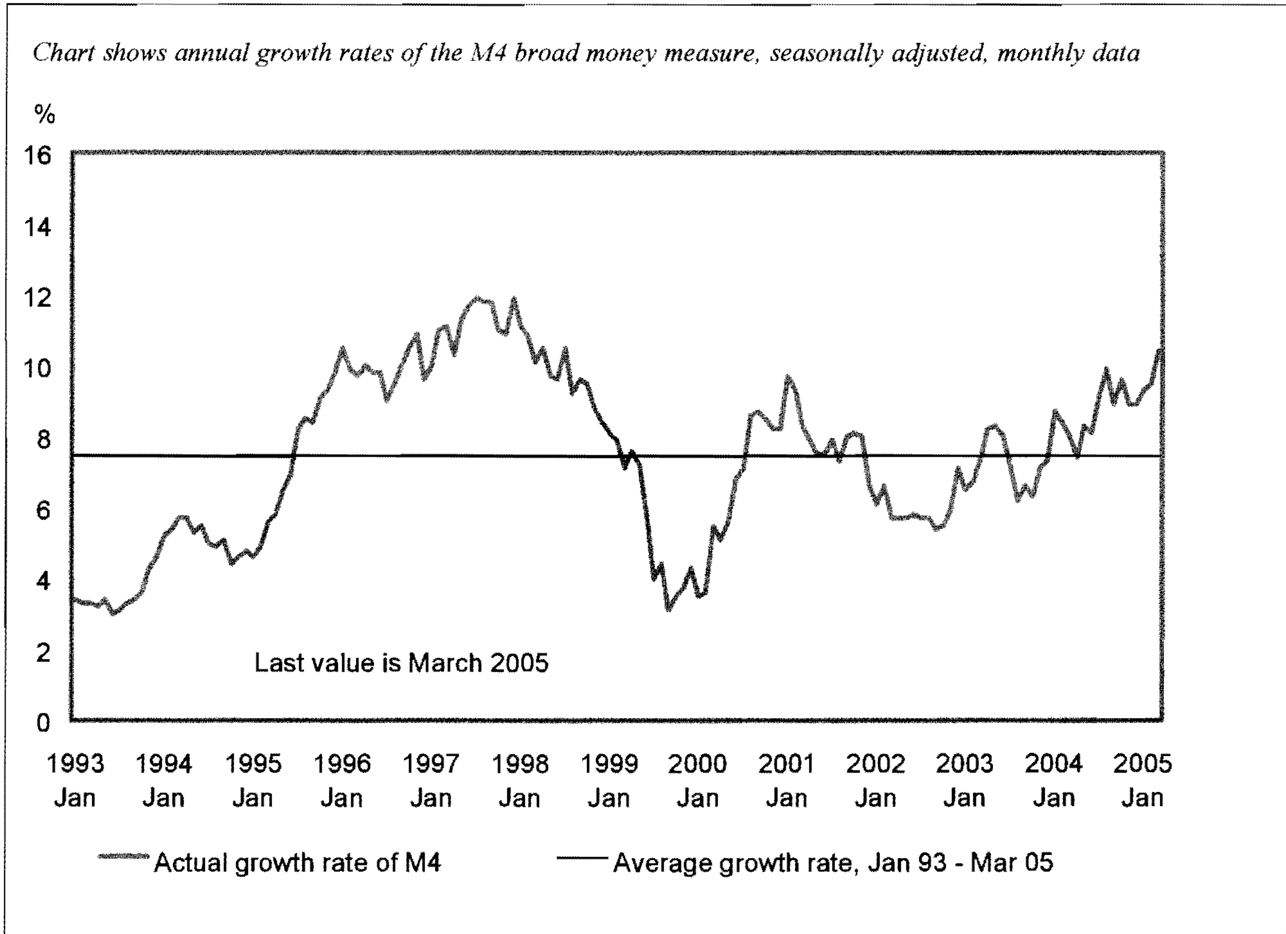


Chart shows quarterly GDP growth (against left-hand axis) and composite "purchasing managers index", weighted for relative importance of manufacturing services and construction (against right-hand axis)

According to the national income accounts, the so-called "production industries" represented only 21.8% of the nation's gross value added in 2001. (Manufacturing alone was 17.2% of GVA.) By contrast, the service industries contributed 71.6% of GVA and so were far more critical to the economy's behaviour. It is sometimes claimed that the demand for services is derived from the demand for goods (i.e., manufactured goods), but that is not really so. In particular, the demand for the international business services on which the UK has been specialising is more closely related to world economic conditions than to the fortunes of UK manufacturing. At any rate, the chart gives values for the composite Purchasing Managers Index (or PMI), which is weighted according to the relative importance of industry, services and construction. Its current values - in the mid 50s - are consistent with slightly *above-trend* growth, despite the setbacks in housing and consumer spending.

