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Contents

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The death of deflation

Global and UK money trends imply continuing inflation

The much-analysed *Death of Inflation*,

The 1990s saw progress against inflation in nearly every country. At the start of the decade memories of double-digit inflation were still fresh and many commentators expected it to return. Nowadays an inflation rate above 4% is regarded in the leading industrial countries as unacceptably high. Confidence in governments' and central banks' ability to run a successful monetary policy ran so high that in 1996 Professor Roger Bootle (now at Capital Economics) wrote a book on *The Death of Inflation*. Indeed, by early 1998 the fall in inflation had been sustained for long enough for some economists to start talking about "deflation" (i.e., actual declines in the price level).

but deflation not in prospect

Early 1999's global recovery has made this talk look unconvincing. "Global deflation" gave economists something to chatter about last year, but it was a nine-month wonder. The rebound in oil prices and an upturn in non-oil commodity prices reflect reviving demand as well as oil-exporters' restriction of supply. More pointedly, the world's largest economy - that of the USA - suffers from high monetary growth, buoyant demand and over-heating. An active debate has developed about the course of American inflation. Although the debate is unresolved, one point is clear. Some economists forecast a rise in inflation and others little change, but no one now expects the USA's consumer prices to go down continuously from one year to the next. The change in mood could fairly be described as *The Death of Deflation*.

Can we talk about the *The Death of Deflation*?

An important influence at work here has been the increase in the rate of money supply growth for the G7 industrial countries. Lombard Street Research compiles an index of broad money growth for the G7 nations, based on data from national sources. Its annual rate of growth fell steadily from the 15% - 20% area in 1972 and 1973 to under 10% in the mid- and late 1980s, and to under 5% between 1992 and 1995. But since early 1996 it has moved up again and currently stands at about 7% a year. Against this background, it may seem surprising that late 1997 and 1998 was a weak period for global economic activity. However, this weakness was heavily concentrated in Japan and countries outside the traditional industrial world. The International Monetary Fund compiles financial indicators for "developing countries" as a bloc. They give a quite different readings from the advanced economies. Whereas in the advanced economies money growth recorded its post-war peak in the early 1970s and inflation in the mid-1970s, in the developing countries the post-war peak inflation was in 1994 (at 51.8%), while for money growth it was in 1993 (at 91.2%). The developing countries imposed a tight monetary squeeze on themselves in the mid-1990s, with powerful effects on global trends in demand, output and inflation.

Inflation and money growth trends different in developed and developing countries

Professor Tim Congdon

30th July, 1999

Summary of paper on

"Would the introduction of the euro lead to another boom-bust cycle?"

Purpose of the research paper

The Government insists that it wants to promote UK participation in the euro-zone, although the European Parliament elections of 10th June suggest that this policy is unpopular. The research paper considers how the introduction of euro-zone interest rates would affect the cyclical path of the UK economy.

Main points

* **The UK's adoption of the euro would lead to (virtually) identical interest rates in the UK and the rest of the euro-zone. The UK - like other members - would be constrained by the one-size-fits-all monetary policy.**
* **Expectations of the UK's future membership of the euro-zone have affected the sterling yield curve and, hence, current decisions to lend, borrow and spend at interest rates "down the curve" (e.g., a five-year fixed-rate mortgage). (See p. 6.)**
* **Because euro interest rates are lower than sterling interest rates, the imprint of these expectations on the sterling yield curve has already had a significant effect on the UK macroeconomic conjuncture.**
* **With UK base rates falling in the last nine months, signs have emerged of a sharp upturn in the growth of both residential and commercial mortgages. (See pp. 7 - 8 and p. 11.)**
* **The number of mortgage applications to buy houses is correlated with the number of housing transactions a few months later, while the number of housing transactions affects spending on consumer durables. (See p. 9.)**
* **The growth of bank lending to property companies has increased sharply in recent quarters. (See p. 11.)**
* **The behaviour of residential and commercial mortgage credit in response to recent interest rates declines suggests that the UK's adoption of the euro, and the consequent assumption of euro-zone interest rates, would lead to a further acceleration in the growth of credit and money. The wider result would be another boom-bust cycle.**

This paper was written by Professor Tim Congdon, with help from Mr. Brendan Baker in the preparation of the charts.

Would the introduction of the euro lead to another boom-bust cycle?

Euro-size monetary policy does not fit the UK

Euro-zone has one-size-fits-all monetary policy

A conspicuous feature of the European single currency is that it has made interest rates uniform across all member countries, even though their macroeconomic circumstances diverge widely. The favourite descriptive phrase of this development is sartorial, with the euro-zone said to have a "one-size-fits-all" monetary policy. A mere two or three years ago the situation was quite different. Its participants' monetary policies were of sharply contrasting breadth, depth and shape, with their own interest rates, real exchange rates, and growth rates of credit and money. Not surprisingly, the introduction of the euro has been uncomfortable. In Germany economic activity has been weak in early 1999, whereas in Spain, Portugal and Ireland demand and output have boomed. Over the last two years financial markets have sometimes become excited by the prospect of UK entry into the euro-zone. How would the UK react to the euro- zone's one-size-fits-all monetary policy?

