FABIAN SOCIETY

Controlling inflation:

two views

Gerald Holtham and Neil MacKinnon

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Design: Tony Garrett

July 1990

ISBN 7163 0539 9

ISSN 0307 7523

Printed by The College Hill Press Limited (TU), London and Worthing

Published by the Fabian Society, 11 Dartmouth St, London SW1H 9BN

Introduction

The next Labour government will require more than one term of office to complete its programme in such fields as education and social policy. But its chances of re-election will not depend solely, or even primarily, on the progress of those policies. They will depend on the progress of the economy.

It is easy enough to criticize the current government's conduct of economic policy. Nigel Lawson ran excessively loose macroeconomic policy, resulting in fast inflation and a gaping trade deficit. Subsequently, interest rates have been put up to try and damp down spending in the economy; so high rates too are the consequence of policy mistakes.

Yet the fact is that Lawson was seldom criticized by anyone on the Left for operating too loose a monetary policy at the time he was doing it. On the contrary, for most of his Chancellorship he was accused of "monetarism", popular shorthand for being too deflationist. Certainly his tax cutting Budgets were criticised, but mainly because the Left wanted higher government expenditure rather than lower taxes. Few suggested at the time that there should be neither, that fiscal policy was too loose. Indeed, it is difficult to believe that a Left-wing government would have run much tighter fiscal and monetary policies than Lawson did, at a time when unemployment was over 2 million and the Budget was in surplus.

Lawson fell for his own publicity and acted as if the supply potential of the British economy had, indeed, improved enough to sustain rapid demand growth. His unintentionally prolonged expansion exposes an ugly fact. The British economy remains very prone to inflation. There has been no supply-side miracle during the period of Conservative government, only a deep recession, which enfeebled industry, and a cyclical recovery. Even now, with so many signs of overheating in the economy, unemployment remains over 1 1/2 million, on the government's own doctored statistics. This tendency to inflation will be one of the greatest challenges the next Labour government must face.

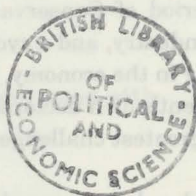
So far Labour's response has been to emphasise entry into the European Exchange Rate Mechanism (ERM) plus a number of measures to improve the

efficiency of British industry, measures of "supply-side socialism". They include greater provision for education and training and a revitalized regional policy. The policies are sensible and overdue. But it is necessary to be very clear: none of those measures will have a considerable effect on the behaviour of the economy within one Parliamentary term. They are long-term measures with long-term effects. If a Labour government is to persist into the long-term and achieve those effects, it must control inflation in the interim.

This essay looks at the policy dilemna which will face a British government after entry into the ERM: how to control inflation without placing an intolerable strain on an already emaciated industrial sector. It proposes measures to strengthen automatic stabilizers within the economy, and to give individuals a tangible incentive to anticipate lower inflation in their own actions. These include:

- introducing a more progressive tax system
- indexing tax brackets to target inflation rather than real or forecast inflation
- maintaining cash limits on public expenditure
- co-ordinating pay bargaining

Finally, the essay looks at the need for short term measures to restrain excessive borrowing, given that ERM entry will bring lower interest rates.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The Policy Dilemma

1

It is now probable that the current government will take the pound into the ERM well before the next election.

Surprised by the failure of high interest rates to deflate the economy, the government seems intent on entry at a high exchange rate, with sterling at a central parity against the Deutschmark not far below 1:3. The intention is both to reduce the contribution of import prices to inflation and to limit profit margins of exporters, imposing an immediate discipline on companies so that they begin to resist wage demands.

There is no reason to doubt that if a policy of a fixed exchange rate is pursued single-mindedly enough and for long enough, inflation in the United Kingdom will converge on that of our European trade partners. Any tendency for this country's traded goods prices to rise faster than the European average would result in declining competitiveness and loss of markets. That would result, in turn, in growing unemployment and widening balance of payments deficits. A balance of payments deficit entails borrowing from abroad. Eventually the loss of income, due to unemployment, and of net wealth, as foreign debts piled up, would reduce demand and inflation in the United Kingdom.

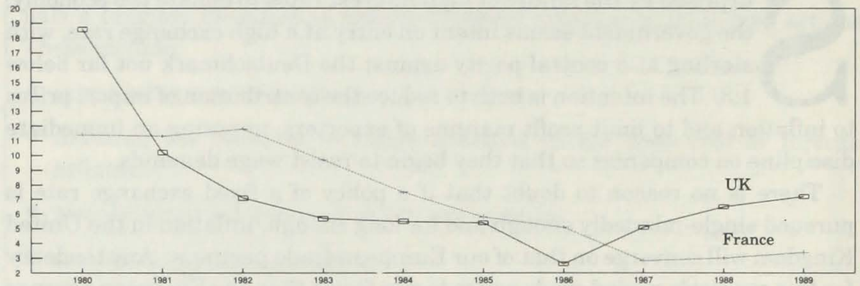
For a country with a higher inflation rate than its trade partners, fixing the nominal exchange rate is therefore a deflationary move. Yet it is not the most deflationary move imaginable. Indeed, one of the characteristics of such a regime is that it rules out extremes of policy; it severely limits the government's freedom of action in managing aggregate demand. If the exchange rate is to be pegged, then monetary policy must be devoted to that task. Short-term interest rates must be set at whatever level is necessary to maintain the exchange rate.

By contrast, a policy of going flat out for deflation at present could, for example, involve still higher interest rates and a prolonged further appreciation of the exchange rate. A sharp upward move in sterling, induced by high interest rates at a time when British inflation was higher than the European average, was the core of Conservative policy in 1980. It accounts for the severity of the recession of 1980-82. That recession helped to reduce inflation substantially, at a fearsome cost in lost production and lost industrial capacity. Conversely, the Lawson boom, which re-stimulated inflation, began with a policy of letting sterling depreciate by some 15 per cent in 1985-86, under the

convenient cover of a falling oil price. If the United Kingdom had been in a fixed exchange rate system, neither the initial deflation nor the subsequent reflation could have been so pronounced.

That is illustrated by the course of inflation in the UK and in France, which was an ERM member throughout the 1980s. The UK experienced a sharper deceleration in prices followed by renewed inflation, whereas in France there has been a more gradual and steadier decline of price and wage inflation. This is illustrated in the graph below.

Inflation in France and the UK



It is a truism, nonetheless, that ERM entry is no panacea. If a Labour government, or indeed any government, simply relies on the ERM to look after inflation, it can be predicted with confidence that the outcome for the British economy will be dire.

If wage and price inflation proceed at current rates while sterling does not depreciate, the profit margins of British companies will be subjected to a progressive squeeze. That will eventually have the desired results of encouraging cost-cutting and increasing both productivity and resistance to unrealistic wage demands. However, it will also discourage investment in expanding capacity, it will limit the growth of employment even in relatively successful firms and it will doubtless force many firms to cut back on output, close plant and, in some cases, shut up shop altogether. The squeeze of the early 1980s was supposed to leave industry leaner and fitter. Its condition in a good many sectors, in terms of technology and capacity, is more like emaciation. To repeat the dose is to risk a slide into anorexia nervosa.

The important variable in influencing investment and employment is not the nominal exchange rate, as published in the newspapers, but the real rate, that is the rate adjusted for different price levels and inflation rates in different countries. The problem with using control of the nominal exchange rate as the sole means of reducing inflation is that doing so raises the real exchange rate because the nominal rate does not fall to make up for the faster

domestic inflation. The burden of adjustment then falls excessively on the traded goods sector of the economy. The more stubborn the inflation problem, the greater the burden. If inflation responded rapidly to the treatment there would perhaps be little to be concerned about. If inflation tends to be persistent, however, bankruptcies and plant closures ensue. Industrial capacity and know-how are depleted. This cannot be shrugged off as the result of the operation of some immutable law of comparative advantage. Moreover, given the costs of setting up in business and re-establishing marketing and other networks against entrenched opposition, that lost plant and capacity does not spring back into existence if at some future time the real exchange rate becomes competitive again. Some part of the losses prove permanent. Even after five years of relatively rapid growth, British unemployment remains substantially above its 1979 level. Another squeeze on industry would very probably result in another ratchetting up of the level of long-term unemployment.

