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Treasury Chambers, Parliament Street, SW1P 3AG
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12 June 1989

P R C Gray Esq
Private Secretary to
Prime Minister
10 Downing Street
LONDON
SW1

Dear Paul

THE RECENT RISE IN INFLATION

As you requested in your letter of 24 May, I attach a note on the recent rise in inflation. I also attach some points for Prime Minister's Questions tomorrow.

Yours
Alex

A C S ALLAN
Principal Private Secretary

PONTS FOR PRIME MINISTER'S QUESTIONS

Shadowing DM led to current inflation?

Economic policy is the policy of the Government as a whole. Inflation has risen, and to an unacceptable level, and that means that monetary policy has been too loose at times in the past, as my rhf has stated. One such period was in the aftermath of the stock market crash, when there were very real fears about industrial confidence.

More complex than that?

Of course the causes of inflation are complex, but then we all know that the rhg doesn't understand the first thing about them. [Won't take lectures on inflation etc... (including point that underlying rate - ie excluding MIPs - is lower than lowest achieved under last Labour Government)]

Agree with Walters 'EMS half-baked etc'?

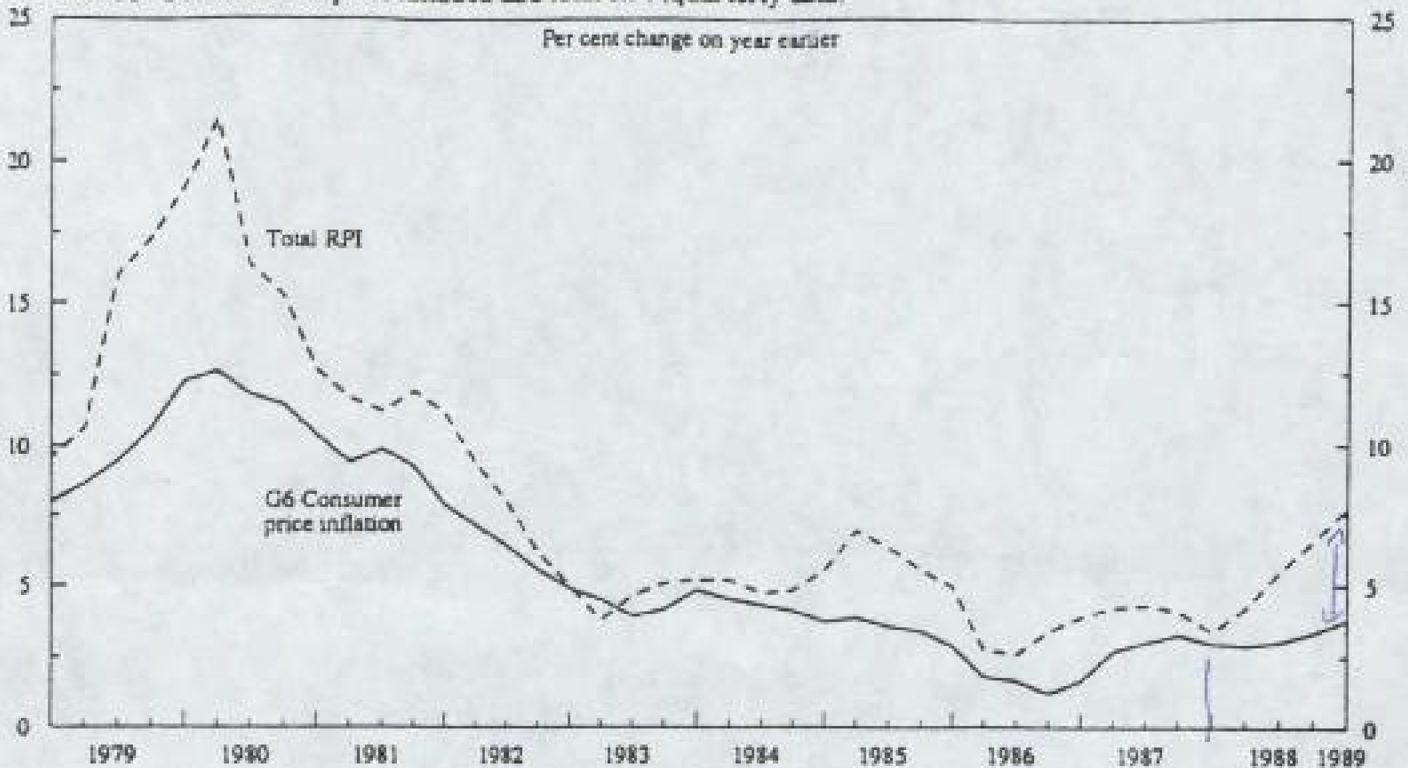
Government's policy is to join when the time is right. As my rhf has said, time is not right now. For example, will want to see how EMS copes with abolition of exchange controls in major countries.

TREASURY PAPER SUBMITTED ON 12/6/89

THE RECENT RISE OF INFLATION

The broad pattern of inflation through the 1980s has been similar in the UK and the rest of the G7. Inflation fell sharply between 1980 and 1983. The trend was distorted by the collapse of oil prices in 1986. Inflation has been rising since the beginning of 1987.

Chart 3 G6 Consumer price inflation and total RPI (quarterly data)



Inflation in the G7

2. The rise in inflation worldwide mainly reflects the unexpected buoyancy of the world economy. Demand has been much stronger than anyone expected, with rapid growth of consumer spending and fixed investment. Both are connected with a strengthening in the supply performance of the G7, helped by widespread deregulation. Pressure upon capacity has increased.

3. In the event, the stance of monetary policy at the G7 level turned out to be insufficiently tight to deal with the strength of demand pressures. There are a number of possible explanations:

- the conduct of monetary policy was made much more difficult by changes in the behaviour of the monetary indicators, partly reflecting financial deregulation;

- inflation rose as the once-and-for-all effects of lower oil prices worked their way through but also because the lagged effects of lower oil prices boosted growth more than expected;

- the world economy was surprisingly subdued in late 1986 and early 1987 which encouraged some further easing of the policy stance;