The standard view in UK financial markets until European elections on 10th June,

A standard view for much of 1998 and early 1999 was that Mr. Blair's Government would be re-elected in, say, late 2001 and that a referendum on the single currency would follow. On the assumption of a favourable headwind from the result of the general election, the referendum would deliver a "yes" vote for entry in early 2002. The exchange rate would be pegged in perhaps late 2002 or early 2003, so that interest rates thereafter would be more or less the same in the UK and the euro-zone. Of course, for dates in the forward yield curve after the pound's assumed abolition sterling interest rates would be notional, as they would have to be identical to euro interest rates.

with imprint on yield curve which has now been changed

The imprint of these market expectations on the relative position of the sterling and euro swap yield curves was apparent for several quarters from late 1997. (See the charts on p. 6.) A constant pattern was for swap rates in the pound and the euro to be almost convergent at the more remote dates in the 10-year-and-later area (when the pound is deemed likely to have disappeared), while a big gap persisted in the short dates of up to two years. At the short end it could be safely assumed that the pound would continue to exist and that the Bank of England's setting of interest rates therefore remained relevant. The Conservatives' unexpected success in the European elections on 10th June came as a shock to the well-established pattern of market expectations. With Mr. Blair appearing to shift his ground on the timing of the referendum, sterling rates in the two- to four-year area moved upwards and away from euro rates.

Interest rate expectations affect current decisions

Plainly, the UK's monetary-policy environment has already been much influenced by interest rates in the euro-zone. This influence has been felt, despite Mr. Blair's reluctance to set a date and make a binding commitment. Moreover, the bending of the sterling yield curve towards the euro level at points a few years "down the curve" has had an impact on the UK's short-term and

i. Effect on residential mortgage demand

medium-term macroeconomic outlook. Most obviously, the cost of three-year-and-later fixed-rate residential mortgages in early 1999 was remarkably low relative to the Bank of England's repo rate and the three-month inter-bank rate. Indeed, cheap mortgages overcame the adverse effect on housing demand of both the loss of tax relief on mortgage interest relief and the persisting burden of excess mortgage debt from the past. (See the charts on p. 7 and p. 8.) Despite the upturn in housing from 1993 onwards, the growth of mortgage debt was restrained. In particular, throughout the mid-1990s the value of mortgage commitments in inflation-adjusted terms stayed obstinately beneath the record touched in the home-buying frenzy of early 1988. However, in March this year the previous peak was exceeded. Even allowing for a substantial amount of refinancing, UK mortgage credit has started to grow strongly.

ii. Effect on commercial property market

Expectations of euro-zone entry have also had a powerful effect on commercial property. By driving down swap rates and gilt yields in the three- to ten-year area, these expectations have reduced the cost of borrowing in exactly that part of the curve where property investors most rely for finance. In a marked change from the traditional post-war pattern, gilt yields have dipped beneath property yields. Gearing has become particularly attractive, even after adjustment for possible low rental growth and high depreciation charges. Logically, early 1999 has seen a surge in bank lending to the property sector. (See p. 10.)

iii. Effect on spending on big-ticket consumer items

A strong revival in the demand for residential and commercial mortgages - of the kind seen in early 1999 - is characteristic of the early upturn phase of a typical post-war British business cycle. Part of the explanation is that fluctuations in aggregate spending are heavily influenced by fluctuations in spending on big-ticket capital items. As buyers of such items often need to borrow, the volume of purchases is correlated with changes in credit growth. Another well-known and recurrent pattern in the personal sector is that the turnover in the biggest-ticket item of all (i.e., houses) is associated with increased expenditure on lesser big-ticket items (i.e., consumer durables, notably furniture, carpets and curtains, kitchen equipment and so on).

The chart on p. 10 shows the relationship between the number of residential property transactions and consumers' expenditure on durables. As became apparent in the boom of the late 1980s, the stated destination of a credit flow has no precise connection with subsequent spending patterns. A mortgage loan may appear to be "for home purchase", but the ultimate recipients are of course not the mortgagors but the vendors of the property in question. If these vendors had owned most or all of the equity in the property, they can use the mortgage proceeds for any purpose they wish, including big-ticket consumption. (These issues were discussed in a number of papers in the 1980s. See, for example, "The coming boom in mortgage credit", a paper of 4th June 1982 from the stockbroking firm, L. Messel & Co., written by Tim Congdon and Paul Turnbull, re-published as "Introducing the concept of 'equity withdrawal'", pp.274 - 287, in T. G. Congdon *Reflections on Monetarism* (Aldershot: Edward Elgar for the Institute of Economic Affairs, 1992).)

iv. Effect on growth of money balances

The current increase in residential mortgage credit is therefore a valuable advance indicator of more buoyant consumer spending in the summer and autumn of 1999. However, it is quite wrong to confine an analysis of the macroeconomic impact of credit growth purely to items which are, to a large extent, bought with borrowed funds. A far more important effect of the increased extension of new bank credit (i.e., of additions to banks' assets) is a higher rate of growth of bank deposits (i.e., of additions to banks' liabilities).