It is apparent after the experiences of the 1980s, in Britain and elsewhere, that the equilibrium level of the real exchange rate - the level consistent with high employment and a sustainable balance of payments position - is not independent of the previous path of the actual exchange rate itself. This phenomenon of path-dependency is known to economists as "hysteresis". A long period of over-valuation of the real exchange rate results in a current account deficit and a build-up of foreign debt (or a decline of net foreign assets). It can also cause the destruction of industrial capacity. The value of the real exchange rate must eventually go back down to its old equilibrium level and then it must go lower still to generate higher exports to service the extra foreign debt accumulated during the period of overvaluation. Yet the capital stock of the country has been reduced by firm closures during overvaluation. To encourage investment and industrial regeneration, the real exchange rate must be yet lower again.

Relative Inflation

But how are these movements in the real exchange rate to be accomplished when the nominal rate is fixed? The answer can only be via relative inflation. By fixing the nominal exchange rate at a time when the inflation rate exceeds that abroad, the government pushes up over time the level of the real exchange rate. After a period of deflation, the inflation rate will come down to the same rate as in other countries. Then the real exchange rate will stop rising but it will still be higher in level than at the time that the nominal rate was fixed. To bring it down, inflation in the United Kingdom must go not as slowly but more slowly than abroad. If, due to hysteresis effects, the real exchange rate needs to be even lower than it initially was, the period of relatively low inflation must last longer than the period of relatively high inflation. That is

a tall order. Achieving it is likely to result in a long period of depressed demand growth with output growing less than potential. No wonder that when the IMF is dealing with developing countries that have been pursuing inflationary policies, while it urges budgetary and monetary rectitude upon them, it generally encourages them to devalue and does not recommend the maintenance of an overvalued exchange rate to combat inflation. The implications for the supply-side are usually too deleterious.

There are, moreover, reasons why the path of adjustment is likely to be particularly rocky, arduous and long in the United Kingdom. Interest rates are very high in the United Kingdom because under existing institutions such rates are necessary to deter very high levels of demand for credit by the personal sector. This is due in part to deregulation and easy credit policy, which led to an explosion of house prices, leaving households with some one trillion pounds of collateral in the housing stock, only about one quarter of which is mortgaged. There is a standing temptation to use borrowing to withdraw some of this equity and maintain high levels of consumption in relation to income. This situation no doubt helps to explain why the savings rate of UK households has been only about 5 per cent of post-tax income in recent years, less than half that of other European countries or of British savings rates in earlier decades.

An initial effect of ERM entry may well be to force down interest rates as hot money flows in to take advantage of high nominal interest rates relative to those abroad, relieved of the fear of a large depreciation of the currency. If this did trigger renewed personal borrowing and even lower rates of saving, the sheltered sector of the economy, producing services or goods not subject to international trade competition, would receive a boost. That would serve to maintain the momentum of inflation just at the time that the traded goods sector came under increasing competitive pressure. A truly protracted squeeze on the traded goods sector would be needed to outweigh the effect of domestic credit creation and slow the economy down.

France in the ERM

If the government does join the ERM but otherwise current policies are maintained, a much-attenuated replay of the 1980-82 recession is therefore possible. The best that could be expected would be something like that which the French economy underwent after 1983. In that year, the Mitterand government made a U-turn and embarked on a period of austerity. Whereas in the previous three years it had devalued the Franc's central rate within the ERM three times, by a cumulative 11 1/4 per cent against the ECU and 26 1/2 per cent against the Deutschmark, between 1984 and 1990 it devalued only twice, by a cumulative 1 per cent against the ECU and 9 per cent against the DM. The last devaluation was in January 1987. The value of the real

Real Effective Exchange Rates in France and UK Index 1985 = 100		
	FRANCE	UK
1980	113.3	112.5
1981	108.0	115.8
1982	103.2	111.7
1983	99.3	102.6
1984	97.5	98.1
1985	100.0	100.0
1986	103.6	93.1
1987	104.9	93.0
1988	102.5	100.4
1989	100.3	100.8

Source: IMF

exchange rate (trade- weighted) has been broadly stable after 1983, having fallen by nearly 15 per cent per cent in the previous three years [see table]. Four years of slow growth followed the U-turn, in which unemployment rose from 8 1/2 to 10 1/2 per cent. Average annual GNP growth was around 1 1/2 per cent with industrial production about 1/2 per cent slower.

This did, however, have the desired effect on inflation. Wage inflation fell from around 12 per cent in 1983 to 6 per cent in 1985. By 1988 French wage inflation was below 4 per cent a year and unit labour costs were growing more slowly than those of Germany. France continues to run a trade and current account deficit but the process of restoring competitiveness via low wage inflation is under way. The real trade weighted exchange rate fell in 1989 and this year French wages are growing at 4 1/2 per cent, compared with over 5 per cent in Germany. Real GNP growth picked up to some 4 per cent in 1988 and unemployment has begun to fall, though at 9 1/2 per cent it is still higher than in 1983.

Obviously, it is hoped that entry into ERM might induce a change of expectations and behaviour on the part of British wage and price setters and so short-circuit the pains of adjustment. Yet there is nothing in historical experience to suggest that the United Kingdom will be able to manage the process of disinflation more easily than the French. Indeed, specific British problems suggest a worse outcome unless new policies are found. It is safer to suppose that on current policies there will be four years of slow growth and rising unemployment with little improvement in the current account. That sounds like a repeat of Labour's experience after 1963 and like the recipe for a one- term government. Yet if a Labour government tried to break out of the strait-jacket via a series of devaluations, it could not control inflation nor sustain foreign confidence.

In the next section I shall argue that the ERM provides a useful framework for inflation control; its discipline should be accepted with the government aiming to maintain a fixed exchange rate. But it must be supplemented with other policies, bearing down on inflation so as to minimise the damage to the traded goods sector and Britain's wasted industrial muscle.

2 Policies for Disinflation

Inflation is generally a sign of excess demand. However, the excess demand need not be current; there certainly is no excess demand at present. Inflation may reflect a sort of fossilized demand - excess demand existed in the past and set up expectations of continued price rises.

If price and wage setters proceed on the assumption that prices will continue to rise, their expectations are self-fulfilling and prices do continue to rise even though supply and demand are in broad balance. This type of inflation can be combatted only by a refusal to "accommodate" the expectations. A fixed exchange rate is precisely such a form of non-accommodation in that it is incompatible with the inflation continuing. Clearly, if expectations could be influenced directly, such that the inflation ceased when the fixed exchange rate was announced, then the real exchange rate need not rise; there need be no martyrdom of the traded goods sector. However, lower expectations are necessary but not sufficient for lower inflation. People must not only believe that inflation will fall, they must act on that belief if their expectations are to be self-fulfilling. Even if people believe that inflation may come down, do they have any incentive to anticipate lower inflation in their own actions?

The answer is that they probably do not. Higher real wages benefit everyone who receives them and disadvantage only the small minority who become unemployed as labour costs rise. It is true that a generalized increase in nominal wages leads to inflation, at least of non-traded goods, with, consequently little increase in real wages after all. A general restraint could result in lower inflation with little change in real wages. Yet there is no way for individual groups to achieve lower inflation by their own behaviour. If an individual or group alone shows restraint, they cannot prevent the inflation and they simply ensure that their real income is lower. It make no sense to show restraint or to make a low estimate of probable inflation unless there is a strong reason to believe that others will be doing the same. Even then, from a rationally selfish point of view, it is better to go ahead and make the wage claim and achieve a higher real wage. Pay bargaining in a decentralized system, therefore, has strong elements of the "prisoners dilemma". In practice

that means it is likely to be inflationary, a situation that is generally counteracted by demand restraint and higher unemployment. Labour needs a policy that reinforces the anti-inflation bias of ERM so as to minimize the adverse impact on the UK's competitiveness. To do that, it must help to strengthen expectations that inflation will come down quickly and, if possible, give people an incentive to anticipate lower inflation.

The Role of Fiscal Policy

The fiscal system must be reformed to reinforce anti-inflation policy. It so happens that the necessary reform fits well with ideas of social fairness that most Labour voters hold.

One of the traditional functions of the system of government spending and taxation is to provide automatic stabilizers for the economy. If the economy slows down, government revenues fall and social transfers increase; the public sector deficit expands, supporting activity. Fast growth or inflation has the opposite effects. This automatic stabilization has, however, been greatly weakened by the tax changes of the present government. The reduction of top tax rates and of the number of tax brackets has reduced the progressivity of the tax system and the tendency for revenues to move counter-cyclically. The justification offered for this has been that simplification of the tax system is good in itself and progressivity is bad as it provides a disincentive for people to work harder and earn more.