The medium-term prospect

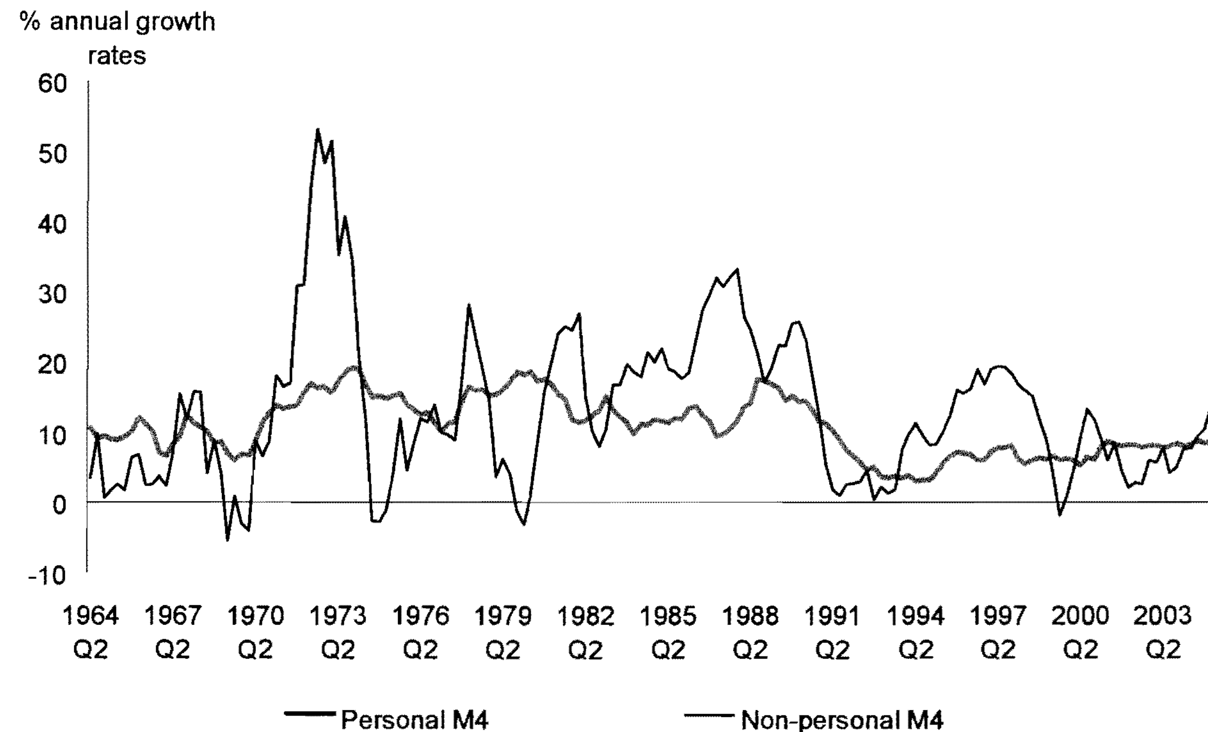
Recent blip upwards in money growth



The predictive value of leading indicator indices (and of such components of these indices as business survey results) declines more than six to nine months from today. Beyond that date monetary trends tend to be more useful, since the growth rate of the money supply is usually characterised by some inertia and is related to that of nominal GDP in the long run. From the start of 1993 until March 2005 the average annual growth rate of M4 has been over 7%, a figure compatible with a 5%-a-year growth rate of nominal GDP (and 2% - 2 ½% inflation) because of a rise in the desired ratio of money to incomes. However, since early 2004 the annual growth rate of M4 has climbed from 7% towards its current value of over 10%. As the chart shows, this upward blip in money growth is still modest compared with what happened between 1996 and 1998. Nevertheless, it is now well-defined and argues against expecting demand weakness over the coming year.