People and companies alter spending to keep money balances in line with the demand to hold them

These extra deposits are money. A condition of macroeconomic equilibrium is that the demand to hold money balances should be equal to the quantity of such balances actually in existence. If the demand for and supply of money differ, agents adjust their expenditure and portfolios in order to bring them into equality. These adjustments are the heart of the transmission mechanism of monetary policy. In the hurly-burly of actual business life, asset prices, and corporate and personal balance sheets, are in constant upheaval as people, companies and financial institutions struggle to keep their money holdings not too far from equilibrium. Demand and output are in turn buffeted about by the balance- sheet turmoil. In the short run excess real money balances are associated with above-normal asset prices and above-trend economic growth, but in the long run the demand to hold real money balances is dominated by real economic variables, particularly real income. (See p. 12.)

This is the more general importance of the reviving growth in credit for residential mortgages and commercial property. The faster credit growth signals that money growth will be rather high over the next few quarters. M4 growth slowed from mid-1997 to early 1999, partly as a by-product of the Bank of England's decisions to raise interest rates from 6% in May 1997 to 7 1/2% in June 1998. Whereas M4 growth was 11.8% in the year to July 1997, it was 5.6% in the year to June 1999. But interest rates have now tumbled, which has revitalized credit demand. The strong message from recent credit trends is that M4 growth will increase in the next few months. A fair assessment is that annual M4 growth will stay in the 7% - 10% area until mid-2000 and perhaps for much longer. Two implications are that company balance sheets will remain robust, which will help investment, and that asset prices will continue to enjoy support from excess corporate and institutional liquidity.

v. Effect on asset prices and balance-sheet strength

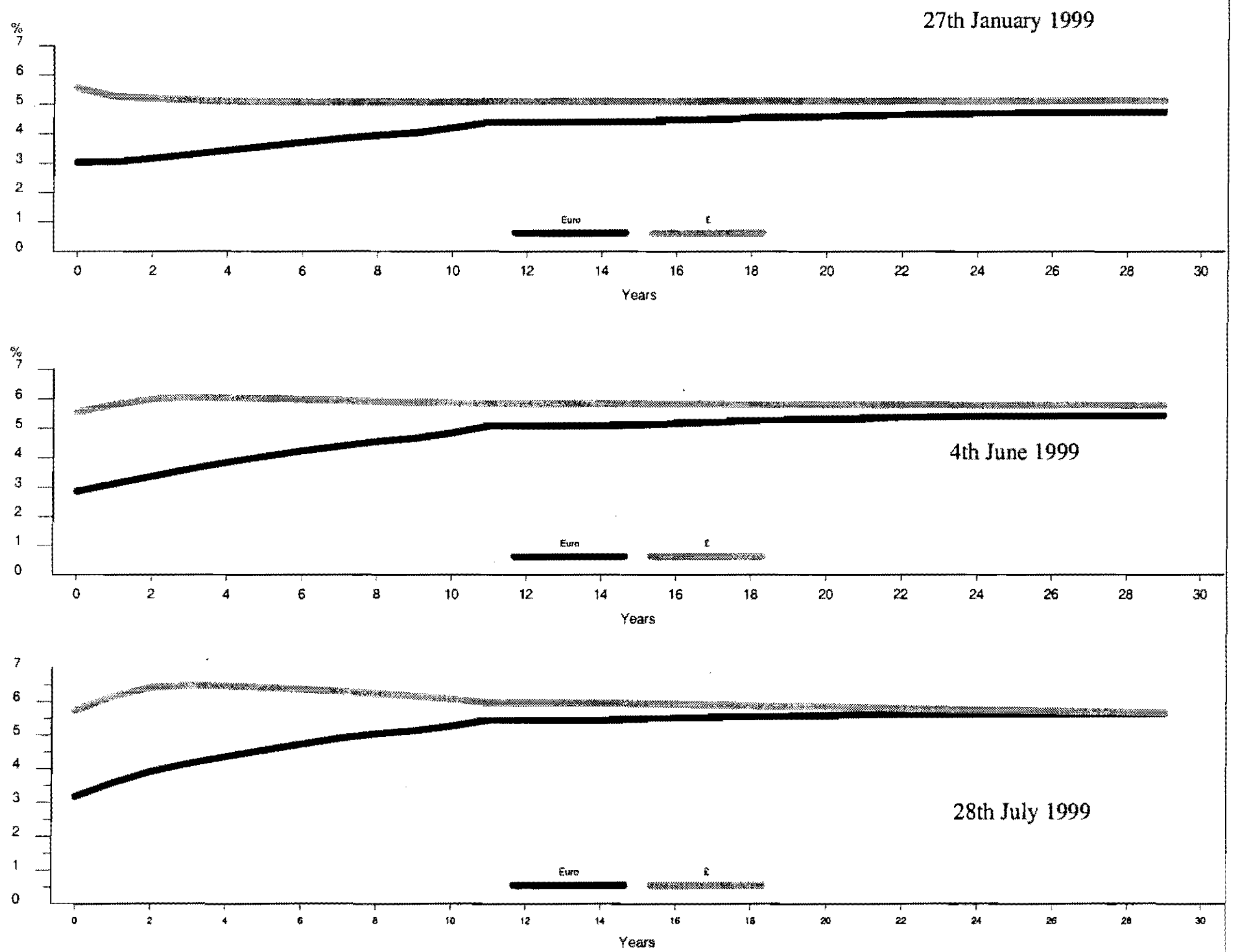
Moreover, the British economy has felt these effects for two main reasons. Part of the explanation is that since last summer the Bank has abruptly reversed the previous interest rate increases, while - throughout the last two years - large sections of the sterling yield curve have been influenced powerfully by the lower euro yield curve and convergence hopes. The message is clear. Full UK participation in the euro-zone would require that base rates fall to 3% or less, and that the euro and sterling yield curves become identical until the eventual full disappearance of the pound. The introduction of the euro would therefore lead to a resumption of excessive rates of credit and money growth, and, hence, to a silly and unjustified boom. As the last 30 years have demonstrated, booms are invariably followed - sooner or later - by busts.

