

Week End Box

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Ridley's Memos

COVERING SECRET

TO ALL MEMBERS OF THE LEADER'S CONSULTATIVE COMMITTEE

The Research Department have been asked to prepare the two enclosed papers - Operation of Incremental Scales under Pay Restraint (LCC/76/112) and The Monetary Approach to Forecasting Inflation (LCC/76/113) - and to circulate them for this evening's discussion by the Shadow Cabinet on incomes policy under Item 4 of the Agenda.

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THE MONETARY APPROACH TO FORECASTING INFLATION

1. At last Wednesday's Shadow Cabinet meeting Sir Keith Joseph suggested that the Research Department should provide a short note on the monetary approach to inflation. This paper is a quick response to that request.

WHAT DO MONETARISTS SAY?

2. In general terms it is argued that there is a strong if not precise correlation between movements in the money supply and movements in prices a considerable period later. Except in periods of great stability the time-lags and the response of prices to money supply increases will be somewhat variable.
3. The economic mechanism involved can be looked at in two parts.
- (i) Monetary growth will lead before long to higher levels of demand and lower levels of unemployment. This in turn will raise prices through some kind of modified Phillips curve process.
- (ii) Monetary growth will both raise the prices of a range of real assets, such as houses, stocks and shares and will stimulate higher wage increases.
4. Firm evidence on the precise nature and size of the time-lags and the size of the response of prices to a given monetary stimulus is rather vague, particularly in the UK. Professor Walters and, following his example, Sam Brittan argue that the output increases come after 9 months to a year while the price response follows after about two years.

The problem of establishing the link between money and prices by intellectually respectable statistical procedures is considerable. There is - above all - a serious difficulty in deciding what definition of money to adopt and, having done that, in obtaining the necessary figures. The two measures of money supply best recorded and most closely monitored in the UK are the familiar M1 and M3 series, which have been published monthly for some years now. Neither is very satisfactory for the purpose in question, since both exclude a significant range of liquid assets which

- (a) theory tells us should be included in our concept of money
- (b) equally important, are exchanged for assets included in the definition of M1 and M3, as the interest rate structure and other factors vary.

It follows that even though it might be possible in principle to establish a very close and precise equation which generated very accurate predictions, the data simply will not allow one to do so. It also follows that the imprecision observed in the relationship does not mean that there is no underlying chain of causation.

6. Once one analyses the mechanisms involved in the money-prices link - and English academic work has gone some way towards illuminating them - it turns out that the Monetarists and the Keynesians are in fact occupying very similar terrain, though both sides prefer to deny the fact. Where they differ is either in their views about what the geography will permit or in their arguments about what is politically desirable, or both. Thus some Keynesians deny that the Phillips curve exists at all, while some monetarists claim that it is not in theory possible to shift the position of the Phillips curve except through the discipline of unemployment. (As it happens both these views are almost certainly wrong).

THE CRUDE EVIDENCE

7. The relationship between annual increases in money supply and annual increases in the RPI is set out in the chart appended to this note for the years 1967 onwards. The price changes have been correlated with money trends of two years earlier, on the lines suggested by Professor Walters. The statistics used are

- retail prices
- M3
- a wider measure of liquidity devised by Phillips & Drew called L3.

A number of conclusions about the past can be drawn from this information.

M3 and Prices

8. Prior changes in M3 were a bad guide to changes in prices in the years 1969-72, which fell and rose in magnitude from one year to the next in inverse relationship to what the M3 trend predicted. Price increases in 1973-75 were very much less than the relevant M3 increases suggested, though the rises and falls are properly matched.

Approx. annual rates of increase, %

	M3	RPI	
1971/70	12	9	1973/2
1972/71	26	16	1974/3
1973/72	29	24	1975/4

L3 and Prices

9. The wider L3 measure gives a much better fit with the RPI trend, though it is off target in relation to price changes in 1971 and 1975 (in which year it undershoots by even more than M3 overshoots).
10. A broad relationship between money supply changes and price increases is nonetheless discernible, and Professor Walters' two-year lag seems to fit the facts quite well.

THE FUTURE

1976

11. It is already fairly clear that the 12 month RPI increase will be over 15 per cent even by the last quarter. If so it will be considerably above the rate suggested by either the M3 and L3 increases of 1974, as the chart shows.

1977

12. What then would the monetary trends of 1975 imply for prices in 1977? It is intuitively tempting to suggest that the outcome should lie somewhere between the 8 per cent increase in M3 and the 12 per cent increase in L3 of 1975. But it is clear that the range of possible outcomes is rather wider, perhaps anywhere in the 6 to 15 per cent p.a. zones. Since the L3 indicator is in all probability a better guide than M3, the most likely outcome must be toward the upper end of the range at 12 per cent p.a. or more. That would give the following trends since 1970.