Excess money in companies and financial institutions

Chart shows M4 holdings of personal and non-personal sectors, where companies and financial institutions constitute non-personal sector, quarterly data. Q1 2005 is partly estimated

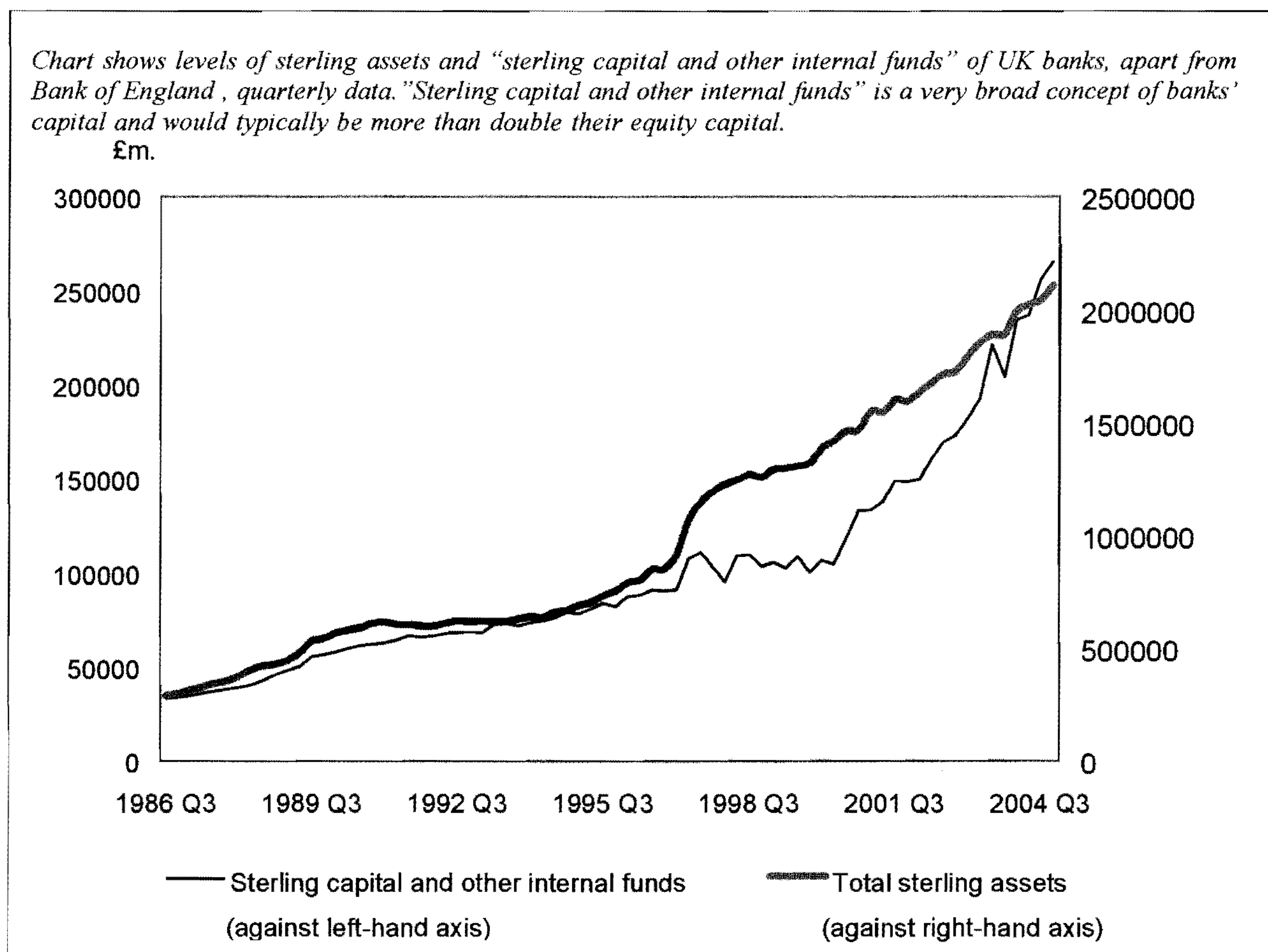


The major cyclical swings of the last 35 years have been associated with - and, arguably, caused by - similar swings in the growth of the quantity of money, on the broadly-defined measures such as M4. One way of identifying excess money is inspection of sector money supply growth rates, as there is ample evidence that personal sector money is more stable than non-personal money. (The point is obvious from the chart, but see also p. 8 of the May 2004 issue of Lombard Street Research's *Monthly Economic Review* on 'Money and asset prices in boom and bust'.) The current phase of rather high M4 growth has only very recently been accompanied by an annual rate of non-household money growth in the teens. Nevertheless, the resurfacing of this pattern is interesting. In the year to March financial sector money climbed by 16.9%, while money held by non-financial companies (i.e., mainstream industrial and commercial companies) has been growing at about 10% a year since late 2003.