UK participation in the euro-zone wold lead to another boom-bust cycle

The euro convergence/divergence game

Sterling interest rates already influenced by the euro

Charts are of "swap rate" yield curves. Dates have no particular significance, apart from the last two being before and after the European election.



The interest-rate yield curve conventionally slopes upwards to the right. The reasons for this shape are a matter of controversy, although a plausible view is that investors must be compensated for the greater price volatility associated with holding longer-dated paper. However, in early 1999 the sterling yield curve sloped downwards to the right. One explanation is that financial markets expected the UK to join the euro-zone early in the next century. As the UK's interest rates would be identical to those in the euro-zone after entry, some convergence had to occur in the months before the anticipated entry date. These convergence expectations received a blow from the result of the European Parliament elections on 10th June, as shown by comparing the curves for 4th June and 28th July.

No housing bubble yet

But house price increases are ahead of interest costs

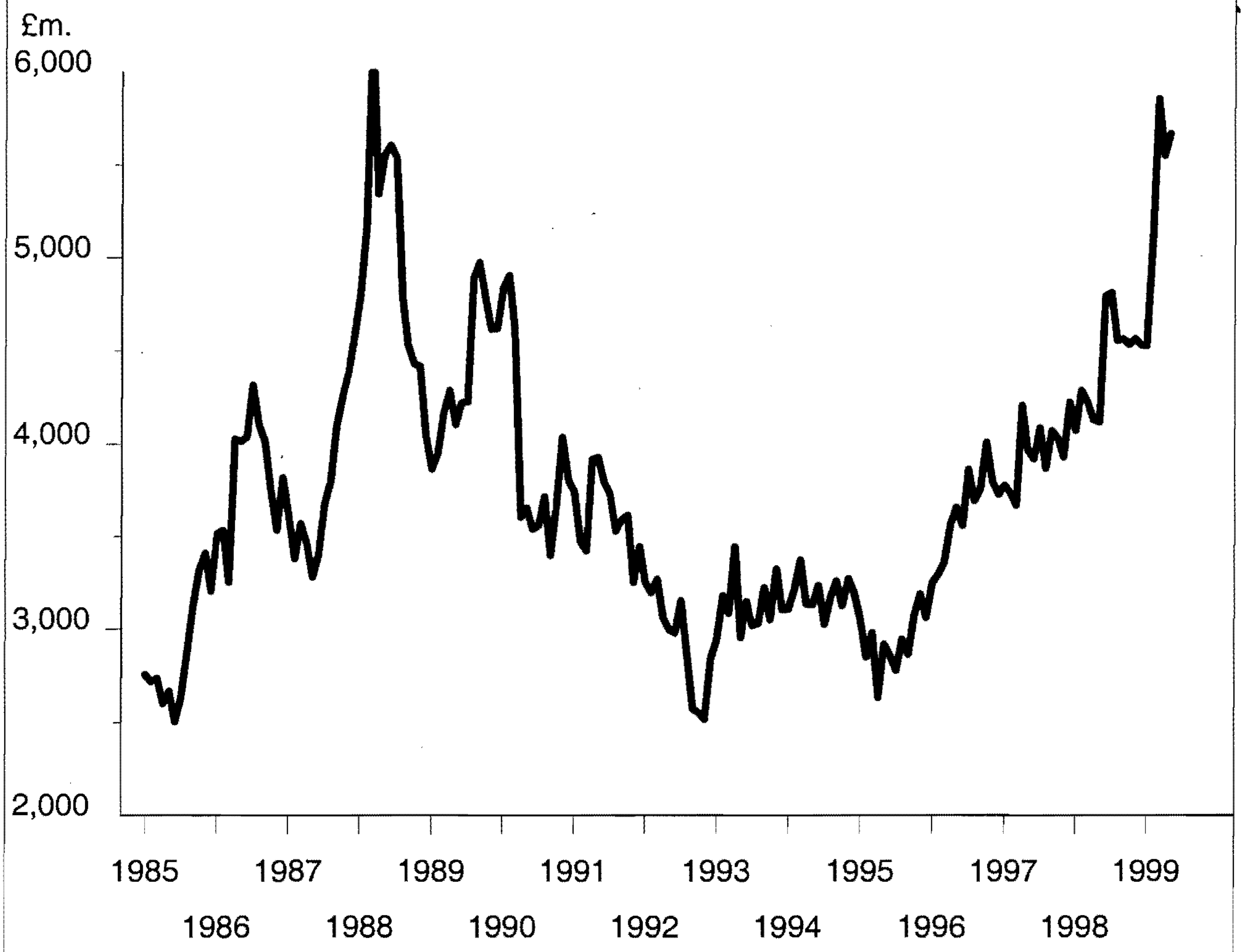
Chart uses Nationwide house price series, annual data. Interest rate is variable rate, with historical data drawn from Council of Mortgage Lenders. Sources: Nationwide, Inland Revenue, Council of Mortgage Lenders, Lombard Street Research estimates.

