Briefing Note

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INFLATION IN RETREAT

The Government's success in bringing down the rate of inflation continues to surprise even the optimists. At the time of the Budget, the Chancellor cautiously estimated a 9 per cent rate for the end of 1982. The December figure has turned out to be only 5.4 per cent. That is the lowest rate of inflation for nearly 13 years. It is a far cry from 27 per cent registered under Labour in 1975, and 22 per cent in the wages boom that the Callaghan Government left behind in 1979-80. The picture would be even brighter if the nationalised industries had peformed as well as the private sector: nationalised industries' prices still rose by 14 per cent in the past twelve months.

Inflation has fallen faster in Britain than in any other major industrialised country. The present Government is set to be the first government for twenty years to achieve a lower average rate of inflation than its predecessor.

This is a major triumph, for it means that the Government has fulfilled its central and principal economic commitment.

The benefits of stable prices are incalculable. They include:

- Protection for the savings of the thrifty and the living standards of the poor.
- Lower interest rates, which give industry the confidence and the means to invest.
- Improvement in industry's competitive strength in export markets.
- An end to the wage and price spiral, with consequent improvement in industrial relations.

Above all, as **Mr Leon Brittan,** Chief Secretary to the Treasury, has said: 'The reason for pursuing inflation as the primary objective is precisely because the curbing of inflation is a necessary condition for dealing with unemployment and because today's unemployment is largely the product of yesterday's inflation' (*Hansard,* 19th January 1983, Col. 420).

The Exchange Rate and Inflation

It has to be accepted that recent falls in the sterling exchange rate could prejudice further falls in inflation. As the **Prime Minister** made clear: '... it makes all your imports dearer, it means that the next round of imports and semi-manufactured goods which go into our finished exports are dearer' (*Weekend World,* 16th January 1983).

However, our long-run progress in conquering inflation should not be jeopardised, and in any case the usual assumptions about the effects of depreciation are likely to be a poor guide to the prospects this time because:

- A fall in the exchange rate will only have a lasting effect if it results from weak monetary policy, and we do not have that at present.
- Importers into the United Kingdom have healthy profit margins and will be reluctant to raise prices in today's market conditions.
- Commodity prices are generally weak.
- Food prices reflect the value of the Green Pound, changes in which tend to offset exchange rate movements anyway.

Meanwhile, some of the fall in sterling may prove to be only temporary, since it is partly due to the uncertainty about oil prices.

The Labour Party and Devaluation

Foolish policy statements by the Labour Party have not helped the stability of the pound. As the Chancellor, **Sir Geoffrey Howe,** pointed out: 'some people in the market place, however few, have begun to hedge against the possibility, however remote, that those capable of such statements might some day have to exercise the responsibilities of office' (*Hansard,* 19th January 1983, Col. 361).

Shadow Chancellor **Mr Peter Shore** has said that major devaluation is the only way to restore Britain's lost competitiveness, but he is having some difficulty in deciding how much devaluation he wants. Initially, his key assumption was a 30 per cent devaluation spread over two years (*Programme for Recovery,* 23rd November 1982); later this was revised to 17 per cent (*Labour Briefing,* September 1982); even later to no particular figure at all (*The Times,* 10th January 1983) and finally to the view that a 20 per cent improvement in our present competitive position was 'in the order of reality' (*Weekend World,* 23rd January 1983).

Whatever the size, Mr Shore has not learnt from his party's experience. First, gains in competitiveness from devaluation tend to be quickly eroded by domestic wage and price inflation. Thus, between 1969 and 1976 the value of sterling fell by *over a third,* but competitiveness improved by *only 2 per cent.* Second, a precise exchange rate policy is very difficult to implement. The last Labour Government was no more able to hold the exchange rate up in 1976, than it was able to hold it down in 1977, despite massive intervention (well over $10 billion) and cuts in interest rates from 15 per cent to 5 per cent.

Mr Shore's answer to this is to back up his devaluation with a battery of controls over prices, the foreign exchanges and if the unions acquiesce, over pay. These are the failed policies of the past.

Pay, Productivity and Competitiveness

There is no short cut to competitiveness, as the **Prime Minister** made clear: 'This kind of devaluation which they (Labour) are trying to get never lasts. It's a substitute for getting your industries efficient and that only lasts about a year or so and then you're right back to the fundamental problems' (*Weekend World,* 16th January 1983).

The only route to lasting competitiveness is to reverse the poor pay and productivity performance that made us so uncompetitive in the first place, and to maintain sound monetary conditions.

Great progress has been made. In the 1979-80 pay round, settlements were averaging 15 – 20 per cent; in 1980-81 they fell into single figures; and in 1981-82 to only 7 per cent. Meanwhile, manufacturing productivity has risen by 12 per cent since the end of 1980.

Realism is not everywhere apparent, especially in the public sector. It took an eight month strike to drive home the realities on pay in the NHS; and now the country faces a strike in the water industry in support of a totally unjustified claim for 15 per cent. **Mr Norman Tebbit,** Employment Secretary, has pointed out: 'With low inflation a reality, low pay settlements become even more important if we are to regain competitiveness, regain markets for our goods and regain jobs' (21st January 1983).

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