These disincentive effects exist but attempts to quantify them suggest that there has been a clear tendency in recent political discussion to exaggerate them. A fairer income tax system, as proposed by Labour, would start with a lower initial tax rate than the current 25 per cent and rise steadily to a rather higher rate than the current 40 per cent. There is no purpose in returning to penal top rates of tax, as the revenue effects of such rates are negligible or perverse. But a top rate of around 53 per cent, as in West Germany, would be reasonable. Moreover the German pattern of a having a continuously rising schedule for marginal tax rates rather than discrete bands could also be considered.

It would be possible to set up this more progressive tax system so that the overall burden was no different from the existing system but it would be much more stabilizing. That is a useful first step.

A second step would be to amend the automatic indexation of tax brackets for inflation. This measure had the reasonable objective of stopping the Chancellor deriving political kudos from "giving back" tax receipts due to inflation. It draws support from liberal notions that governments cannot be trusted with windfall tax revenues because self-serving bureaucrats will simply find ways to spend the money. I return to that point below but now

merely note that this indexation removes a powerful tax stabilization mechanism against inflation. It should be amended by indexing tax brackets not to actual or forecast inflation but to target inflation. Then if inflation runs faster than the elected government thinks desirable, the income tax burden would automatically increase. It should be noted that in West Germany, the least inflation-prone country in Europe, not only is the tax system steeply progressive but it is not indexed at all. Arguably, it would be less pernicious to index the tax system for real growth and let it raise the tax burden with inflation rather than the reverse, whereby the government allows the tax burden to rise with real growth but does not penalize inflation, as is the case at present.

What difference would non-indexation of tax brackets make? To investigate this, two simulations were run on TAXMOD, the UK tax model maintained at the LSE, comparing tax receipts with and without indexation of allowances and thresholds. With current tax brackets and allowances, indexation makes an appreciable difference to income tax revenues. At 1990 scales and income distribution, if inflation runs at 5 per cent, non-indexation results in an additional 1.4 billion for the exchequer. That is about 3 per cent of total income tax revenues and just over one quarter of one per cent of GNP. With the current two-band income tax, proportionately the greatest increase in average tax rates caused by non-indexation falls in the middle of the income distribution (deciles 5-7).

Now consider the situation under a more progressive system. It was difficult to simulate the German system on TAXMOD as the marginal tax rate

Effect of 5 per cent Inflation on Income Tax Receipts

Income decile	Average weekly Net Income £ (family)	Tax change current scale pence	%	Tax change progressive scale pence	%
1	32	-1	.03	-2	.06
2	58	-8	.14	-7	.12
3	71	-28	.39	-25	.35
4	85	-53	.62	-50	.59
5	102	-91	.89	-95	.93
6	123	-99	.81	-127	1.04
7	145	-114	.79	-150	1.04
8	174	-120	.69	-181	1.04
9	217	-149	.68	-264	1.22
10	356	-247	.70	-481	1.35

Source : TAXMOD simulations

in Germany does not go up in discrete steps but on a continuous schedule, rising as a linear function of income. It was approximated by assuming a system of six tax bands, with a starting rate of 19 per cent, then five bands of 24, 31, 39, 47 and 53 per cent. Bands were fixed so that the system would have yielded the same revenue for 1990 as the current UK system. All other taxes and allowances were assumed to be unchanged. Non-indexation of this system with an inflation of 5 per cent yields additional revenue of 2.1 billion, compared with full indexation, an increase of nearly 5 per cent in personal tax revenues and some 0.4 per cent of GNP.

The incidence of the inflation tax is also more progressive under this system with the proportionate burden rising steadily with position on the income distribution (see table).

Cash limits on expenditure

The argument that such target indexation would encourage public sector profligacy can be met by maintaining a practice begun by the Labour government in 1976 and continued by the present government: setting cash limits on expenditure. Expenditure plans by the government should be costed assuming the same target rate of inflation as is used to index taxes. Then, if inflation goes faster, not only would revenues increase but "real" expenditure would fall. The cuts into spending power would be made by both blades of the scissors. And while the government could increase real expenditure by targetting a high rate of inflation, by doing so it would forego revenue and vice versa.

Note that the use of cash limits certainly does not entail any intention to restrict real public expenditure unconditionally. Public expenditure should be planned in real (i.e. constant-price) terms, in a multi-year framework, and may be high or low, as cost benefit analyses, economic growth projections and political priorities dictate. Initial real expenditure plans would be quite independent of current inflation. Evidently, a Labour government will have a backlog of high-priority public spending to consider. What is at issue here is not the level of real public spending but how it responds to excessive inflation. Only if inflation were excessive would real public spending run into cash limits. Then a secondary set of issues would be raised about priorities; i.e. what suffers within each department of expenditure as a result of cash limits? Evidently, if the inflation target is ambitious, each department would need contingency plans to implement these secondary priorities, if necessary.

An obvious objection is that it would be inappropriate to make the burden of inflation control fall on government spending after a period in which it has been pared back brutally by a Conservative government. That view must attract sympathy but it should be recalled that the alternative could be a more pronounced squeeze on the tradeables sector. The point about cash limiting

public expenditure and target-indexing taxes is partly to ensure that the non-traded goods sector bears its share of any adjustment burden necessary.

An advantage of this approach is that it does not depend on discretion nor on the ability to forecast future inflation. Fiscal policy would tighten significantly and automatically whenever inflation was excessive. The proposal should not be misunderstood. In no sense is fiscal stringency proposed as an alternative to monetary tightness. An ultimately non- accommodating monetary policy is necessary, irrespective of fiscal policy, but it is assured by a fixed-exchange rate strategy. It is not suggested that a fiscal squeeze would permit the government to depreciate the exchange rate. Indeed, if excess inflation resulted, via automatic stabilizers, in a rise in the tax burden and a fall in real government expenditures, it is possible that real interest rates would tend to fall too - as the government's credit demands would be less. In some circumstances, such a decline in interest rates could lead the exchange rate to depreciate. Given an ERM commitment, such a depreciation would have to be resisted by a tightening of monetary conditions to maintain interest rates. In effect, the fixed exchange rate means a monetary tightening, in some sense, automatically follows a fiscal tightening. (Interest rates would be unchanged but the growth of money and credit aggregates would be less). The two policy levers become complements not substitutes. And it happens automatically, without any forecasting or difficult judgement being needed.

Another objection is that these policies could still prove inadequate. Fiscal drag of £2 billion sounds impressive until set alongside the explosion of personal borrowing in the UK in recent years. Between 1986 and the end of 1988, personal borrowing rose by £100 billion, much but not all of it mortgage debt for house purchase. If people go on borrowing on such a scale, and banks are permitted to lend, the impact on spending could swamp the automatic fiscal contraction proposed. That is a particular danger if hot money flows, following ERM entry, meant that interest rates had to be lowered to stabilize the exchange rate. This risk has led to calls for credit controls. Certainly some special counter-measures might be needed, which are considered below.

Co-ordination of pay bargaining

Meanwhile, note that the risk of another credit explosion is less the lower are people's expectations of inflation for any given nominal interest rate. A fixed exchange rate plus an announced target rate for inflation, reinforced by automatic stabilizers, should improve the climate of expectations. Nonetheless, they do not necessarily deter wage bargainers or price setters because of the notorious prisoner's dilemma, referred to above. There is clearly a role of co-ordination to be carried out to facilitate the concerted restraint that would keep inflation down and prevent everyone paying the higher taxes that would follow from inflation.

That begins to sound like an incomes policy and no-one likes incomes policies. Trades union officials do not like them for the obvious reason that they restrict bargaining, undermining the official's role. Employers find them an encumbrance, preferring the "right to manage", preferably in a situation of excess labour supply where they can easily replace recalcitrant workers. A general perception of failure attaches to past British attempts at incomes policy, culminating in the breakdown of Mr Callaghan's proposed pay norm in 1978 and the "winter of discontent".

In other countries, the picture is dark though less uniformly black. Austria and the Netherlands operated successful incomes policies in the 1960s, though the Dutch policy broke down in the 1970s. Other countries, such as Sweden and Denmark, have had a more patchy experience. Germany has dabbled occasionally in more formal incomes policy while maintaining a system in which the central bank tries to set a framework for wage bargaining by forecasting potential growth and indicating permissible inflation; the Bundesbank then anounces a target growth of a monetary aggregate believed to be consistent with those but which would not "accommodate" faster growth or inflation. To some extent, the system is a confidence trick as there is little reason to believe that targetting the growth of the monetary aggregate, even if it were achieved, would really constrain the economy in any given year, even if it did so in the longer run. In practice it is impossible to disentangle whether wage bargaining has been restrained partly out of respect for the monetary targetting, or whether monetary targetting has been relatively successful because of the restrained nature of German wage bargaining. It is at least plausible that they have been mutually reinforcing.