The relationship between interest rates and the rate of house price change is crucial for both consumer confidence and decisions to buy houses. In the six years to mid-1989 the annual rate of change in house prices was always ahead of the post-tax mortgage rate; in the following six years it was consistently behind. (Note that the interest rate in the chart is that on variable- rate mortgages.) More recently, house price increases have again moved above the rate on variable-rate mortgages and - because of the inversion of the yield curve (p. 6) - even further above the rate on fixed-rate mortgages. Continued declines in interest rates would extend this pattern, adding further stimulus to the growth of mortgage credit. (See p. 8.)

Mortgage credit escaping from the doldrums

Mortgage approvals returning to late 1980s' levels

Chart shows mortgage commitments, by banks and building societies, in constant 1987 prices. Sources: Bank of England and ONS.

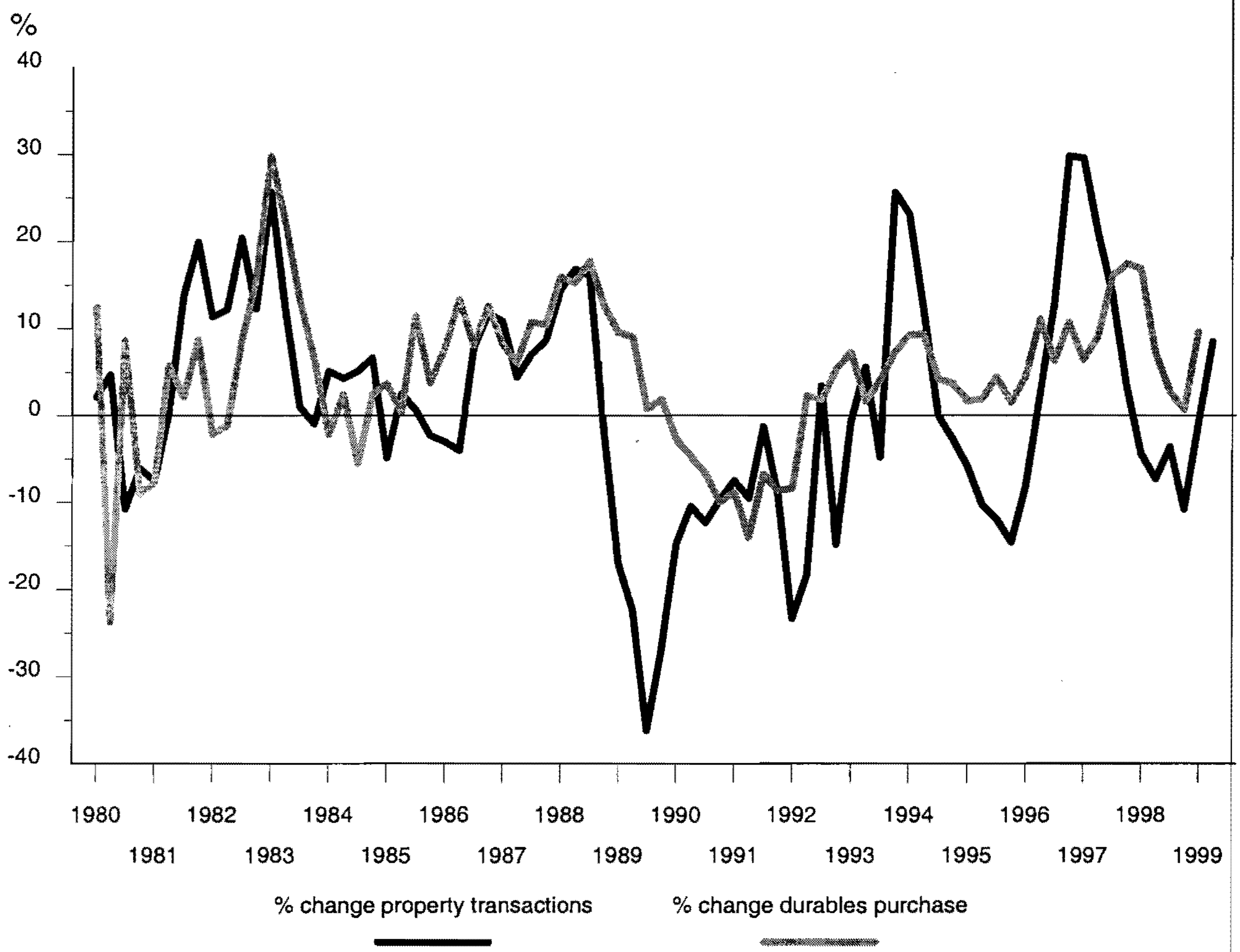


Expecations of significant house price appreciation were one motive behind the mortgage boom of the late 1980s. As the chart shows, mortgage approvals soared between 1985 and early 1988, reaching a peak in March 1988 ahead of the large tax cuts announced in the Budget of that year. Even after adjusting for inflation, the March 1988 figure for mortgage approvals has not yet been matched. The figure for March 1999 almost pipped it, but not quite. It should also be recognized that mortgage approvals at present have a large element of refinancing. Mortgage approvals to buy houses in early 1999 were more than 20% up on a year earlier, but they were still lower than in spring 1988. If interest rates fell once more, the 1988 peak would be exceeded.