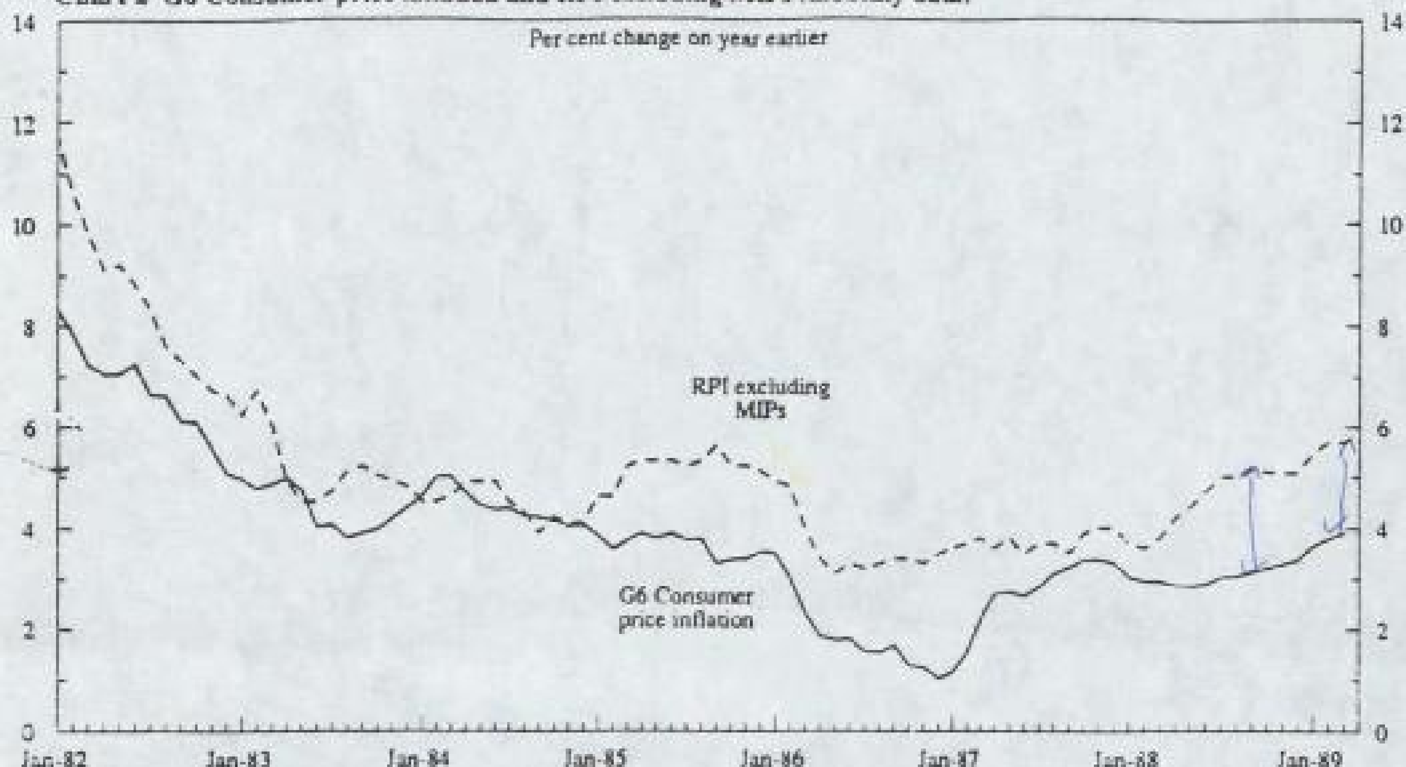
- interest rates had begun to rise during the course of 1987 but this tightening of policy was aborted by the stock market crash in October 1987. There was widespread concern about the dangers that could ensue from a further collapse of prices and the threat to the international financial system. To prevent this potential collapse of confidence, monetary policy was eased throughout the G7 countries;

4. Since the rising pressure of inflation became evident in the Spring of 1988, monetary policy has been tightened noticeably. Interest rates in Germany and the US have risen by more than 3 per cent and substantial increases have taken place elsewhere.

Inflation in the UK

5. The true picture in the UK is obscured by mortgage rate changes - which distort international comparisons. Excluding mortgage interest payments, the similarity with developments in the rest of the G7 is even greater. But at each stage the pattern is more acute in the UK; inflation fell faster in the early

1980s; it shows a more pronounced flattening between 1984 and 1987; and recently has increased more sharply.



6. The unexpected strength of demand has been particularly striking in the UK. Some of the reasons are:

- the earlier fall in inflation was greater;

- the supply side improvement with rising productivity, profitability and investment, went further;

- the reduction in oil prices produced less benefit in the UK; oil's contribution to the balance of payments was diminished and the expected decline in sterling offset some of the gains to the general price level;

- deregulation in the financial markets was more complete;
- developments in the housing market played a unique role.

7. It remains surprising that consumers have adjusted their savings levels to the extent they have. Credit liberalisation has had a major effect upon behaviour. In contrast to the United States, where people have now become accustomed to a deregulated credit regime, consumers in the UK have found the ready availability of credit a heady experience. This unfamiliarity has produced overshooting, and the ratio of personal sector debt to income now exceeds that in the US. In time, consumers will adjust to the realities of debt service but in the meantime it has meant a stimulus to demand.

8. The housing market has played a special role. Mortgage borrowing has been the main source of credit expansion. The easing of monetary policy following the stock market crash was evident in the growth of house prices and expansion of mortgage demand from the beginning of 1988. This was compounded by the announcement of the ending of double mortgage relief which did not become effective until the beginning of August. What was a curbing of the tax relief on credit was seen by the public as a sort of 'special offer': it sparked off an intense period of house purchase by potential sharers, who were then joined by other buyers who sensed prices might run away from them.

The money supply

9. Bearing in mind the lags in monetary policy, it is clear in retrospect that monetary policy should have been tighter on average throughout the last three or four years. But it is difficult even now to say by how much.

10. Over the period, MO has been the best monetary indicator. But it is a contemporaneous rather than a leading indicator of money GDP. So even if policy had been exclusively based upon MO, the strength of the forces in operation - the falling personal saving ratio and the investment boom - make it unlikely that

changes to interest rates made in response to MO developments would have been in time to prevent excess demand pressure.

11. It has been said that broad money growth was a useful leading indicator between 1985 and 1988 and showed the need to tighten monetary policy earlier. But that has to be set alongside all those occasions, since we started our policy of financial deregulation, when giving increased weight to broad money would have led to the wrong response. We could not and still cannot base policy on broad money. But can we ignore it?

12. It is, moreover, impossible to believe that the policy of not overfunding was at the heart of the monetary expansion. This is wrong on two counts. First, the ending of overfunding does not explain the acceleration of broad money growth and, second, it has not been established that the growth of broad money causes faster growth of nominal GDP.

13. It seems inescapable that we should continue to rely on MO as the best measure of the money supply. We have to recognise that we are without a reliable and reasonably long leading indicator of money GDP. So it is not possible to prevent fluctuations in inflation generated by surprises to domestic or external demand or capital flows. The job of monetary policy is to make sure that these surprises do not generate sustained higher inflation. This ? is what has been done. Monetary policy has been tightened sharply ? and the inflation surge will subside.

Exchange rate

14. Monetary policy has taken the exchange rate into account as an essential ingredient in monetary conditions for many years - both because of its direct effects and because of the unreliability of the monetary aggregates at a time of structural change.

15. There is no reason to doubt this long established policy. A higher exchange rate tightens monetary conditions and puts downward pressure on interest rates and vice versa. There is a

direct effect on import prices; and exchange rate changes affect the profitability of UK manufacturers by constraining their ability to raise prices. There are second-round effects through their impact on inflationary expectations and wage negotiations. Other countries adopt this approach for the same reasons.