In sum, a number of countries had some success with incomes policies in the first two decades after World War II but there was a sharp falling off in the success rate after that and a general breakdown in the 1970s. Such arrangements as have persisted into the 1980s are informal, except in Australia. Detailed and statutory policies do not fit well with the current climate of economic liberalism.

The decline of incomes policies owes much to changed economic circumstances and the changed role that they were called upon to play. In the first phase of such policies, they generally set out to influence the level of "nominal" wages. The idea was to restrict the growth of money wages in order to restrict the rise in prices in a situation of full employment. There was no intention to control the level of real wages, ie to control the relative movement of wages and prices. It was assumed both would rise together. Nor was there, in general, the aim of affecting wage relativities.

That changed with the oil-price crises of the 1970s, which worsened the terms of trade of oil-importing countries. Then it was no longer a case of simply sharing out the fruits of growth; national incomes had been reduced by higher energy prices and losses had to be shared. There was a fight over a

diminishing cake, which was generally lost by profits. In most European countries the profits share of GNP fell in the 1970s while inflation rose sharply and trade balances went into deficit.

In that situation, incomes policies were called upon to do too much. They were used to reduce rather than to control inflation but they were also used to attack real wages in an attempt to reduce consumption spending and hence balance of payments deficits. Clearly it is difficult to get trades unionists to agree to cuts in living standards, except very briefly at a time of evident national crisis. If they agree, they risk losing the support of their members. In some countries, including the UK, inducements were offered in the form of a social contract or compact, whereby wage restraint was to be traded for an influence on government social or macroeconomic policy. In general, these social contracts were not a success. Union leaders could be blamed by members for lack of successful bargaining but were unlikely to be given credit for the successes of macroeconomic policy, assuming there were any. Moreover, the spectacle of union leaders apparently haggling over general policy with the elected government made the unions seem excessively influential and contributed to a loss of general popularity. No wonder that few union leaders wish to repeat the experience.

Only in Australia in the 1980s has any form of social contract - the "wages accord" - survived as a centrepiece of policy. There it has certainly been associated with a lengthy period of slow growth or even decline in real wages, despite vigorous GNP growth. In European countries, trades unions were generally unable to deliver real wage cuts for long. Most governments eventually had recourse to deflation and higher unemployment to reduce inflation and stop the growth of external debt.

That experience strongly suggests that a distributionally neutral policy, aiming to influence the overall level of nominal wages, may have some success but any policy that attempts substantially to alter real wages, relative to what they would have been in the policy's absence, is unlikely to work.

Such a conclusion appears to leave little room for an incomes policy within the framework of monetary and fiscal policy set out above. A fixed exchange-rate commitment will, in the end, determine prices; these are set by foreign competition and what the market will bear, not just by wage costs. So any change in nominal wages induced by an incomes policy changes real wages, profits and employment too.

Limited objectives

However, matters are not entirely bleak. At present, the objective should not be to reduce real wages. They have not been outstripping productivity in recent years and the profitability of British companies is quite high by historical and international standards. The concern is rather that, if output

prices are restrained by a fixed exchange rate, wages will continue to grow unabated, resulting in loss of competitiveness and unemployment. The aim of any incomes policy would be not to restrain real wage growth below the growth of productivity but to ensure it did not outstrip productivity so much as to push British unit cost inflation above that of trading partners. The policy would look to prevent an unwarranted acceleration of real wages but not to restrict them absolutely or relative to trend.

It could be argued of course that, as the United Kingdom still has high unemployment and a balance of payments deficit, real wages are too high in some sense. However, given existing skills and capital stock, and the difficulties people have in changing the region in which they live or the type of work they do, it seems improbable that full employment could be restored by the expedient of reducing wages. Reducing unemployment must depend on the various supply-side measures proposed by Labour, some of which can draw on Swedish experience of maintaining low unemployment by active policies to make the labour market function better. Trying to reduce wages by devaluation is likely to result in inflation while, as noted above, attempting it via an incomes policy has never been successful for long.

There is still the difficulty that people do not have adequate incentives to voluntarily take part in an incomes policy, even one with the modest objectives proposed. Indeed with over 60 per cent of the population buying property having borrowed a sum fixed in nominal terms, there is a fairly general interest in having inflation continue, quite apart from each individual's or group's reluctance to take the lead in combatting it. The fiscal reforms proposed above would, however, increase the interest in having lower inflation. By making inflation less popular it would increase the general disapproval of those people or groups thought to be causing it.

Target inflation

Labour Party policy currently proposes regular discussions among government, employers, trades unions and others. It also proposes a new independent statistical unit to provide information on pay and prices in order to "develop a broad understanding of what is feasible". One function of such a unit could be to set out the factors underlying the target inflation rate. The underlying principles are simple enough.

Given the inflation rate of traded goods prices in other countries, the permissible inflation rate of traded goods here is given too. (Note that we are speaking of average inflation across all categories of traded goods; there need be no attempt to define target inflation for specific sectors.) It cannot for long exceed the average rate (trade-weighted) of our trading partners and competitors. Given the trend growth of labour productivity in our traded goods industries, we can derive a warranted rate of growth of nominal wages in

industry (equal to foreign inflation plus domestic productivity) and, by extension, in the economy generally. Now that average wage growth is determined, subtracting average productivity growth in the non- traded sector gives the rate of target price inflation in that sector, assuming an unchanged share of profits. Overall inflation then equals the weighted average of inflation rates in the traded and non-traded sectors, where the weights are given by the importance of the respective sectors in domestic consumption.

That would be the minimalist approach. If the system worked well and it proved possible to target the inflation rate fairly closely, the government would have another instrument which could be used to combat unemployment. That could be done by targetting an inflation rate for traded goods lower than in other countries, so increasing competitiveness. Demand for British goods would then increase raising output and employment. It seems unlikely, however, that the system would work well enough to permit this sort of fine tuning and being excessively ambitious could undermine the credibility of the system.

There are foreign precedents for having a group of independent experts or "wise men" set out the parameters for wage bargaining. It is a practice that has been followed in both Germany and the Netherlands, in an effort to influence expectations and promote coherent wage and price determination. Of course, the government would be ultimately responsible for adopting the inflation target and embodying it in tax practice.

With target inflation and average warranted wages growth defined, and automatic sanctions against excess inflation in place, actual bargaining is best left to the parties most directly concerned. The government will generally want to set public sector wages so that on average they respect the guidelines - though in its early years it may wish to raise some public sector salaries relative to wages in general on microeconomic grounds; some public sector salaries have fallen far behind in recent years. However, the government should have no interest in intervening to influence relativities in the private sector.

An important role for government could be in the area of institutional reform. There is some evidence that the wage bargaining process is less inflationary in those countries, such as Japan and Germany, where it is not too decentralised but is conducted at an industry level, facilitating co-ordination. National wage bargains, on the Swedish model, have been found to be too inflexible. In the UK in recent years there has been a tendency towards more and more plant-level bargaining. That sort of decentralization would make a formal 1960s-style incomes policy inoperable and makes any sort of co- ordination harder to achieve. At this stage it is unclear how easily the tendency is reversible. Co-ordination is also apparently facilitated by the practice of concentrating important wage negotiations in a certain period of the year - like the Japanese "shunto", or spring wage "offensive".

Short Term Measures

3

ERM entry will bring lower interest rates. Measures will therefore be needed to restrain excessive borrowing.

The special situation of the UK housing market, in which a vast amount of personal wealth is now locked, has already been mentioned. It constitutes the UK's equivalent of a "monetary overhang" on the East European pattern. In the long run it will be necessary to tackle this problem by changes to the tax treatment of housing. Reintroducing an element of property taxation in local government finance is one step, to which Labour is committed. These are very important issues in the field of taxation policy but their discussion is beyond the scope of this paper.

The immediate macroeconomic problem could be to restrict borrowing in a way that was compatible with a fixed-exchange-rate target. Clearly, uninhibited use of interest rates is excluded as likely to drive the exchange rate outside agreed bands.

To some extent, borrowing could be restricted by some tightening of regulatory procedures. Minimum deposits could be required for house purchase and the enforceability of contracts made dependent on the regulations being met. These could have some effect on the volume of borrowing as well as being desirable in themselves in reducing the risk of bad debt. They could, of course, be politically unpopular. Another suggestion has been the use of credit controls. The term has been used in two quite different senses.