Consumer upturn ahead

Purchases of durables related to housing activity

Chart shows annual % age changes in the number of property transactions and real expenditure on durables, quarterly data. Sources: ONS and Inland Revenue.

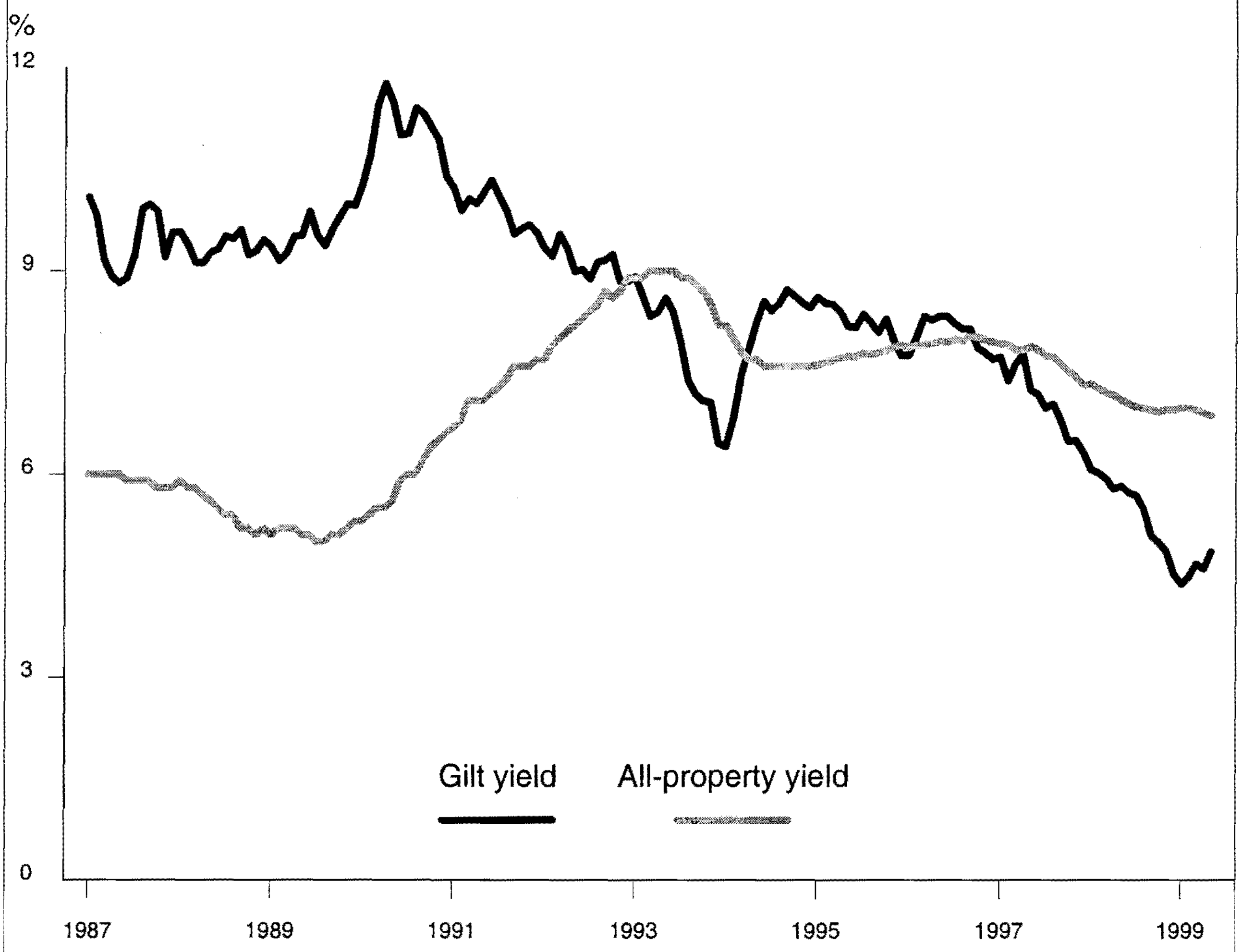


Consumer spending on durables is quite small, estimated in 1995 to have been 9.0% of total consumer spending. However, it is disproportionately important to the business cycle, because of its volatility. (By contrast, spending on such items as food, heating and light is very stable.) Durables consumption is related to the housing market, for at least two reasons. First, when people move house, they make large non- recurrent expenditure on big-ticket kitchen items, furniture, carpets and other durables. Secondly, high housing turnover typically coincides with above-normal house price increases, which boost the consumer confidence of all households, including those who are not moving. Higher mortgage approvals will translate into more home moves.