16. Following the Louvre Agreement in February 1987, there seemed a strong case for using the framework that provided, for espousing exchange rate stability and arresting the steady decline in the exchange rate that had been occurring up to that point. In the event, the pressures soon proved to be the other way, but in the run up to the Election we held the rate below 3DM, and this continued after the Election as the current account moved into deficit.

17. There were obvious reasons for trying to maintain greater exchange rate stability at this time. Industrial performance and investment would have been damaged by a sharp and unsustainable appreciation of sterling - and this of course became particularly important in the aftermath of the Stock Exchange crash when business confidence was particularly fragile; other G7 countries were trying to achieve greater stability within the framework of the Louvre Agreement; and through a commitment to restrain the rise of sterling it was hoped to increase confidence in the equal commitment to resist any subsequent pressure for depreciation.

18. Containing the strength of sterling involved heavy intervention. But it is doubtful if the intervention that took place through 1987 and 1988 had any direct inflationary effect. Intervention increases liquidity in the economy if it is not funded and in some circumstances large-scale intervention can make monetary management more difficult. But during 1987-88, with the public sector moving into surplus, there was no financing problem. The intervention was fully sterilised on any basis. The operation of the Exchange Equalisation Account ensured that there was no addition to the monetary base, and the successful full funding of the intervention ensured that there was no addition to liquidity. The growth of broad money was due to the growth of private sector lending. There was no contribution from the public sector and,

therefore, there was no monetary stimulus - either to broad or narrow money - independent of any effect arising from keeping down interest rates and the exchange rate.

19. So far as interest rates are concerned, base rates were raised to 11 per cent as sterling weakened in Autumn 1986. As sterling appreciated following the Louvre Agreement, interest rates came down gradually to 9 per cent in May 1987. They were raised to 10 per cent as policy was tightened in the Summer. They were reduced, in line with other countries, following Black Monday - ½ per cent cuts in October, November and December. By February 1988 they were back to 9 per cent. Over the whole period interest rates came down only 2 per cent, of which 1½ per cent followed Black Monday.

20. In retrospect, it is no doubt true that we needed a tighter policy in the sense of higher interest rates, or a higher exchange rate or some combination of the two, in both 1986 and 1987 and in the early part of 1988 too. The 3DM policy played some part in this. But it is important not to exaggerate the part it played in a misjudgment of monetary conditions which we shared to a considerable extent with the rest of the world and which had many other causes.

Conclusions

21. This analysis points to the following conclusions:

(a) inflation has risen everywhere;

(b) international comparisons are distorted by the inclusion of mortgage interest payments in the RPI;

(c) excluding the effects of mortgage interest, the rise in inflation stems primarily from the same causes as in the rest of the world;

(d) monetary policy in the UK has had to cope with two linked factors which produced great strength in demand:

(i) the extent of financial deregulation - a once-for-all phenomenon

(ii) the rise in property prices;

(e) together with booming investment, these have put monetary policy under strain. But interest rates have been raised to bring inflation back down;

(f) MO remains the best monetary indicator, but no indicator is fully reliable at a time of structural change;

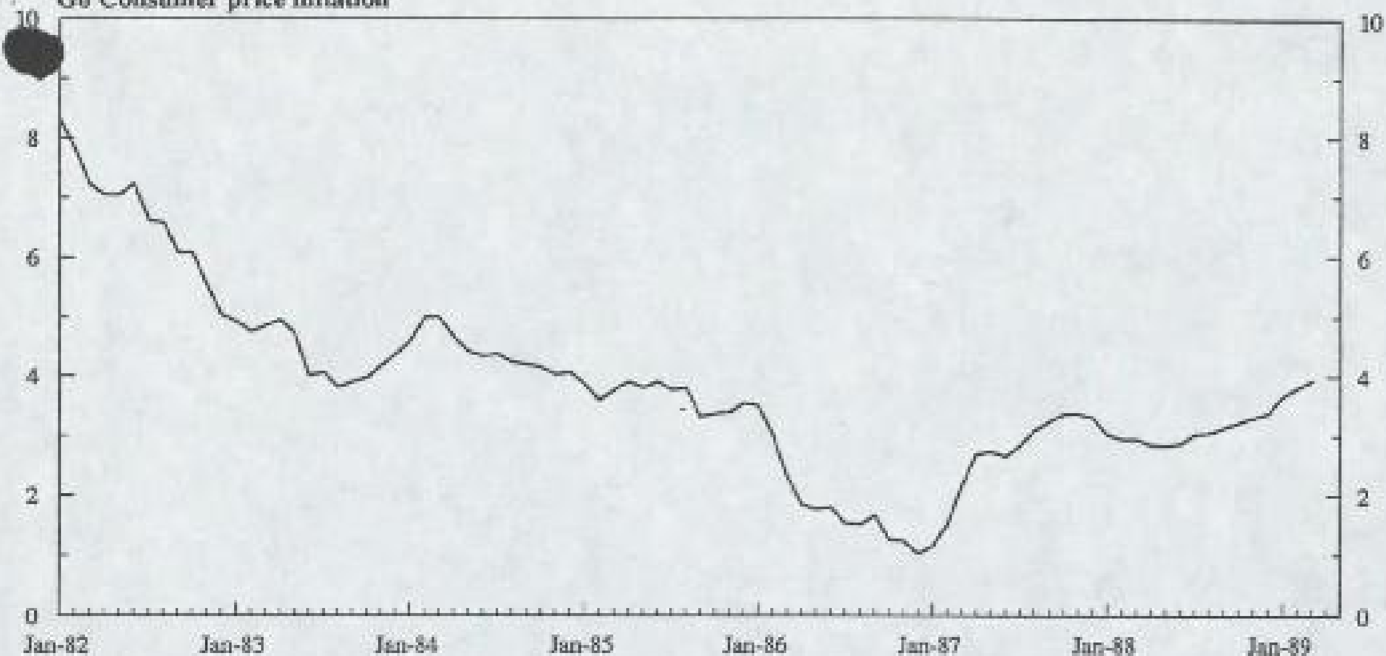
(g) taking the exchange rate into account and avoiding excess depreciation of the pound remains an essential ingredient in monetary policy.