The first is quantitative ceilings on the amount of new credit a bank or other institution is allowed to extend. Quantitative controls of this sort existed in the 1970s when the "Corset" established fines for banks whose liabilities grew faster than some limit. One difficulty is that such a restriction would create excess demand for credit that could bid up its price, i.e. raise interest rates. Now, as a matter of fact, the Corset had little apparent effect on interest rates as banks did not generally compel established customers to compete for scarce credit by bidding for it; they preferred to ration credit according to their perception of a potential borrower's credit- worthiness. To the extent that the banks would continue to act in that way, credit controls could be a partial alternative to higher interest rates, though they do bring in train their own distortions. In particular, they clearly discriminate in favour of established borrowers and against smaller and newer ones. However, a more serious

difficulty is that the current banking situation is probably more competitive than it was in the 1970s with the entry of more foreign banks into the United Kingdom. In the current situation, there could be more bidding up of interest rates than there was before. Quantitative controls, therefore, might have to be accompanied by interest rate controls if they are to ration credit, rather than being just another way of raising interest rates.

A more serious problem still is that, with or without interest rate controls, it would be difficult to make such a rationing system effective for very long given the current absence of exchange control. Companies would immediately increase their borrowing offshore and individuals would begin to do so eventually, particularly in the context of a fixed exchange rate, which limited the exchange risk to foreign borrowing and lending. Small consumers would find offshore borrowing difficult but if enough company borrowing was done abroad, resouces would be left for them domestically, within the credit guidelines. Of course, the guidelines could be tightened progressively to take account of that but it would be very difficult to sustain this approach without abandoning the UK's international commitments to integration of financial markets in the context of the ERM.

Reserve deposits

The term "credit controls" has also been used in a different sense, namely requiring banks to maintain reserve deposits with the Bank of England. This is done in the majority of European countries and a solid case can be made for it as an alternative technique of monetary management. However, it is not a way of restricting credit without raising interest rates.

With a reserve deposit system, the central bank (it would be the Bank of England in the British case) lends to the commercial banks so that they can always maintain the required reserves. By raising the cost of this lending it can raise the cost of credit to banks. This extra cost is then passed along to clients. In other words it is another way of managing interest rates. The most important European central banks operate using inter-bank interest rates as their main immediate target variable which they influence by the altering the cost of the reserves they provide, leaving reserve requirements constant as a proportion of banks' liabilities. The last time the Bundesbank altered reserve ratios, for example, was in February 1987.

In that situation the reserve requirement acts as a sort of tax on the banks and certainly does not serve to reduce interest rates. If the central bank does raise reserve requirements, it forces the commercial banks to borrow more reserves. As that borrowing costs money while the reserves do not pay market interest rates, it also raises the cost of credit. In no important European country does the central bank increase reserve requirements and then refuse to make funds available. If it did, inter-bank money market interest rates

would rocket, making it impossible to manage the exchange rate. Eventually, in such a case, the banks would be forced to curtail loans in order to meet reserve requirements. Credit would be restricted alright but the consequence would be a spiral of retail interest rates bringing the demand for credit down in line with supply.

It has been suggested that the mere possibility that the government might increase reserve requirements, even though it would make the reserves available at a price, amounts to the threat of imposing a larger tax on the banks if they lend "too much". Such a possibility might make banks more cautious in extending credit. This is a plausible argument but it is not clear why this caution, in reducing the supply of credit, would not also raise its price eventually. And certainly it would be rash to rely on this effect to achieve a substantial restriction of credit when there was excess demand for it at ruling interest rates.

Credit controls, in the sense of compulsory reserve requirements, do not allow the authorities to restrict credit substantially or for long without raising interest rates.

The essence of any effective special measures to curtail borrowing must be to put a wedge between the cost of funds to would-be domestic borrowers and the return on lending by foreigners. If the cost to domestic borrowers rose - irrespective of where they borrowed from - that would restrict borrowing; while if meanwhile the return to foreign lenders was unchanged there would be no inflow of hot money disturbing the pound. Such a wedge can be achieved with taxation in a way that does not violate any current international agreements.

A tax on borrowing

One possibility would be a levy or tax imposed on domestic borrowing. The main idea is to tax borrowing by households for consumption purposes though it must be accepted that any attempt to "target" the tax to specific borrowing purposes would necessarily be very rough and ready. There would be some scope to levy the tax on bank loans to the household sector while making working capital to companies exempt but it would be impossible to tell whether a small businessman with an unincorporated enterprise was borrowing for investment or consumption purposes. The tax could be extended to second mortgages, though not first ones, on the grounds that the former were more likely to be facilitating equity withdrawal for consumption purposes. If the tax were levied at, say, 15 per cent on interest payments, that would raise the effective rate on a 10 per cent loan to 11 1/2 percent and on a 15 per cent loan to 17 1/4 per cent. Alternatively, a lower rate, say two per cent, could be levied on the principal of the loan. Then the tax would not vary with the interest rate itself. Loan contracts booked offshore that did not pay the tax could be made unenforceable under British law. Though that could raise legal issues

under EC law, it would force a "risk premium" on foreign loans to British residents, raising their effective interest rate.

A supplementary measure could be a variable-rate withholding tax on non-resident holders of British securities or deposits. There is currently a withholding tax for foreigners, levied on holdings of gilt-edged securities, for example, at the basic rate of income tax. If British interest rates rose (or fell) but the withholding tax were reduced (raised) commensurately, post-tax returns to non-residents would be unchanged and they would not alter their investments in sterling. Currency movements would thus be partly insulated from movements in domestic interest rates. The European Community has tried to set a uniform withholding tax for all member states but the effort failed; there is currently no international requirement in this area.

Specifically in the context of British entry to ERM with interest rates some 6 1/4 per cent higher than those in Germany, lower returns to foreigners might well be needed to prevent the pound rising beyond agreed bands. This could be achieved by letting UK interest rates fall and supplementing them with a tax on domestic borrowers, or by leaving rates alone but increasing the withholding tax on foreign investors - or some combination of the two. Such measures need not be viewed, or presented, as permanent features of British economic management but as special resources designed to cope with the particular disequilibrium represented by the housing market, which can be resolved only over a period of time.

Conclusion

Two sorts of anti-inflation policy should be distinguished.

One is a permanent policy that makes up part of the framework of macroeconomic management; the other sort is a temporary policy, designed to combat a particular difficulty or crisis. This paper has made three proposals for the former, permanent category: a fixed exchange rate within the ERM as the objective of monetary policy; a reform of the tax and public expenditure system to reinforce automatic stabilizers against inflation; measures to promote more co-ordinated pay bargaining. The paper has also acknowledged, though without discussion, the need for changes in the tax treatment of housing. In the second, temporary, category the paper has considered means to restrain excessive borrowing, given the probability that ERM entry will bring lower interest rates. It proposes special taxes to put a wedge between credit costs to domestic borrowers and returns to foreign lenders.

Nonetheless some co-ordination of pay bargaining would be useful in helping wage and price setters to respond to the new situation. Measures should include publication of target inflation and a warranted rate for average wage growth, to be used by the government in public sector settlements. Institutional changes to facilitate co-ordinated wage bargaining could be explored with the directly-interested parties but would ultimately be left to them.

ERM entry is a valuable plank in an anti-inflation policy. However, it is inadequate on its own and could well result in excessive damage to British competitiveness and industrial health. Supporting policies are needed to ensure that the burdens of adjustment are not too great and do not fall entirely on the traded goods sector of the economy.

The author would like to thank Professor David Currie and Fabian readers for helpful comments, and Ms. Holly Sutherland of the LSE for running the simulations of TAXMOD.

Introduction

"The central objective of the Medium Term Financial Strategy (MTFS) is the defeat of inflation". This bold claim has been the centrepiece of Conservative economy policy ever since the MTFS was launched in 1980.

Indeed, according to the 1980 MTFS the defeat of inflation was quite simple to achieve - "Control of the money supply will over a period of years reduce the rate of inflation". Of course, control of the money supply turned out to be easier said than done, even allowing for the tenuous relationship between inflation and the money supply. Nevertheless, successive versions of the MTFS continued to repeat the Government's central economic objective, with changing emphasis on different indicators of monetary and fiscal policy to guide policymakers towards that objective.

The contrast between the objective of the Conservative Government and reality is turning out to be quite striking. At the end of the 1980's, retail price inflation stood at 7.7% and was rising towards double-digit levels by the summer of 1990. Moreover, inflation in the UK was some 2-3 times higher than rates prevailing in Continental Europe, the US and Japan. The gulf between rhetoric and reality was becoming so apparent that the "ultimate objective of stable prices" - a phrase often found in the Financial Statement and Budget Report (FSBR) during the 1980's -was conspicuous by its absence in the 1990 FSBR. In fact, against a deteriorating outlook for inflation the FSBR admitted that "these policies do not guarantee a permanent low rate of inflation".

