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THE INFLATIONARY DRUG

Text of a speech given by Nigel Lawson, MP, Financial Secretary to to the Treasury, to the Annual General Meeting of the Engineering Industries Association, in London on Wednesday 25 June 1980.

I think everyone realises that the economy is not going to come right overnight. What you want from me, I suspect, Mr Chairman, is some assurance on two things. First, that our policies offer the firm prospect of curbing inflation and restoring the economy to genuine, sustainable, prosperity.

Second, you want some understanding of why the present period, which is undoubtedly a difficult one for British industry, is necessary to achieve that economic cure.

On the first point I can be both brief and emphatic. You may be certain that our policies of curbing the growth of the money supply, of reducing government borrowing, of cutting the burden of public expenditure, of restoring incentives and of extending the scope for enterprise will succeed in curbing inflation and restoring prosperity. The assurance springs from the simple fact that every country, without exception, which has pursued a similar strategy and held to it firmly for a reasonable period, has been successful. Although success is certain I cannot pretend it is without cost or delay.

It is encouraging to see light at the end of the tunnel. But what many people cannot understand is why we had to enter the tunnel in the first place. Are our present hardships really necessary or could success be achieved by some less painful route? If retrenchment and a tight monetary policy curbs inflation will we not have to remain permanently depressed to prevent it recurring? In any case is it not absurd to suggest that we can make ourselves better off by making ourselves worse off?

When thinking about these questions I find it helpful to develop an analogy.

Inflation is a disease. The disease it most clearly resembles is drug addiction. Just as the addict stimulates himself by injecting a drug, so government has learnt to stimulate the economy by injecting money. The addict uses a syringe whereas Governments inject extra money by spending more than they raise from the public by taxation or genuine borrowing.

The initial response to a monetary injection is pleasurable. Those upon whom the government spends the extra money feel better off. When the recipients in turn spend the extra money those who make the goods or perform the services on which that money is spent also feel better off.

But just as with the drug addiction the initial euphoria is followed inevitably by depression.

This is because the euphoria created by excessive monetary injection, like that caused by injecting a drug, is the result of an illusion.

The extra money reflects no underlying increase in the capacity of the economy to produce goods and services. The sense of well-being it creates is therefore illusory. The illusion is soon broken against reality. The extra money is chasing a given amount of goods, labour and capacity. Consequently unions, manufacturers and individuals raise their money wages and prices in response to increased money demand.

As wages and prices rise the value of money falls; the volume of goods it will buy declines; if, as often happens, the price level at first rises by more than the previous monetary injection, unemployment will emerge as people are priced out of jobs and products out of markets.

The easiest way to alleviate the depression which follows a 'trip' is to take another dose. But the addict soon finds that each successive dose has to be a little larger to achieve the same 'high'. And each subsequent depression becomes more severe and more painful.

So it has been with the British economy. To stimulate each successive boom has required larger and larger financial injections. The effectiveness of a given dose of the monetary drug has diminished because the economic body has learnt to raise prices and wages even more rapidly in response to each stimulus. Thus by the dawn of the 80s we have reached the stage at which the inflationary illusion of prosperity is almost immediately swamped by the inevitable depression.

So much for the diagnosis. How about the cure? Any cure must involve withdrawing the drug. And that inevitably means withdrawal symptoms.

There is simply no means of escaping them.

Once the series of monetary stimuli is withdrawn there is bound to be a more or less painful period when unions and employers learn that their price and wage expectations must be scaled down. The sooner this lesson is learned, the less pain there will be.

Of course nobody but a masochist wants the cure to be more painful than necessary. Hence the Government's Financial Strategy involves the gradual reduction of monetary growth over a period. Some people, Professor Hayek, for one, urge the harsh and abrupt course of stopping monetary growth immediately. That seemed to us likely to impose unnecessarily severe strains on an enfeebled economy.

Even the more gradual path we have chosen nevertheless involves a painful period of adjustment. In particular, it involves a period of painfully high interest rates. But high interest rates are not of course an objective of Government policy. They are a temporary necessity in the early stages. As monetary growth comes under control, lower interest rates will be one of the signs of success.

Changes in the quantity of money have to be assessed over a reasonable period. Month by month movements do not tell us very much. That is why the monetary targets run for about a year at a time - and are rolled forward every six months.

Over the last 6 months, despite fluctuations, the money supply has been growing at a rate which is in the centre of the present target range of 7-11%. This covers a period in which bank lending has oscillated between very low and very high figures. Government borrowing has moved from a period in which it has been exceptionally low to a single month in which it has been exceptionally high.

But our policy is to control the money supply in aggregate. Not this or that component. Overall its performance has been reasonably good. Other indications of the money supply, besides the target aggregate sterling M3, show that this is no flash in the pan. So we can feel encouraged. The improvement in control over the last year holds out the prospect of a considerable slow-down in the inflation rate - consolidating a slow-down which we can in any case look forward to in the next few months.

So there is increasing confidence and greater room for optimism on the monetary front than for some time. And the financial climate is also improved by the continuing fall in US interest rates. There is no case for taking ill-considered risks. But equally it would be wrong to think that monetary policy could be operated as if we lived in a world of perfect certainty.

Meanwhile, what I want to emphasise above all is that the pains we are now experiencing are all fundamentally the consequence of past monetary injection. They are not the 'cure' for inflation any more than the drug addict's withdrawal symptoms are a 'cure' for addiction. So when people accuse the government of 'using unemployment to cure inflation', do not believe them. The present unemployment is the consequence of many years of inflation. Moreover, it is transitional and will subside as the economy adapts to a growth of monetary demand in line with production. In the meantime the Government is anxious to do all that is in its power to alleviate the unavoidable difficulties of transition without backsliding into injecting more money.

The experts tell us that the reason people slide into addiction is that they prefer illusion to reality. And they can only be cured when they decide to face up to reality.

When the British people elected this government last year on the biggest swing since 1945 I believe they instinctively recognised that the inflationary disease had reached a near terminal state. Either we continued on to hyper-inflationary disaster: or we braced ourselves to face up to the cure, to suffer the withdrawal symptoms, and to make our way back to stable money and real prosperity.

The British people decided to face up to reality; to abandon the illusion that prosperity could be bought by printing money - rather than earned by the reality of work, investment and productivity.

I am convinced that the determination to face up to economic reality is sufficiently deep rooted for the British to resist the 'pushers' who still peddle the inflationary drug.

We will only resist it if we recognise their message. It is an insidious appeal to slip back into inflationary addiction. "Just one little extra dose of money" is all they urge "to ease the withdrawal symptoms". Others have been more flamboyant: they say, for example, that government should print "much more money". And we are recommended to increase "monetary growth to match inflation".

Fortunately this government has no intention of heeding such siren calls. We are determined to curb inflation and leave this country free to face up to reality. And here I can end on a note of cheer.

Reality brings its problems. It also brings prizes for those who overcome them. As you overcome the very real problems of today I am sure you will earn for yourselves and for our country the prize of prosperity tomorrow.

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