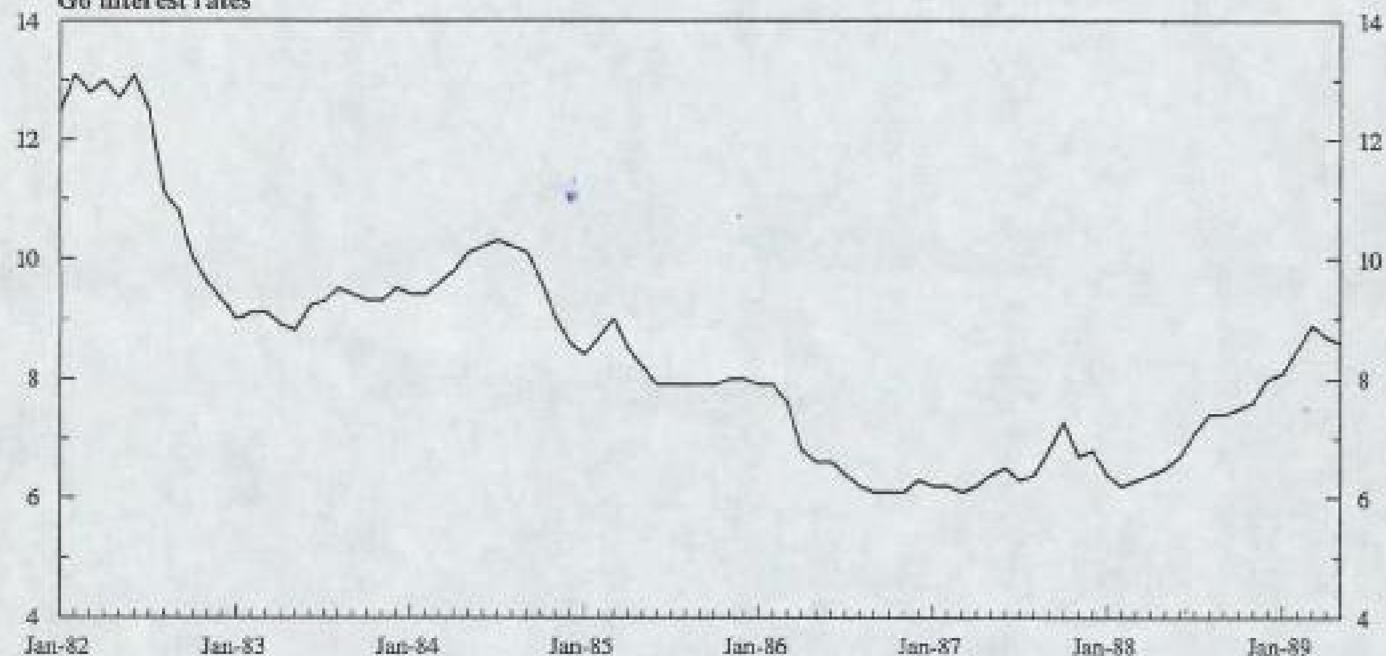
(h) there is no case for giving broad money a more significant role or for returning to overfunding;

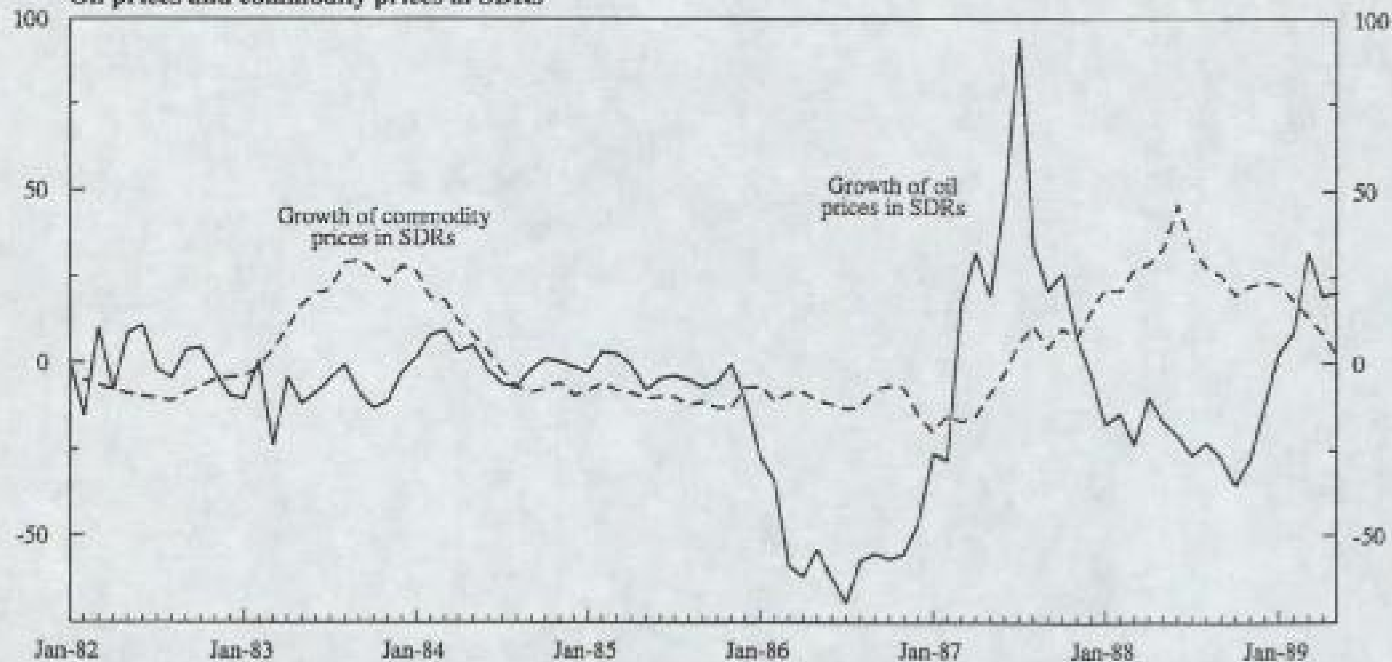
(i) intervention has been fully sterilised and had no effect on either broad or the narrow measures of money;