A profitable and growing banking system

1. Levels of sterling capital and assets of banks in UK

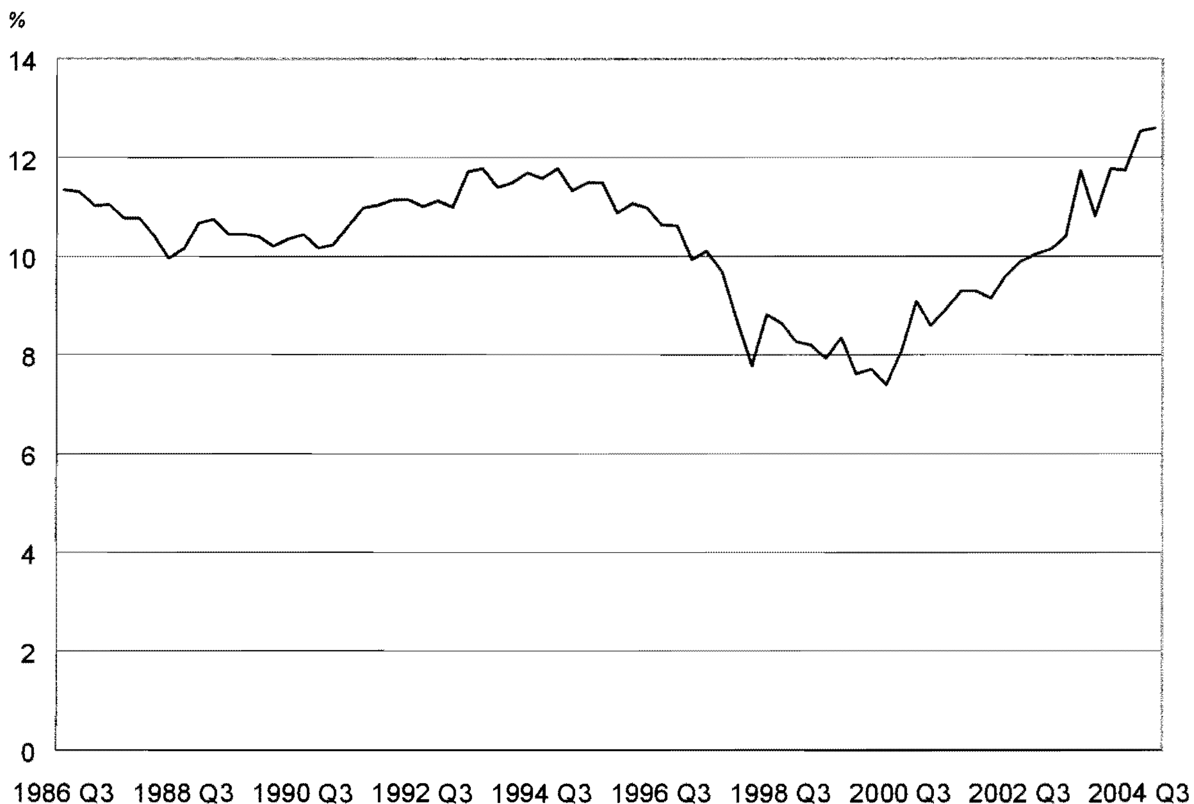
Chart shows levels of sterling assets and "sterling capital and other internal funds" of UK banks, apart from Bank of England , quarterly data. "Sterling capital and other internal funds" is a very broad concept of banks' capital and would typically be more than double their equity capital.



A vital issue in macroeconomic analysis is the outlook for bank credit and the money supply if the prevailing level of interest rates continues. (When a bank extends a new loan, it creates a new deposit. The deposit is money.) Fundamental here is the capital position of the banking system. In essence, banks are more likely to want to expand if they are profitable and well-capitalised than if they are unprofitable and capital-deficient. The chart shows the levels of UK banks' sterling assets and "capital and other internal funds", where "capital and other internal funds" is a very broadly-defined concept of banks' capital. In the 18 years covered by the chart the compound annual growth rates of capital and assets have been 12.1% and 11.5% respectively. Assets grew faster than capital in the mid-1990s, but since late 1999 capital has exploded. In the five years to end-2004 it increased at a compound annual rate of over 21%!

2. The "capital -and-other-funds"-to-assets ratio

Chart shows ratio of "sterling capital and other internal funds" to total sterling assets, quarterly data. For explanation, see opposite.