The aim of this essay is to show that setting economic policy with zero inflation as the sole and ultimate objective is misguided and needs to be supplemented by objectives that ensure sustainable improvements in the real capacity of the economy. Exclusive use of interest rates to control inflation is unduly restrictive and unnecessarily damages the real economy and prospective productive potential.

A constructive inflation strategy should make fuller use of monetary and fiscal policy in order that the growth in domestic demand is "supply-friendly". While ERM membership is by no means a quick fix in solving the Conservative inheritance of high inflation and a weak real economy, it does promise to provide greater "credibility" in terms of guaranteeing sustainable lower rates

of inflation than the now discredited MTFS. The positive financial discipline of ERM membership needs to be complemented by "short-term" and "long-term" strategies such as

- . an improvement in pay bargaining procedures. The introduction of a "Euro-pay norm" for industry would help crack the 'wage-price spiral' in the UK economy and speed up the adjustment mechanism towards lower rates of inflation.
- a reform of public sector pricing behaviour, introducing "Euro index linking" in the setting of public sector utility charges, especially where price rises have been consistently over and above the UK rate of inflation
- an industrial strategy which improves Britain's productive potential and competitiveness over the long term and incorporates measures to improve the skills of the workforce.
- methods of controlling credit such as reserve ratio requirements, similar to those used in other G7 economies.

In this regard, Labour's policy on inflation offers a much more realistic way of securing stable rates of inflation in the UK economy than the destructive short-term approach of the Conservatives.

1 The Inflationary Context

The many economic costs of high inflation have been well documented. However, it is clear that the Government's anti- inflation policy is motivated to a significant extent by one particular theme - that markets and economies work better at lower rates of inflation and best of all at zero inflation.

This view was outlined in a Memorandum from HM Treasury to the House of Commons Select Committee on the Treasury and Civil Service (Third Report, Volume III, 1981). "In addition to its social consequences, inflation has economic costs. These are largely associated with the uncertainty it creates. A number of studies have suggested that the higher the rate of inflation...the more unstable it becomes. There is strong evidence that, as this happens, the dispersion of relative prices increases...So both relative and absolute prices become more difficult to predict as inflation rises. Since relative prices are the crucial signals in a market economy this instability must impair the efficient working of the economy".

In other words, high inflation is thought to cause greater variability in relative market prices, a variability only tenuously linked to relative scarcities. Price signals are distorted and economic performance suffers. It follows that living with high inflation, even though it may be stable and predictable, could not be considered as a policy option.

This begs several questions. For example, how is the efficiency of relative price movements to be measured? Is there any evidence of a causal relationship between aggregate inflation and measures of market efficiency? Is current anti-inflation policy likely to improve market efficiency and the performance of the UK economy. An examination of these questions was carried out by the author while still an economist at HM Treasury[1]. The results of that work showed that

- it is by no means clear that even in theory the direction of causation runs from inflation to relative price variability.

- the most important contributions to relative price variability in the UK were the prices of goods which are most sensitive to policy changes such as alcohol, tobacco, rates and rents and durable goods.

It follows that it is not necessarily inflation which has been too high for markets to work efficiently but policy itself which may have been too fickle. Relative price uncertainty in the UK may have been something of a self-inflicted wound especially in the 1980's. Inflation this year (1990) is a classic case where government induced price increases (the poll tax, excise duties, rents and rates, the devaluation of the 'green pound', etc.) have not only generated a sharp increase in 'headline' inflation but also aggravated the wage-price spiral in the economy. This situation contrasts markedly with the US experience where hikes in measured relative price variability may be traced specifically to commodity price shocks, rather than economic policy. The paper drew the following very tentative policy implications:

- There is probably no stable structural relationship between relative price uncertainty/variability and aggregate inflation and it would be naive to frame policies as if they were.
- Zero inflation is probably not sufficient and possibly not even necessary to make markets move efficiently. Some 'core' or 'warranted' relative price variability is required to ensure efficient allocation of resources as well as to limit the damage from external shocks (an oil price hike, for example).
- (iii) There is something of a "targets and instruments problem" with current anti-inflation policy. For example, if downward price rigidities in certain key markets, eg. labour, are diagnosed as one of the main causes of our poor economic performance, then policy should address itself more directly to improving the proper functioning of these markets. Disinflation in itself is not enough.
- (iv) Even within the framework of an anti-inflation policy, Government should be aware that other policy actions, most importantly on indirect taxes and those affecting the exchange rate, may increase relative price variability and the 'noise' in the price mechanism.

Top of the inflation league

During the Conservatives' period of office since 1979, retail price inflation reached 21.9% in May 1980 before reaching a low point of 2.4% in the summer of 1986. The high point of inflation largely reflected the doubling of VAT to 15% in 1979 while the low point reflected the weakness in oil prices at that time rather than any underlying improvement in the trend rate of inflation.

Inflation: An International Comparison

	1987	1988	1989	1990	1991
UK	5.0	6.5	6.7	4.9	5.6
Italy	6.1	6.1	6.3	5.9	5.5
US	2.8	3.0	3.4	3.3	2.8
France	2.8	3.0	3.4	3.3	2.8
Germany	2.0	1.5	1.5	3.0	3.4
Japan	0.3	0.6	1.5	2.7	2.6
EC average	3.8	4.0	4.5	4.5	4.4

GNP/GDP deflators, figures for 1990 and 1991 are OECD projections (June 1990)

In spite of so-called supply-side improvements by the Conservative Government, underlying inflation (especially that generated in the labour market) has registered little sign of improvement. Wage inflation in the UK is some 2-3 times higher than rates prevailing elsewhere and Government policy has aggravated the wage-price spiral by using the mortgage interest rate as its main anti-inflation weapon.

In addition, underlying inflation appears to be well entrenched in the system, reflecting not only an unbalanced monetary/fiscal policy mix but also mistakes relating to the timing of monetary and fiscal decisions. For example, the policy of shadowing the DM while outside the ERM induced the authorities to cut base rates to 7.5% at a time when domestic demand was rising at its fastest rate in real terms during the postwar period. If that was not enough, the £4bn tax cuts in the 1988 Budget encouraged a consumer boom and massive credit expansion. Not surprisingly, unusually large excess demand pressures triggered an acceleration in inflation and a sharp deterioration in the current account balance. This forced the Government to do a complete about turn and raise interest rates to 15%. Unfortunately, this strategy (in the absence of other policy measures) has squeezed the real economy without any visible benefits on the inflation rate. Of course in 1991, as Government induced price increases (the poll tax etc.) and the impact of higher mortgage rates on the RPI wash out of the year- on-year comparison, it will be quite easy for the Chancellor to secure "headline" rates of retail price inflation close to 5% or below. However, 'underlying' inflation is likely to be in excess of the 'headline' rate though and will tend to undermine the UK's cost competitive-

ness, thus damaging export performance at a time when the onset of the Single Market Programme ("1992") requires the UK manufacturing sector to be as competitive as possible.

The role of world inflation

Previous studies[2] have noted the relationship between UK inflation and world inflation. The key finding is that turning points in UK inflation during the postwar period have typically been related to turning points in the path of real commodity prices, while the level of inflation is strongly affected by changes in the export prices of other countries' finished goods. The implication is that it is perfectly possible for a situation to arise in the UK in which there is no inflation generated from domestic labour or goods markets but inflation still goes up as a result of external factors.

The Conservative Government has operated an inconsistent policy with regard to the exchange rate. The sharp appreciation in 1980-82 squeezed liquidity and decimated the manufacturing sector. The much hoped for anti-inflation benefits from shadowing the DM in 1987-88 resulted in Mr Lawson's resignation as well as resulting in mistakes over the setting of domestic monetary and fiscal policy. The fall in the pound which preceded ERM euphoria in the spring/summer of 1990 and was attributable to Mr Major's base rate shyness forced a sharp rise in import prices.

Monetary policy

Monetarism, at least in the form advocated and practised by the Conservative Government, is widely regarded as a failure. Despite the emphasis on reducing the Public Sector Borrowing Requirement (PSBR), the promised low inflation and low interest rates have failed to materialise.