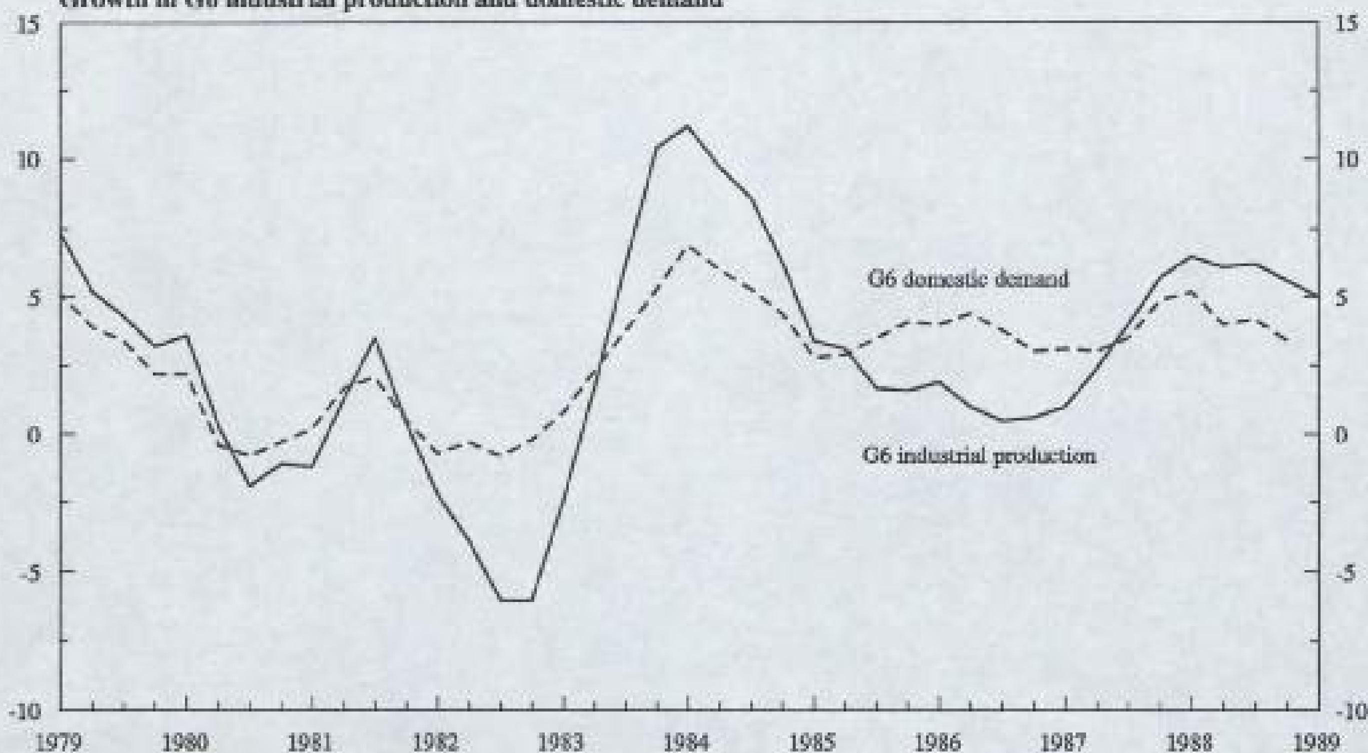
(j) the 3DM policy may have been one factor among many contributing to what, in retrospect, were too loose monetary conditions over the past three years;

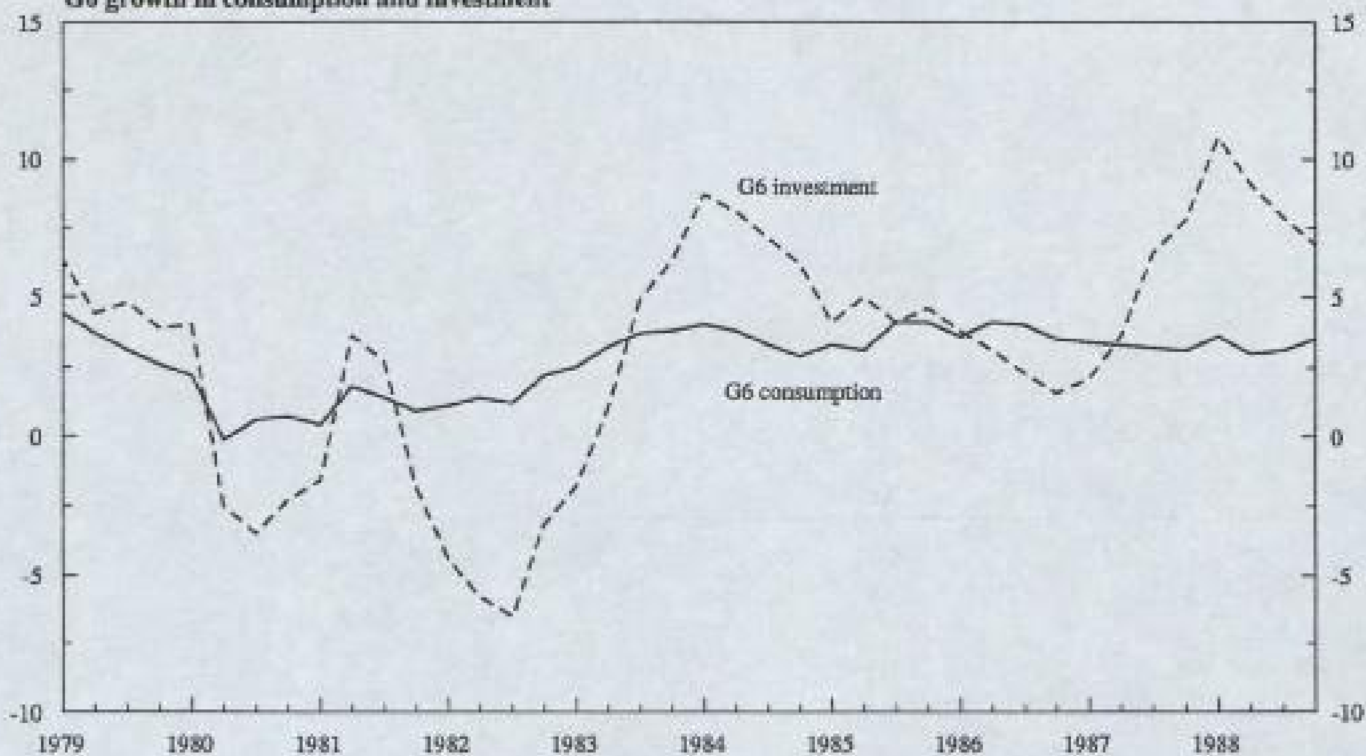
(k) with hindsight, the loosening of monetary conditions in response to the Stock Market crash proved particularly ill-judged, but it is difficult to say what would have happened if we had not done that.