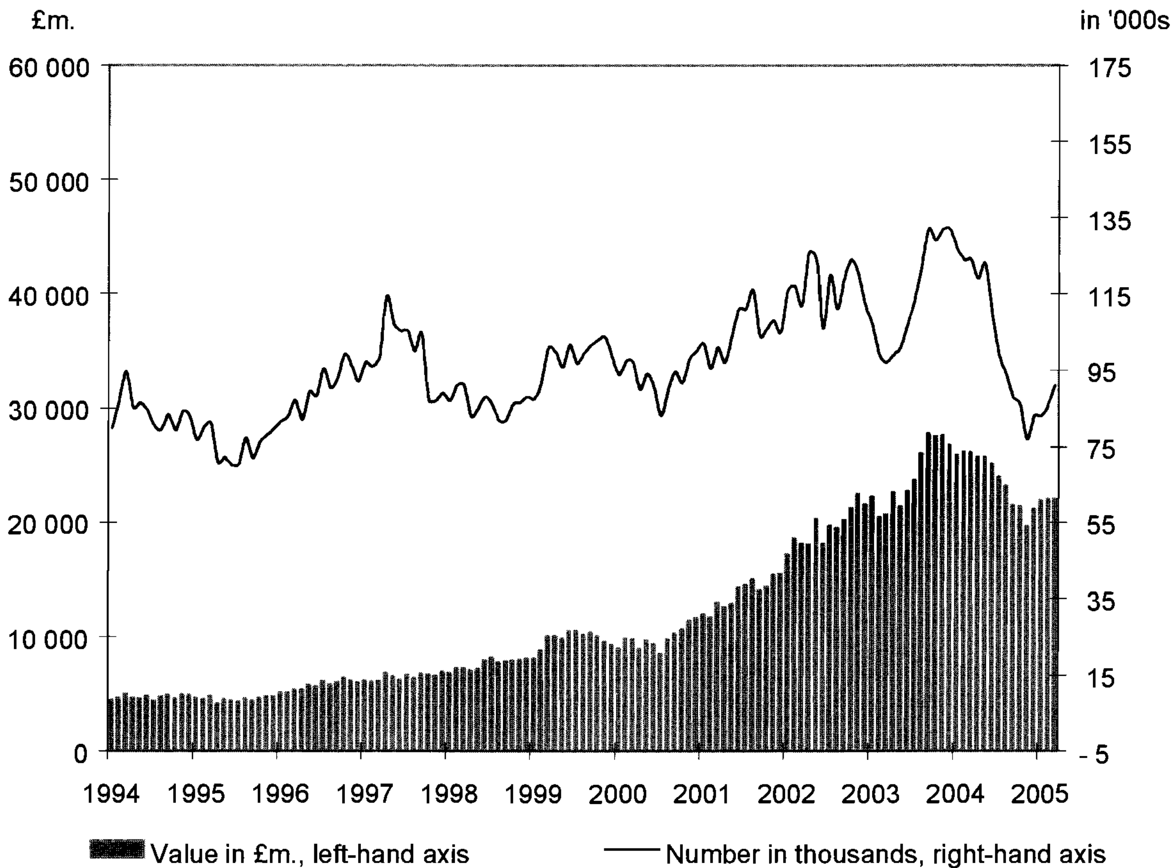


Part of the extraordinary rise in banks' "sterling capital and other internal funds" over the last five years may be explained by a move towards longer-term sources of financing of asset expansion, such as the issuance of "covered bonds" (i.e., bonds which have a claim on certain specified assets and where, as a result, repayment is "covered"). Such sources of finance are not capital. Nevertheless, UK banks are extremely profitable and well-capitalised at present. According to the December 2004 issue of the Bank of England's *Financial Stability Review*, "the median return on equity of the large UK-owned banks rose to 27.3% in [the first half of] 2004", up from an already very high 24.1% in 2003, while their capital ratios "remain well above regulatory minima". If their capital grows at an annual rate of 10% - 15% over the next few years (as seems plausible), it is unlikely that the growth of assets - and their deposit liabilities (which make up most of the money supply) - will be much slower.

Mortgage approvals: value and number

Picking up, after sharp tumble

Chart shows value and number of mortgage approvals, seasonally adjusted, as compiled by Bank of England. Note that approvals may be granted by non-bank mortgage intermediaries.



The behaviour of mortgage approvals is one of the most useful signals to the economy's future. The *number* of mortgage approvals indicates the likely number of home moves in the next few months, influencing demand for carpets, furniture and other household goods, as well as the incomes of estate agents, surveyors and solicitors. The *value* of mortgage approvals points to the scale of banks' mortgage lending, affecting their asset and deposit growth. The growth of deposits (i.e., money) in turn affects asset prices and demand. Finally, while turnover in the housing market is predominantly in existing homes, it has some impact on new housing starts, themselves a classic leading indicator. The chart shows the slump in the *number* of approvals from peaks of 130,000 in late 2003 to 80,000 a year later, which partly explains the current weakness in retail sales. But note that both the number and value of mortgage approvals are now recovering.