An unusual pattern in the property market

If rents grow, property returns should be ahead of interest costs

Chart compares yield on medium-coupon long-dated conventional gilts with Investment Property Databank's all-property yield, using monthly data. Sources: *Financial Times* and IPD.

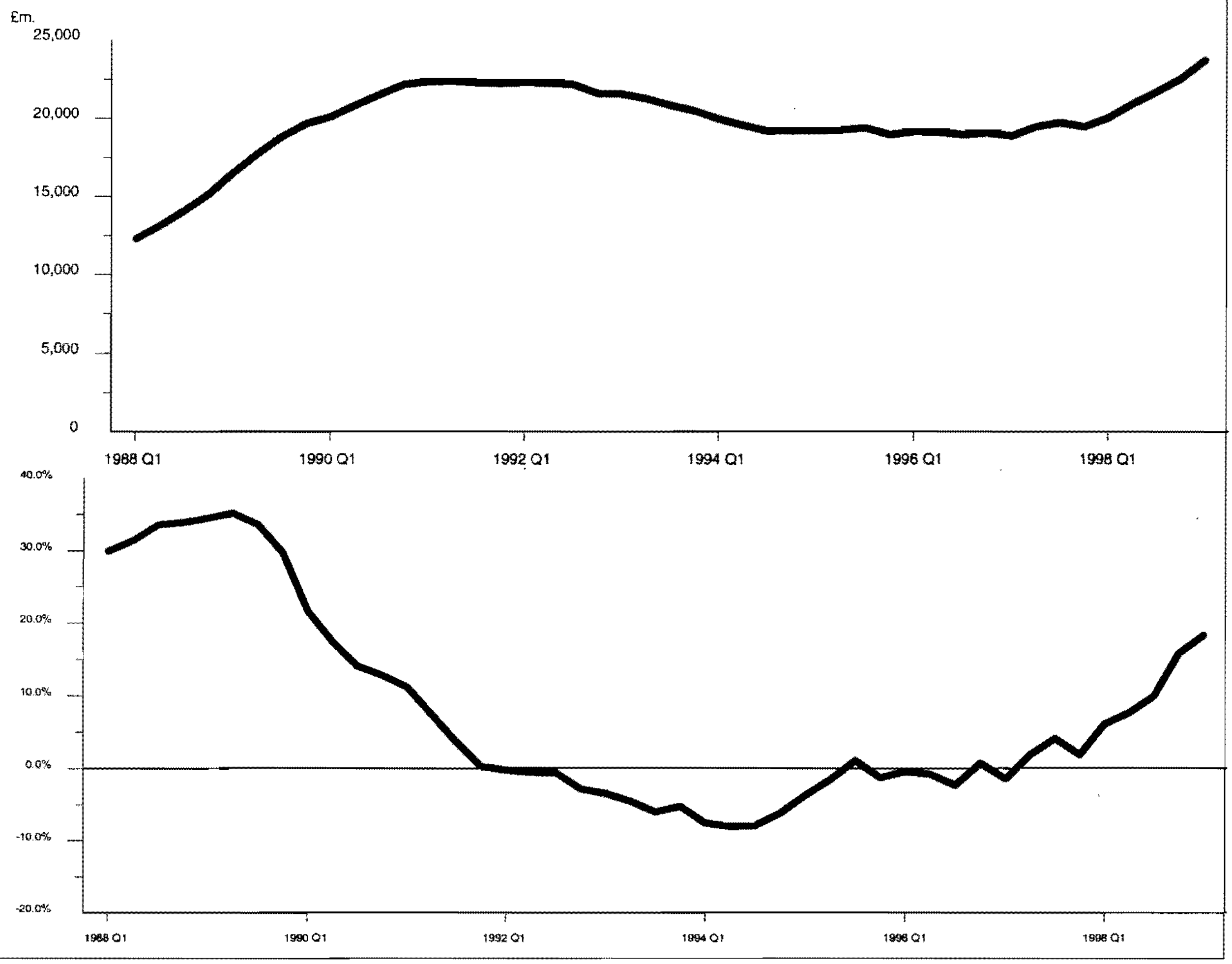


Throughout the 1970s and 1980s interest rates and gilt yields were constantly above the yield on commercial property. The thinking was that, with inflation deeply-entrenched in British society, rents would always rise in money terms. Over time the total return on property ought therefore to approximate the rental yield plus the expected inflation rate. The sum of these two items was above gilt yields. The plunge in inflation in the 1990s has upset this pattern of expectations, so that property yields are now above gilt yields. Superficially, gearing in property investments has become very attractive (see p. 11), but it is important to remember that rising rents may still be needed to offset the effects of depreciation and obsolescence.