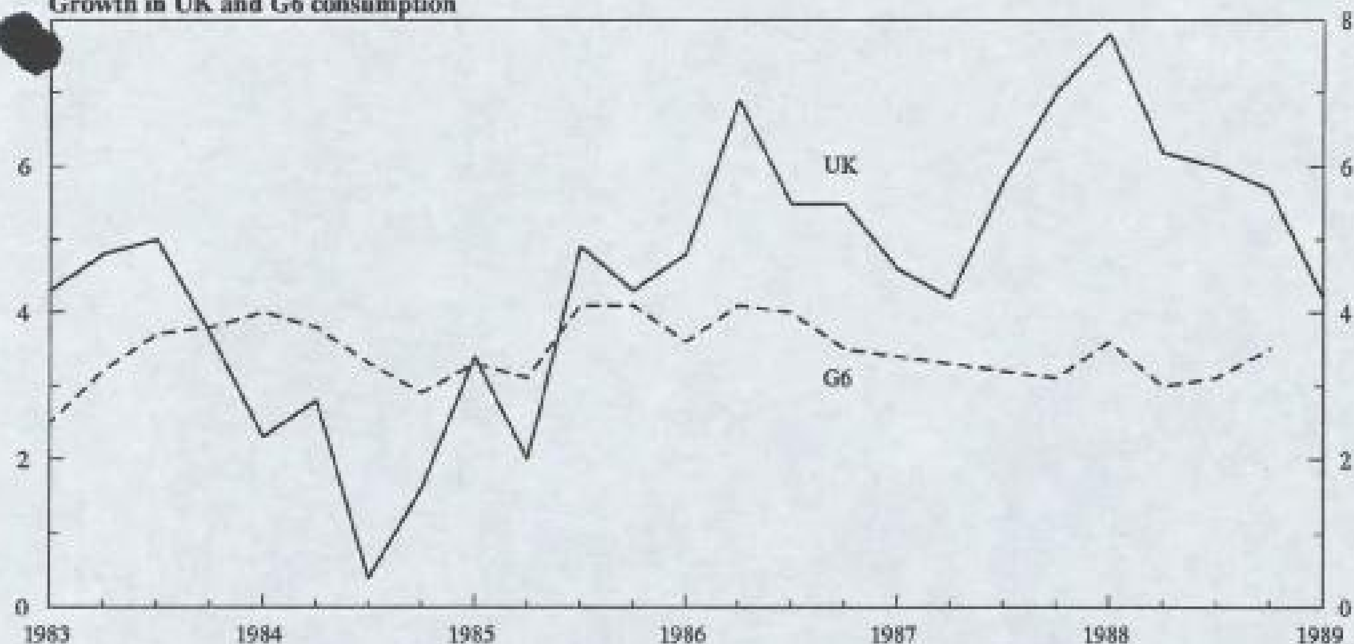

G6 Consumer price inflation
10
8
6
4
2
0
Jan-82
Jan-83
Jan-84
Jan-85
Jan-86
Jan-87
Jan-88
Jan-89

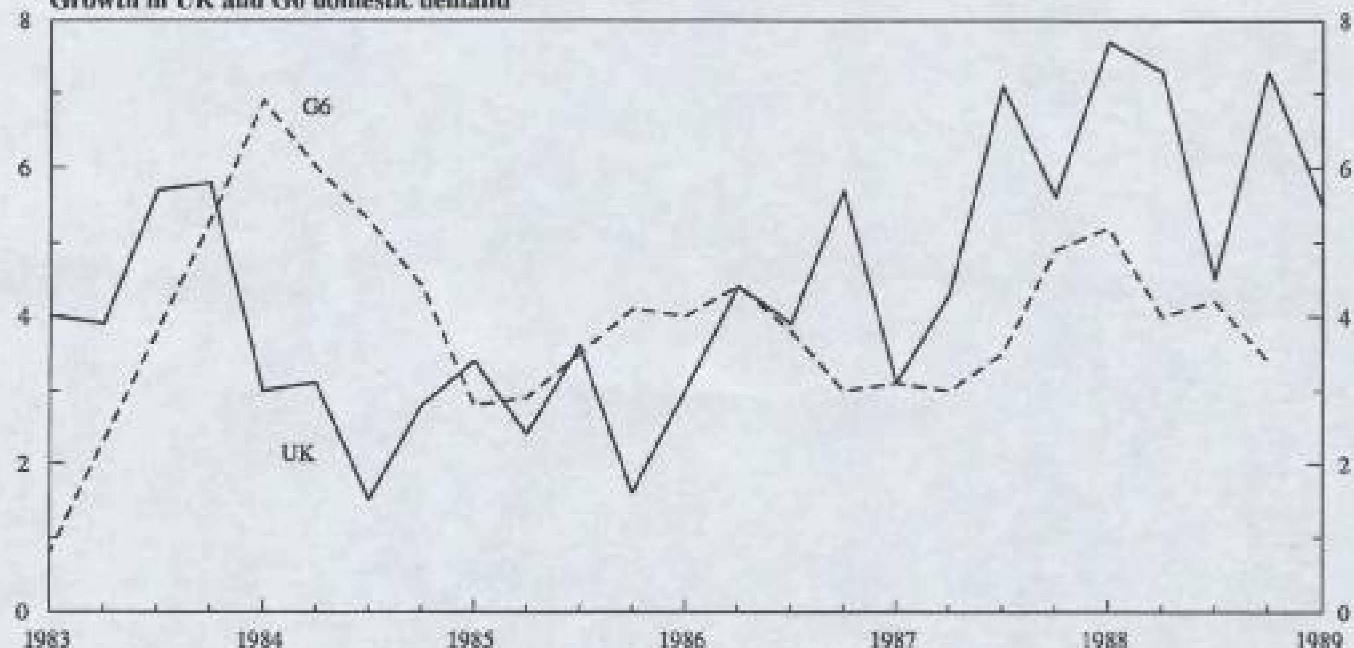

G6 interest rates
14
12
10
8
6
4
Jan-82
Jan-83
Jan-84
Jan-85
Jan-86
Jan-87
Jan-88
Jan-89

