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Bank of England Quarterly on Inflation

You directed my attention after your KJ Committee on Wednesday to the penultimate paragraph of the Bank of England's "Assessment" in the latest quarterly bulletin. From our hurried conversation I gathered that you doubted whether it was conceivably possible that prices could fail to leap next year because of anything that might happen on the wages front, and you felt that the recent surge in monetary growth was bound to make it very much higher. As I see it there is nothing very objectionable about what the Bank's piece says. While one may criticise the assessment for not discussing the consequences of the recent monetary surge, and for not insisting on the importance of keeping the money supply strictly under control henceforward, I am not sure that what they say is seriously incorrect.

It may be helpful if I explain what I think to be the technical considerations which are relevant. Consider first of all the way in which money supply effects the price level. The generally accepted view is that sustained changes in the money supply have an effect on prices with a long and rather variable time lag of about two years or more. Just how long the lag will be will depend on the circumstances - as the international monetary analysis of the London Business School demonstrates it can take four or even five years in as far as excessive monetary growth provokes higher prices through the exchange rate route. Over that somewhat flexible period of two years or so the relationship between money supply and prices will not be strictly one for one for a wide variety of reasons. One is the imperfection of monetary statistics. A second is the fact that our economy is an open one unlike

that of the United States, to which Friedman's stricter formulation of the relationship properly applies.

It is also important to remember that the monetary growth has to be reasonably sustained. As Gordon Pepper has pointed out in a number of recent Monetary Bulletins, a transient surge in the money supply which is subsequently unwound by a period of stern restraint will not have so serious an effect, although that is not to say it will have no influence at all.

The consequence is that it is extremely dangerous to make any precise forecasts about future price changes on the basis of monetary trends, particularly when they are not very well established ones. To illustrate this, I have plotted on a chart the relationship between year on year increases in the RPI and year on year increases in M_3 lagged by two years. The broad tendency for the two lines to move together is clear and undisputable. But the degree of correspondence in any given year, or as one moves from one year to another, is not particularly close. This is perhaps brought out more clearly still by looking at the table which sets out the figures plotted in the graph. One should concentrate in particular on the final column which expresses the gap between the RPI and the M3 increase as a ratio of the RPI. The mean difference works out at some 50 per cent. In other words if one attempted to forecast price increases in a given year on the basis of M_3 two years before, one would expect to err by a factor of no less than a half on either side of the actual outcome. What is more, the final column shows how variable the error can be. This is particularly striking in the years 1967, 1973 and 1976 when the RPI increase fell well short of what the M_3 increase would have suggested; or the years 1972 and 1977 when prices grew by unexpectedly large amounts.

If the money supply is only a long run and qualitative determinant of price movements, then one must reckon, also, with the shorter run factors which have an influence on price growth. Over a period of six to eighteen months econometric research has shown conclusively that wages, world prices, the exchange rate and the tax structure are what determine price trends. The correlation co-efficients are extremely high, and the forecasting equations one could build up using these variables far more reliable than ones based on monetary movements alone.

This may lead one to ask how one reconciles long and the short term influences in a coherent framework. The answer must be that monetary policy is like a slightly elastic tether which determines how far and how fast these other positive influences are able to push up the price and cost structure. If these other short run factors push prices too far, then unemployment rises, profits are squeezed (given sustained monetary discipline) and the initial impulse triggers off the countervailing forces when it passes the limits of acceptable price increases set by monetary policy.

Under these circumstances I see nothing objectionable in the Bank saying that lower wage increases in the coming round will contribute to lower price increases next year. Indeed one could go further and say that it is far better that guidance on the trends in earnings which are compatible with a given monetary target should come from the Bank rather than from HMG - a point which has been stressed in our own internal discussions.

Perhaps I should finish with a few thoughts about the way in which the discussion of counter inflation policy is likely to evolve in the near future. At the moment it seems to me quite possible that the Government will find themselves in July considerably nearer our position than they have been in the current year. It is not inconceivable that they will have largely abandoned dividend control, eliminated price control with the exception of the permanent powers of the Price Commission, abandoned any serious hope of entering next year with a ministerially laid-down wage norm and, even, reconsidered whether sanctions on government contracts can be continued. If we were willing to quietly let events unfold we may even hope that people will wake up one day soon and notice that there is no very serious difference betwen what we would like to do and what the Government are now advocating. But I suspect this will only come about if we do not attempt to heighten the differences unduly between our posture and theirs, something which a major act of public criticism of the Bank of England might well provoke.

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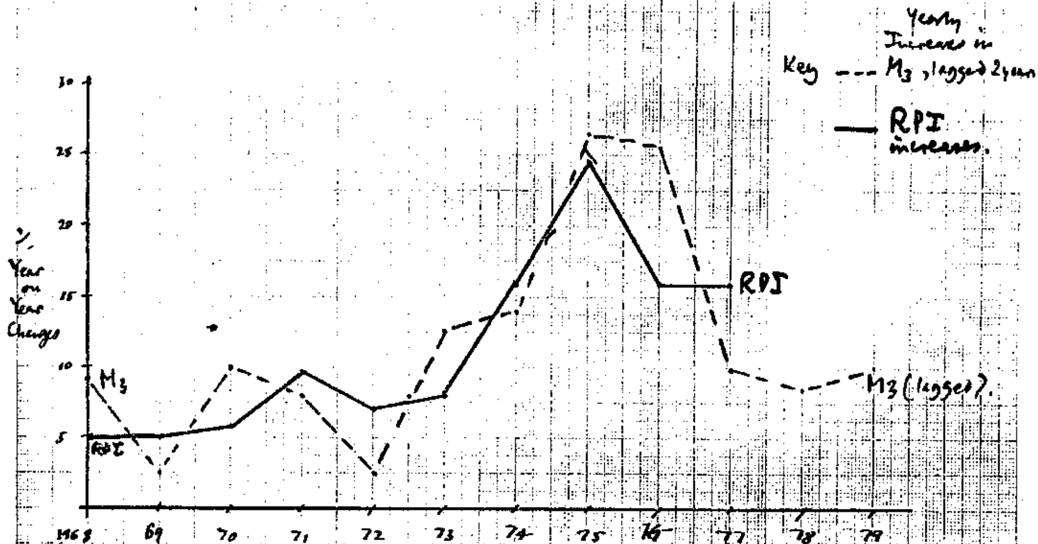
ADAM RIDLEY

Relationship between yearly increases in prices & in money stock of 2 years earlier.



The Relationship Between Yearly Percent Increases in M_3 and the RPI

All figures rounded to nearest ½ per cent.

	M_3	M_3 lagged 2 years	RPI	$\frac{M_3-RPI}{RPI}$
1965	5½			
1966	9			
1967	2½	5½	2½	1.2
1968	10	9	5	0.8
1969	8	2½	5	-0.5
1970	2½	10	6½	0.54
1971	12½	8	9½	0.05
1972	14	2½	7	-0.65
1973	26½	12½	8	0.5
1974	25½	14	16	-0.125
1975	10	26½	24	0.10
1976	8½	25½	16	0.60
1977	10	10	16	-0.375
1978		8½	?	
1979		10	?	

Sources:	(1)	(2) and (3)	(4)
	Economic Trends Annual Supplement 1977	Economic Trends Tables 42 and 50	Col 3 less Col 2 divided by Col 2.

N.B. The M_3 increases are between the first quarter of successive years.