Property lending growing again

Extra gearing a response to favourable financial terms

Top chart shows level of outstanding loans by major British banking groups at end-quarter; bottom chart shows % annual rate of change in level of loans, also by MBBG.
Source: British Bankers Assocation

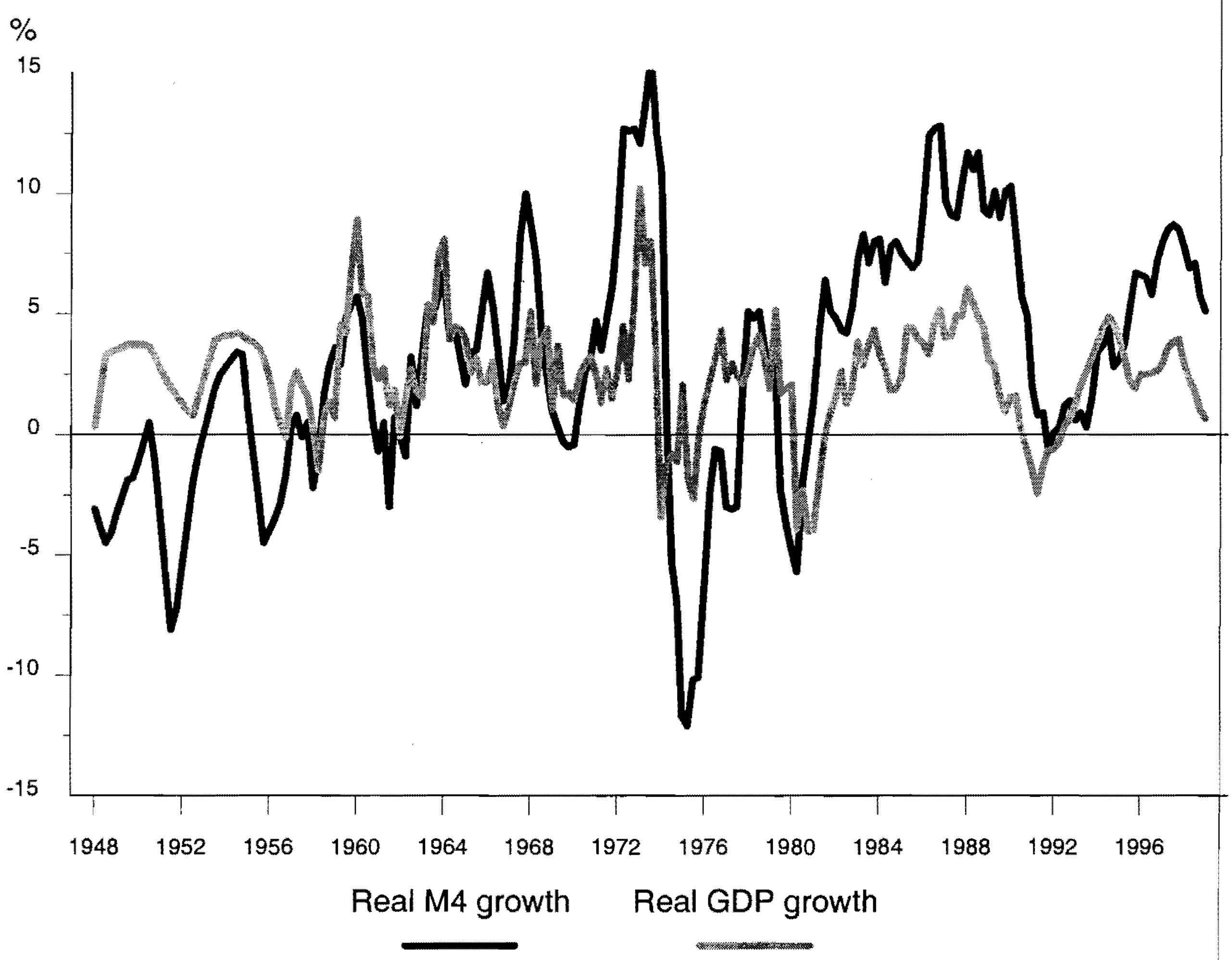


Bank lending to the property sector is highly volatile, with banks' capital adequacy being a critical determinant. When banks have excess capital (because of good operating profits and benign loan loss experience) they seek to expand their balance sheets, boosting the availability of bank credit for property investment. According to the 1999 *Abstract of Banking Statistics*, the "major British banking groups" saw their capital rise by over 6% in 1998, while "Capital adequacy ratios ranged from 10.2% to 15.1% and were well above the statutory requirement". In conjunction with the excess of property over gilt yields (see p. 10), this abundance of bank capital is a key influence on the recent 15%- 20% annual rates of increase in the stock of property loans.

Faster growth in real money ahead

Excess money balances support asset prices and balance sheets

Chart shows annual growth rate in real terms (i.e., adjusted by GDP deflator), using quarterly data.
Sources: ONS and Bank of England.



Many economists comment on how interest rates affect the demand for items bought with borrowed money. But theory does not recognize any significant relationship between bank credit as such and national income. (An individual agent can spend above its income by borrowing from other individuals, but a country as a whole cannot do this. It must borrow abroad.) Economic theory instead focuses on the relationship between money and national income. Because the demand to hold real money balances is dominated by real economic variables, large fluctuations in real money are always important to the business cycle. Bank credit matters because it is a balance-sheet counterpart to the deposits which constitute most of the money supply. The prospective buoyancy in residential mortgages and commercial property lending implies higher real money growth, helping activity in 2000 and 2001.