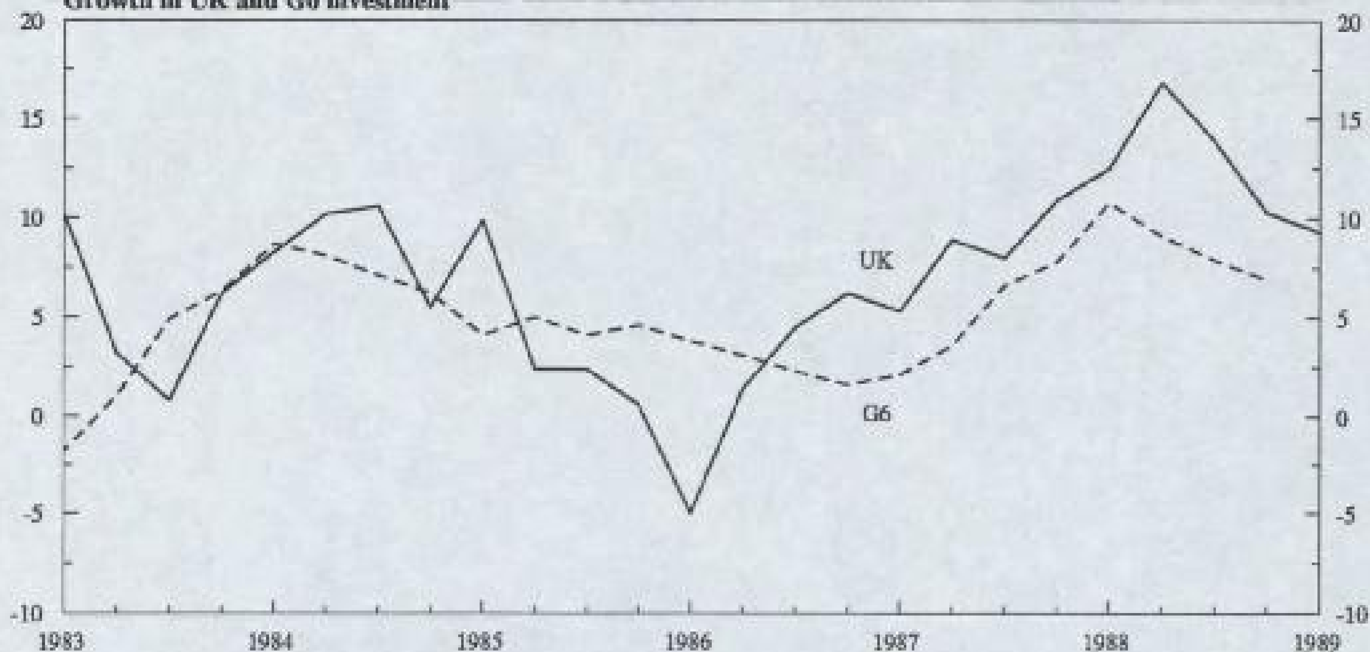

Oil prices and commodity prices in SDRs
100
50
0
-50
Growth of commodity prices in SDRs
Growth of oil prices in SDRs
Jan-82
Jan-83
Jan-84
Jan-85
Jan-86
Jan-87
Jan-88
Jan-89

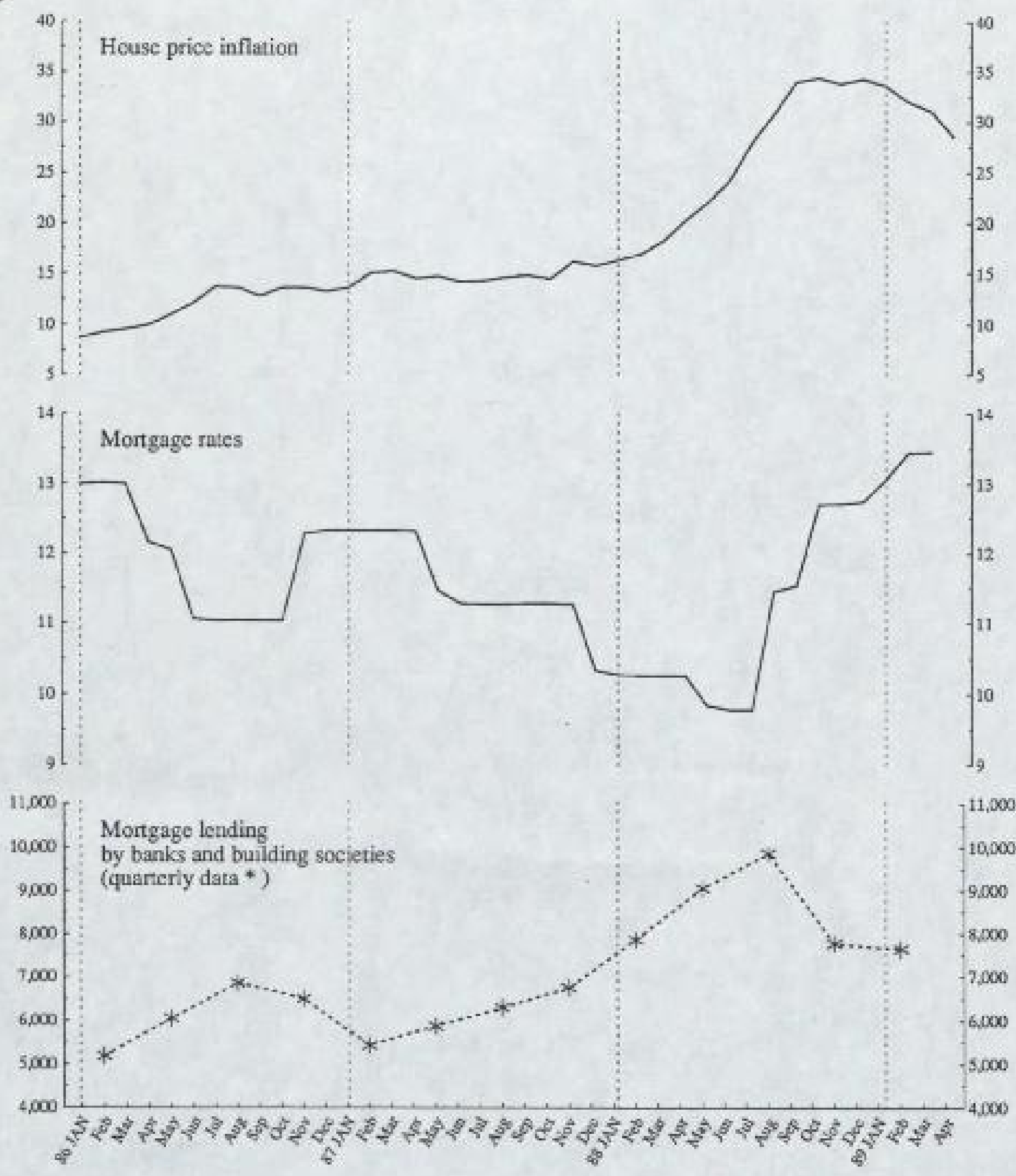

Growth in G6 industrial production and domestic demand
15
10
5
0
-5
-10
1979
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
G6 domestic demand
G6 industrial production

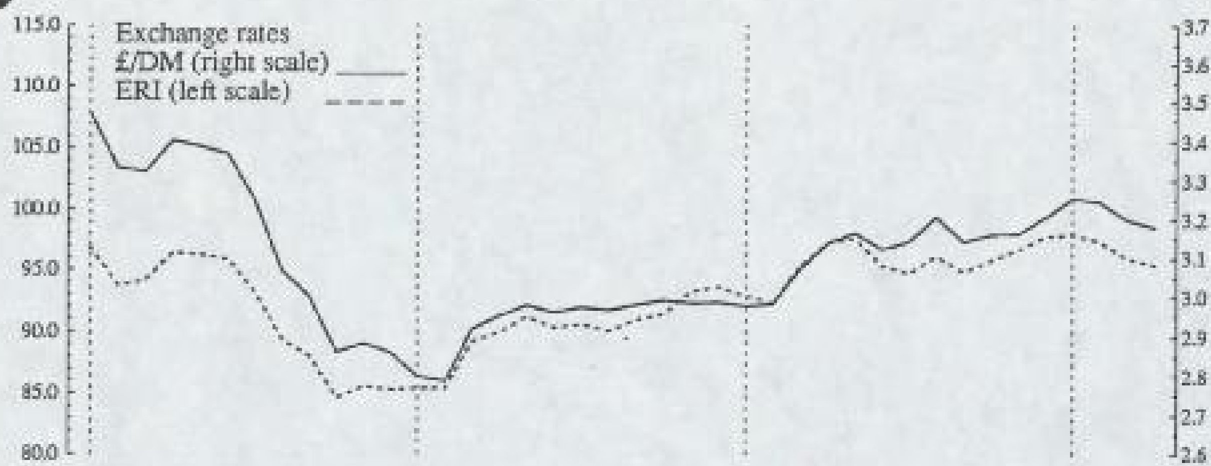

G6 growth in consumption and investment
15
10
5
0
-5
-10
1979
1980
1981
1982
1983
1984
1985
1986
1987
1988
G6 investment
G6 consumption