Approx. annual increases in the RPI

1970	6 -
1	9 -
2	7 -
3	9 -
4	16 -
5	24 -
<hr/>	
Est. 6	16 -
7	12+ -

13. Such a sequence would mean that the Government's RPI targets were missed, that even in 1977 the rate of inflation had still not fallen below the 9 per cent increase of 1973 and that by the end of 1977 prices would have gone up by 90 per cent since Labour came to power and by 150 per cent since 1970.

1978

14. The Chancellor's target for monetary expansion in 1976 appears to imply an annual rate of growth of M3 of about 12 per cent. This would make probable an RPI growth still in double figures in 1978.

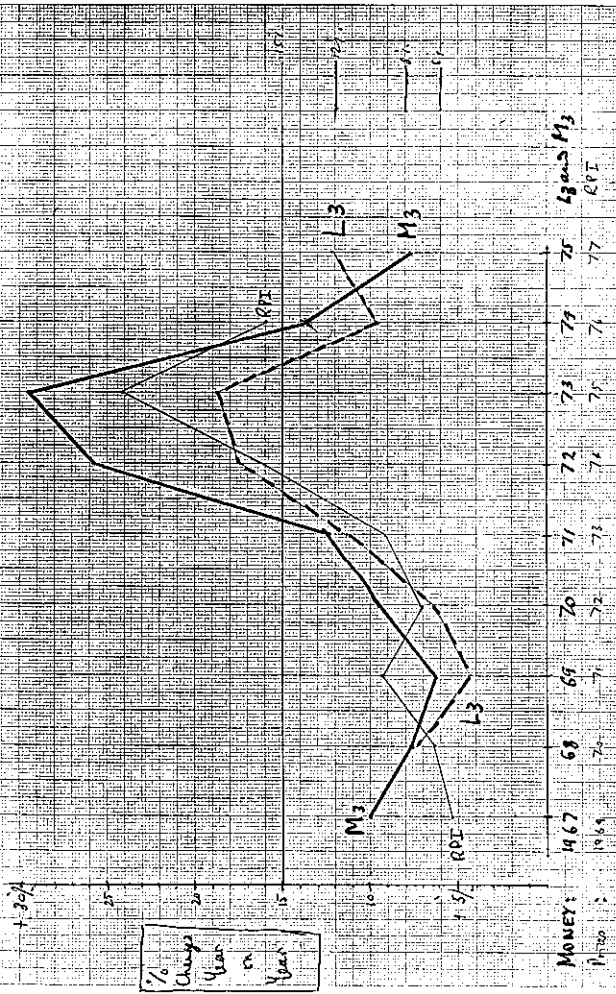
HOW FAR HAS INFLATION BEEN MASTERED?

15. It should be clear from this brief and crude discussion that on a simple monetary approach the momentum of inflation gives no more appearance of being truly checked than on an analysis which starts from what can be discerned from pressures in the labour market and the numerous problems of sustaining effective wage restraint. Either way it seems rather improbable that there will be a single figure inflation rate for several years if present policies continue.

CAN PRESENT POLICIES BE SUSTAINED?

16. This important qualification naturally poses the question as to whether present policies can be sustained. It is already clear that a tightening of monetary policy is being forced on us by external pressures. The recent sharp increases in interest rates may well be followed at intervals by further measures designed to tighten credit. So present policies are already changing on the monetary front, into what is yet unclear. If, next year, there were to be a collapse of wage restraint one could imagine an economic recovery being most unpleasantly extinguished by a clash between a resurgence of wages and very tough monetary policy. The resultant of these two opposing pressures would be a very sharp drop in profits and demand, followed by the now familiar shakeout of stocks, jobs and capital expenditure.
17. If for some reason monetary policy is not tightened appreciably in 1976, then 1977 is likely to see a rate of monetary expansion increase which is, whatever the Government may maintain, unacceptable in the eyes of our creditors. As the analysis in Greenwell's latest monetary Bulletin shows, the size of the public sector deficit in prospect is not compatible with a low rate of monetary growth for much longer, particularly if economic activity revives.

THE RELATIONSHIP BETWEEN POLICE BUDGETS AND CHANGES IN THE MONEY SUPPLY



% Change Year on Year

MONEY: 1967 1968 1969 1970 1971 1972 1973 1974 1975 1976 1977