However, that is not to say that monetary policy is unimportant. Clearly it is, but it is important to recognise its limitations, especially in a period of widespread structural change to the financial system stemming from deregulation and the increasing global integration of financial markets. While many countries still target certain measures of money supply, the role of targets in interest rate decisions has over the years become less important. Interest rate decisions by central banks in Europe, US and Japan have typically been the product of concern over exchange rate gyrations or, in less open economies such as the US, the output/inflation mix in the domestic economy.

In the case of the UK, the Conservative Government has gradually retreated from its initial monetarists principles, abandoning "broad money" targets in 1985. At present, only M0 (narrow money i.e. cash in circulation) retains target status. M0, in principle, is not surprisingly a coincident indi-

cator of retail transactions and there is a reasonable correlation with movements in retail price inflation. But again this should not be surprising. M0 as a policy indicator is more or less devoid of policy content, though on occasions it can provide a useful warning to Governments and the financial markets of the direction of inflation.

The interest rate transmission mechanism in the UK has been quantified by the Bank of England[4] as having direct effects on prices through two broad channels

(1) the pressure of demand and,
(2) the exchange rate.

In (1) the most important channel is the housing market where personal sector expenditure is affected by house prices, mortgage lending and housing wealth. In addition, there are second round effects on expenditure through changes in activity, employment, real incomes and financial wealth. Interestingly, the Bank of England reports that the link between pressure of demand and wages is weak.

The Bank summarises the overall impact of a 1 percentage point rise in interest rates on the economy as a whole. The main points are

- each 1 percentage point rise in interest rates reduces the level of GDP by just under 1% after three years.
- the current account balance improves by some £2bn after three years.
- inflation (as measured by the GDP deflator) falls by 0.5% over the same period, but retail prices actually rise by 0.2% after two years
- a 1% rise in the level of the exchange rate reduces the level of domestic prices by around 0.6% after three years.
- a 1 percentage point rise in short rates reduces house prices by around 3% after one year.

Clearly, relying on interest rates to curb inflation is, according to the Bank of England, a long drawn out process. History has shown that where inflationary processes are well entrenched, a gradualist policy is usually unsuccessful. In addition, relying on interest rates to control inflation has a poor pay-off, as it aggravates the wage-price spiral and damages the supply side of the economy.

Competitiveness

Once an exchange rate depreciation is ruled out (as it would be in the ERM), improvements in competitiveness can only come about through (a) faster

increases in productivity growth or (b) through lower levels of inflation compared to the EC average.

UK productivity levels are relatively low and appear to be a structural rather than a cyclical problem.

Britain's worsening trend competitiveness leaves UK industry very unprepared for the challenges of 1992. Conservative economic policy has hampered industry in three ways:

- through high exchange rates, which have crippled industry by making it uncompetitive in world markets.
- through high interest rates, which have added to debt servicing costs at home. This helps to widen the investment gap between the UK and the rest of Europe.
- by not devoting enough resources to improve the quality of the labour force. Skilled labour shortages act as a severe constraint on manufacturing output. Labour's "supply-side" policies to improve education and training are badly needed if productivity levels are to catch up with continental Europe.

2 A Plan For Labour

The UK will probably join the Exchange Rate Mechanism quite soon. A commonplace view is that membership will allow UK interest rates to fall sharply.

However, the experience of high inflation economies within the ERM is that it is typically a long haul toward significantly lower rates of inflation. The likelihood is that the UK will be compelled to maintain a relatively high level of interest rates and implement some degree of fiscal deflation in order to squeeze pay bargaining behaviour in the labour market and restore credibility with the financial markets following the loss of faith in the Conservative Government's ability to control inflation.

ERM membership is an important element of a "short term" package to control inflation but, as Labour's economic policy measures make clear, in the case of the UK this needs to be supplemented with a variety of "long term" measures to ensure that any reduction in inflation remains durable and sustained. In contrast to the circumstances surrounding the entry of France, Spain and Italy into the ERM, when their economies were experiencing considerable "overheating" pressures, the UK is likely to enter the ERM "over cooled" as a result of a prolonged period of high base rates. Domestic demand is already broadly flat. However, there is a suspicion (quite warranted given past experience) that demand pressures could be easily resuscitated if interest rates fell too quickly. For the UK, though, the key problem is wage inflation, especially as it is considerably higher than rates prevailing in Continental Europe. For a Labour Chancellor, the key issue is how to crack the wage-price spiral and bring the growth in wages down to more desirable levels.

The wage-price spiral

During the 1980s, average earnings in the UK economy have grown faster than the rate of inflation. In addition, the growth in average earnings has been fairly unresponsive to downward moves in the rate of inflation but very responsive to higher rates of inflation. It was only during the 1980-1982 recession, when unemployment rocketed, that there was a sharp drop in average earnings growth.

A key issue for the Chancellor of the next Labour Government is whether the trades unions present demands for wage increases so large that Labour's economic policy would be completely knocked off course. Incomes policies are ruled out in Labour's new economic policy, not because they were previously ineffective in controlling wage inflation, but rather because ERM entry leaves incomes policies redundant.

That is not to say that ERM is going to cast a magic spell on pay bargainers inflation expectations. An incoming Labour government will have to take "the credibility test" as part of ERM entry and this could well involve some uncomfortable policy choices. Certainly, it is going to be a hard slog to lower inflation and higher living standards. It needs to be spelled out clearly to the trades unions that excessive wage claims can mean higher unemployment. The experience of all high inflation economies within the ERM has involved a difficult period of acquiring credibility, sometimes involving fiscal restraint. Clearly, exchange rate devaluation is no longer a soft option as a counter to high wage claims. A Labour Government should therefore make it a medium-term objective that UK wage inflation rises in line with EC wage inflation. Otherwise, within a fixed nominal exchange rate regime, relatively high wage inflation will mean that the real exchange rate appreciates, making UK exports uncompetitive.

Euro-Linking

A Labour Chancellor should announce a "Europay norm" for the UK economy in which the growth in average earnings for the calendar year is targeted to rise in line with the average in Europe. Monitoring of pay settlements could be carried out by existing institutions with the result published monthly through the EC (or through a new independent statistical unit as recommended in Labour's policy document *Looking to the Future).* An announced Europay norm would send a clear signal to pay bargainers in the UK of the need to bring UK wage inflation down to European levels. The norm probably needs to be an informal guideline, nothing more, for wage bargainers. As the Single Market develops, there is every reason to believe that European trade unions will develop much closer links so that wage bargaining will begin to be on a European level. In terms of working conditions, the EC Social Charter points to harmonisation here already.

However, to make the Europay norm more effective, wage bargainers would have to see visible evidence that the "cost of living" was rising at European levels. An important second element in the package would therefore be to index link charges by public utilities in line with the average EC rate of inflation, in other words, "Euro index linking". Private monopolies which charge prices on formulae such as the RPI + X% would be compelled to change the formula to the EC rate + X%. This change in pricing behaviour needs to

be only a short term tactic but could have an important role in convincing wage bargainers that public sector price increases would moderate.

If ERM-membership is to prove effective, a package of this nature to crack the wage-price spiral in the UK economy is vital. It would prevent undue dislocation in the real economy in the adjustment towards lower rates of inflation amd, by placing a lid on the excessive business costs facing industry and business, alleviate cost- push pressures immediately. Relying purely on a stronger pound within the ERM to send an anti-inflationary signal may prove unsuccessful. The Conservative's high exchange rate policy in 1987-88 did little to impinge on pay bargainers inflation expectations and pay settlements remained under upward pressure. Moreover, with the onset of 1992, reliance on a strong pound would unduly damage the competitiveness of UK manufacturing industry at a time when it was still recovering from the downtrend in output and profits growth in 1990.

European Monetary Union

The debate about European Monetary Union is of critical importance to any future economic strategy. Full discussion is beyond the scope of this paper, and has been dealt with in other recent publications.[3]

The outline of the UK's approach, however, should be as follows:

First it should, as soon as is practicable, join the ERM. If this initially occurs with wide 6% intervention bands for sterling then there should be an

The Spanish Experience.

In the second half of the 1980s, Spain was one of the fastest growing economies in Europe, recording annual average growth of around 5% in real GDP. This high level of activity manifested itself in a sharp deterioration in the current account deficit (to 3% of GDP in 1989), a massive expansion in private credit (up 16.5%) and inflation rising to 7%. Announcement that the peseta would enter the ERM reassured the financial markets that the Government was serious about its anti-inflation strategy. However, the Spanish authorities had to implement additional measures including

- the imposition of regulations to stop companies borrowing abroad at lower rates of interest
- a requirement that the banks raise their liquidity reserve ratios

These measures appear to be working. Money supply growth and private credit expansion has slowed considerably. However, wage demands remain high and the current account deficit is still a problem. The Government is maintaining a tight fiscal stance with the budget deficit planned to fall from 1.8% as a proportion of GDP to 1.5% in 1990.

early move to the 2.25% narrow bands operated by all other members except Spain.