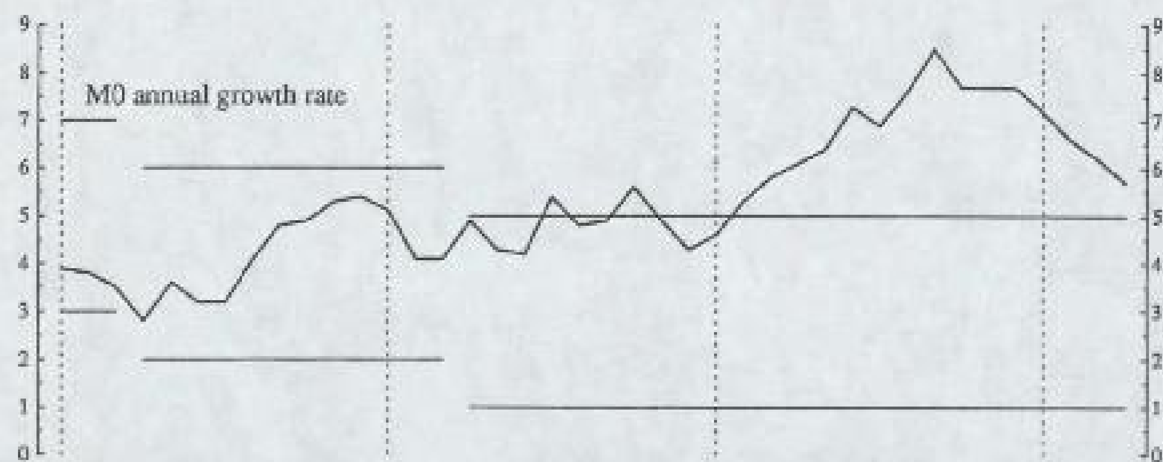

Growth in UK and G6 consumption
UK
G6
0
2
4
6
8
1983
1984
1985
1986
1987
1988
1989

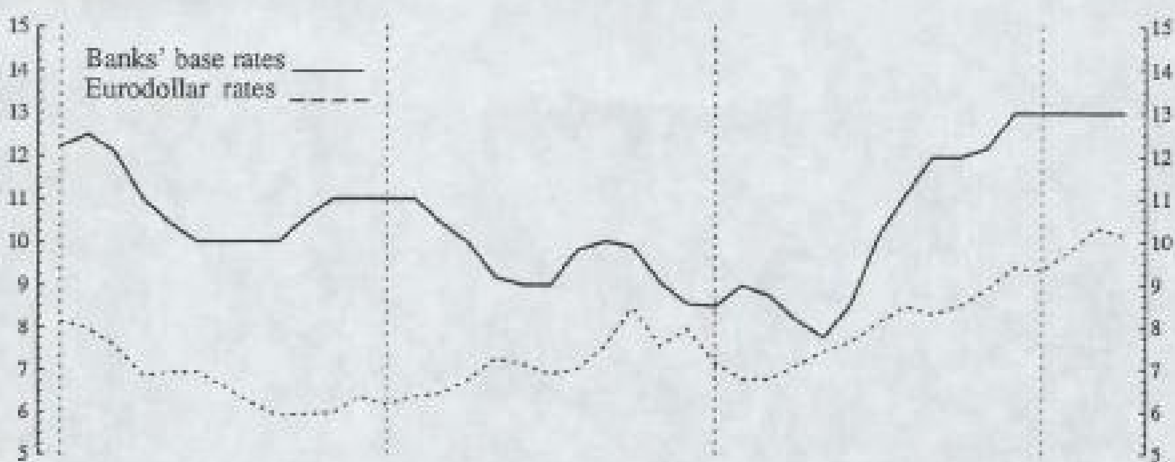

Growth in UK and G6 domestic demand
G6
UK
0
2
4
6
8
1983
1984
1985
1986
1987
1988
1989

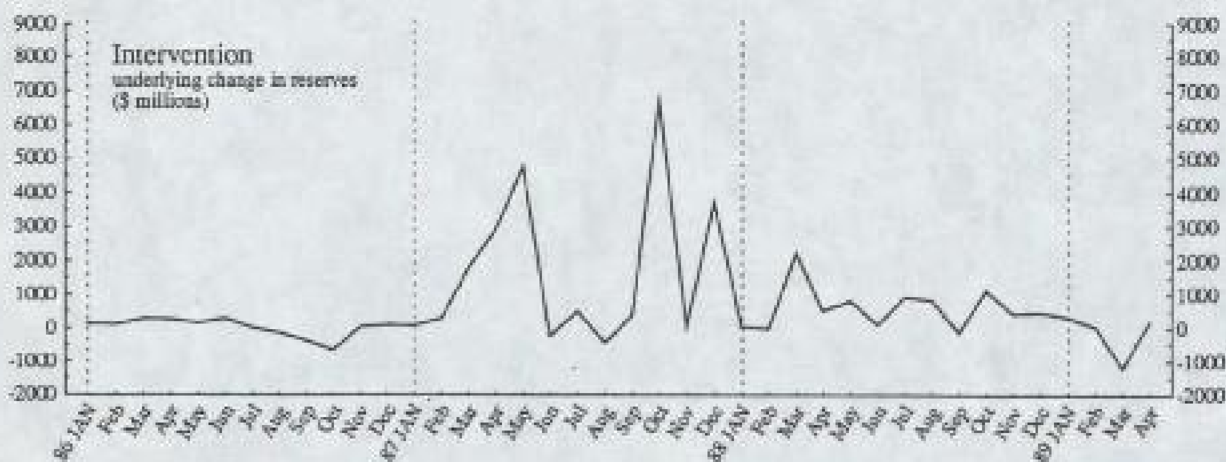

Growth in UK and G6 investment
UK
G6
-10
-5
0
5
10
15
20
1983
1984
1985
1986
1987
1988
1989


House price inflation
40
35
30
25
20
15
10
5
Mortgage rates
14
13
12
11
10
9
Mortgage lending
by banks and building societies
(quarterly data *)
11,000
10,000
9,000
8,000
7,000
6,000
5,000
4,000
86 JAN
Feb
Mar
Apr
May
Jun
Jul
Aug
Sep
Oct
Nov
Dec
87 JAN
Feb
Mar
Apr
May
Jun
Jul
Aug
Sep
Oct
Nov
Dec
88 JAN
Feb
Mar
Apr
May
Jun
Jul
Aug
Sep
Oct
Nov
Dec
89 JAN
Feb
Mar
Apr


Exchange rates
£/DM (right scale)
ERI (left scale)


M0 annual growth rate


Banks' base rates
Eurodollar rates


Intervention
underlying change in reserves
($ millions)