Second it should accept full EMU as a long-term objective.

Third, fiscal and monetary policy should continue to be set by national authorities, though with increasingly formal mechanisms for cooperation at Community level. The ECU would be promoted and encouraged.

Fourth, the UK should table proposals for a rapid build up in the Community's resources for regional assistance.

Fifth, the UK should suggest a series of criteria which need to be met before the Community moves from stage 2 of the Delors Report to the final adoption of Stage 3. These should be concerned with the convergence of economic indicators between member states, the stability of exchange rates, the narrowing of interest rate differentials, and the development of satisfactory fiscal cooperation.

Sixth, the UK should accept the inevitable fact that the final stage of monetary union is not compatible with the present relationship between the Treasury and the Bank of England.

Credit Controls

As part of the range of weapons in an anti-inflation armoury, the use of credit controls on the consumer can act as an effective psychological instrument in curbing excessive demand. In terms of high street spending, for example, the massive boom that took place in the 1987-88 period could have been curtailed if a temporary period of credit controls had been introduced. Specifically, if the minimum monthly repayment on bank credit cards had been doubled, then undoubtedly there would have been an immediate impact on consumer psychology which might have avoided a prolonged and damaging period of high interest rates. Perhaps rather than focusing purely on controlling the price of credit, some consideration should be given as to whether the burden of adjustment be put on the quantity of credit.

However, the bulk of personal sector debt (75%) is in the form of mortgage borrowing, and it was a sharp expansion here that fuelled house price inflation and provided the collateral (via inflated house prices) for a surge in consumer borrowing. While imposing controls on mortgage lending is not administratively difficult, there is always the risk that prospective borrower would go elsewhere to find finance. While there would undoubtedly be some 'leakage' here, the announcement of a limit on building society/bank lending for mortgage purposes would be sufficient to curb house price inflation and mortgage borrowing.

Minimum Reserves

The Conservative Governments's reliance on interest rates to control inflation disregards other measures which, while not substitutes, can be regarded as complements to the interest rate instrument. Not least of these are minimum reserve requirements which have been an integral part of monetary policy in many industrialised countries including the US and Japan. In the EC, minimum reserves are used as monetary policy instruments in all EC member states except the UK and Luxembourg. In the UK, the minimum reserve instrument is used for revenue policy (by demanding from banks 0.5% of their reserve carrying liabilities) but for monetary policy purposes it is redundant. The Government has dismissed the idea of using minimum reserves as an instrument of policy. It should be understood from the outset that using minimum reserves as an active instrument of policy is not an alternative to higher interest rates. In fact, if anything, imposing higher reserve requirements would typically raise the level of money market rates, especially at the very short end. However, the very fact that a system of minimum reserves is in operation serves notice on the banking system that credit cannot be readily expanded. Given the fact that bank lending in the UK has been rising at a year-on-year rate of around 20% for some time, there seems to be a very good case for bringing the UK into line with Continental European practice and use minimum reserves as an important weapon in the authorities' monetary armoury. As the route towards full European Monetary Union (EMU) progresses, it is difficult to envisage substantial differences in EC central bank management methods. Indeed, the proposals presented in the annex to the Report of the Delors Committee include the minimum reserve instrument as an essential component of a common European monetary policy.

Labour's public spending - adding to inflation?

Labour's economic package makes it clear that non-investment expenditure is to be funded from current revenues. Expenditure on long-term productive investment is to be set against borrowing where appropriate.

Critics of Labour's public spending options argue that the cost of implementing Labour's expenditure proposals could amount to an annual cost (at

Total outlays of government as a % of GDP

	1979	1980	1980	1982	1983	1984	1985	1986	1987	1988
UK	42.7	44.9	47.7	47.1	46.9	47.5	46.2	45.5	43.2	43.2 (est)
EC	45.1	45.6	48.2	49.0	49.3	49.4	49.5	49.1	49.2	43.9

Source : OECD

1990 prices) of £18bn. At this stage, guesstimates such as these do not take account of the fact that even with the economy rising in line with the growth rate of productive potential and bearing in mind that tax revenues tend to rise faster than GDP, there is considerable leeway to phase in expenditure as the economy gets back on track. In 1989 total spending power in the economy amounted to around £500bn at market prices. First year spending increases of £5bn, say, pose little strain on the economy and are affordable as the economy expands at non-inflationary growth. The cost of implementing Labour's proposals on child benefits and pensions, about £3.3bn, in today's prices amounts to around 0.7% of nominal GDP, a modest amount by any standards. There ia no reasaon why this should be inflationary.

Taxation and inflation

In comparison with continental European tax systems, UK taxation is less progressive and more inflationary. In low-inflation West Germany, for example, the tax system is very progressive and tax brackets are not indexed as in the UK. Indexing UK tax brackets to target inflation rather than actual inflation (as Gerry Holthams suggests) would mean that unexpected inflation would generate higher tax burdens. This would create a significant incentive for individuals to curb excessive spending.

In terms of indirect taxation, there is little room for manoeuvre now given the constraint of EC harmonisation. However, it is worth noting that excise duties (in ECUs) are far higher on some items in the UK compared to the European average. A Labour Chancellor could reduce the duties on these items to average European level and simultaneously lower the RPI.

Some reform of taxation of housing is required, given the pernicious role of house price mania in fuelling the credit boom and excess demand pressures in the period 1987-89. Measures here might include

(a) maintaining the nominal value of mortgage interest relief at current levels, perhaps by restricting it to a fixed period (say five years), and allowing the real value to be eroded over time (the current Treasury line).

(b) abolishing high income tax relief.

(c) compelling lenders to make mortgage loans conditional on borrowers saving a specific sum (say 10% of the loan), as is done in Germany.

Summary.

The Conservatives' exclusive reliance on interest rates to control inflation is damaging the real economy and widening the investment gap between the UK and its main competitors.

Furthermore, Conservative policy is aggravating the wage-price spiral through a variety of Government induced price increases as well as undermining industry's cost competitiveness. Failure to address the very real structural problems of the UK economy guarantees a deterioration in productive potential and human capital and leave the UK ill-prepared to meet the challenges of 1992.

To crack the wage-price spiral generated by Conservative policies a Labour Government should:

(a)introduce an informal "Euro-pay norm" in which wage increases at the UK whole economy level would be targeted on the Continental European average.

(b) and in conjunction, reduce the burden on the "cost of living" by compelling public utilities and private monopolies (that provide services on an RPI + X% basis) to "Euro index link" their prices not with reference to the RPI but to the average rate of EC inflation.

These measures could be expected to bring UK wage and price inflation down to European levels quickly, without an unnecessary monetary and fiscal squeeze.

Labour's policy offers the best opportunity to address these problems. In the short-run, membership of the ERM provides the financial discipline and exchange rate stability to get UK inflation down to Continental European levels. But ERM membership is not enough as the Conservatives are bound to discover. Labour's policies rightly emphasise the need to improve the economy's long-term productive potential as well as providing badly needed resources for education, training and investment. It will be a long haul towards lower rates of inflation.

(1)Inflation and Relative Price Variability: The UK experience over the past 30 years, A Smith and N MacKinnon, Scottish Journal of Political Economy, May 1987.

(2)Analysis of The Inflation Process, Penelope A Rowlatt, HM Treasury Working Paper No 50, August 1987.

(3) European Monetary Union - The Issues, Gavyn Davies, David Currie, Neil MacKinnon, Irene Brunskill, Institute of Public Policy Research, Economic Study No 4, June 1990.

(4)Bank of England Quarterly Bulletin, May 1990.

Controlling Inflation : two views

Inflation will be one of the greatest challenges facing the next Labour Government. So far, Labour has emphasised the benefits of ERM membership. But other measures will be needed if these benefits are not to be lost.

This pamphlet contains two contributions to the debate from City economists. Gerald Holtham of Shearson Lehman Hutton proposes:

- a more progressive tax structure
- indexing tax brackets to target rather than real inflation
- maintaining cash limits on public expenditure
- short term measures to restrain excessive borrowing

Neil MacKinnon of Yamaichi International presents the case for:

- a Euro-pay norm for wage bargaining
- Euro-index linking for prices charged by private monopolies

He concludes that Labour's policies offer the best opportunity of controlling inflation without unnecessarily harsh monetary and fiscal policies.

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