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Treasury Chambers, Parliament Street, SW1P 3AG
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13 September 1989

Paul Gray Esq
PS/Prime Minister
10 Downing Street
LONDON
SW1

Dear Paul

ARTICLE BY TIM CONGDON

... I attach a note prepared by economists here assessing Congdon's arguments.

Yours

JG.

JOHN GIEVE
Principle Private Secretary

ARTICLE BY TIM CONGDON

Congdon's article considers how the economy needs to develop over the next few years if inflation is to be brought back under control and the current account deficit is to be reduced. He bases his article on two familiar and uncontentious arguments:

- that in the process of reducing inflation it is likely that the growth of output will fall temporarily below the growth of productive potential;

- that domestic demand will grow less than domestic output as the balance of payments improves.

The contentious part of his article lies in the quantification provided on these two issues. The adjustment process to lower inflation and an improving current account could well be painful, but not as painful as Congdon's rather pessimistic figuring implies.

Output growth and unemployment

2. Congdon argues that higher unemployment cannot be avoided if inflation is to come back down to 5% or less. More specifically, he argues that the unemployment rate may have to rise to 9% or more (compared with 6½% now) - the level in late 1987 when pay settlements were last broadly flat - in order to produce the desired effect. He translates this 2½% rise in unemployment into a shortfall in output growth relative to productive potential of 1½-2% per annum for three years - i.e. a cumulative total of 4½-6%.

3. There are a number of reasons for thinking that these figures are unduly pessimistic. First, there is a good deal of evidence, for both the UK and other countries, to suggest that the rate at which unemployment is changing is a more important factor than the absolute level of unemployment in determining the degree of upward pressure on wage settlements. This is certainly consistent with

the continuing buoyancy of real wages in the mid-1980s, at a time when the unemployment rate was very high by past standards. In the last three years we have seen a very rapid decline in unemployment, and not surprisingly this has eventually fed into higher wage settlements. But the decline in unemployment is already slowing, and may soon come to an end. If we are correct about the particular importance of unemployment changes, this in itself will reduce the pressure on wage settlements.

4. Second, the labour market reforms which we have implemented progressively in the 1980s will have reduced the rate of unemployment which is compatible with declining inflation. This may be one reason why the extent to which earnings growth has risen - from 7½% per annum between 1985 and 1987 to about 9¼% now - is surprisingly small given the scale and pace of the decline in unemployment since 1986.

5. Third, as Congdon recognises, there are other mechanisms involved in bringing inflation down: we are not relying only on pressures in the labour market. So long as we do not accommodate inflationary pressures by relaxing our monetary stance, all these mechanisms will come into play. Companies will find it increasingly difficult to raise prices, and the resulting pressure on profit margins (which have been very healthy) will provide an additional source of downward pressure on costs.

6. Adjustment to lower and declining inflation may require some rise in unemployment from present levels, but this is by no means certain. The outcome is not in the Government's hands, but depends on how quickly employees and employers act to moderate the rate of growth of pay. But on the basis of past experience, Congdon's figuring seems unduly pessimistic.

7. Even if one accepts Congdon's assessment of the rise in unemployment required to bring inflation down, his calculation of the cumulative shortfall in output growth relative to productive potential is too big; we would not expect it to be <u>double</u> the

percentage rise in unemployment, as he suggests. Combined with his pessimistic view on unemployment this yields a cumulative loss of output which is some way above our own estimates.

8. The task we set ourselves in this year's MTFS was to bring the growth of money GDP down from about 11% per annum in 1987-88 and 1988-89 to 6% or below in the next year or so. This would be consistent with inflation falling to around 3% by 1991-92, a somewhat more ambitious objective than Congdon seems to envisage. The MTFS also assumed that this would be consistent with output growth of 2% per annum for two years, implying a cumulative shortfall of around 2% relative to productive potential - under half of the 4½-6% which Congdon suggests.

The current account and domestic demand

9. Congdon argues that a substantial fall in the current account deficit must occur, to perhaps 2% of GDP, if we are to maintain a stable exchange rate over the next few years and at the same time allow interest rates to fall. His argument is based on the view that the present deficit is being financed by short term capital flows which cannot be sustained without high interest rates. In fact, of course, the errors and omissions in the balance of payments statistics are so great that we do not know the true counterparts of the current account deficit. Moreover it is misleading in today's integrated capital markets to single out particular forms of finance as being noticeably more volatile than others. As long as we maintain prudent non-inflationary policies we should be able to finance a deficit of around the level we currently expect; there is no need for the short term target reduction in the deficit that Congdon implies.

10. There should of course be an improvement in the current account, as a share of GDP, with the policies presently in place. And Congdon is right to argue that a reduction in the deficit will require growth of domestic demand to be below the growth of domestic output. This inevitably means a sharp slowdown of domestic demand growth in relation to recent rates: 6½% in 1988 and an average of 4% per annum over the last six years. But it

should not be necessary for domestic demand growth to slow down to under 1% per annum over the next three years as Congdon argues; this reflects his very pessimistic view about output growth.. In the MTFS we envisaged domestic demand growing at an average rate of about 1½% per annum over the next two years.

10. Congdon seeks to add credence to his figures for domestic demand by referring back to the aftermath of the Barber boom of 1972-73 and the Healey boom of 1978-79. He points out, quite correctly, that domestic demand actually fell by 4% in both these cases. However, these episodes were entirely different from the present position. Inflation was very much higher in both cases, and rising sharply; this is not the situation we face now. In the previous episodes we were having to adjust to major oil price shocks; and in the Barber period the rise in oil prices caused a major deterioration in our terms of trade.

11. There are, of course, clear signs that domestic demand is already slowing down, although this has yet to be reflected in any significant improvement in the current account. How quickly the current account is likely to improve is difficult to judge but it is bound to be a slow process. Imports have continued to grow strongly this year; but the strength of exports is more encouraging, and fits in with recent academic work which has identified a marked improvement in underlying export performance dating from the early 1980s.

Conclusion

12. Congdon is right to argue that output will have to grow somewhat below productive potential over the next year or so, and domestic demand somewhat slower still, if inflation is to be brought back down and the current account is to improve. It has to be accepted that the extent to which output must slow down, and the accompanying path of unemployment, is uncertain. But Congdon paints a bleaker picture than can be justified as a central forecast.

Econ Pol: Domestic Monetary Policy Pt 2

FILE

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

6 September 1989

ARTICLE BY TIM CONGDON

The Prime Minister has seen the attached article by Tim Congdon in Monday's Times. She would be grateful for an assessment of Congdon's arguments, which she could then discuss with the Chancellor at one of their bilateral meetings. It would be helpful to have this within the next week.

BF

PAUL GRAY

J. Gieve, Esq.,
HM Treasury

VLB

Tim Congdon compares today's outlook with previous squeezes

Three years of austerity to bring down inflation

Everyone agrees that the economy has to slow down if inflation and the balance of payments are to be brought back under control. But how much of a slowdown is needed? And how long does it need to last?

The Keynesian framework of national income accounting provides a useful and familiar approach for answering these questions. This framework gives an incomplete description of the economy since it does not properly recognize the role of such important influences as credit and money. Nevertheless, it does suggest two ideas which are basic to quantifying the scale and duration of the coming period of austerity.

The first is that the actual growth rate of output needs to be beneath the trend growth rate if there is to be a margin of spare resources sufficient to moderate inflationary pressure. The second is that the growth rate of domestic demand needs to be less than the growth rate of output if extra output is to become available for improving the balance of payments. These two requirements can be considered in turn.

To refer to the "margin of spare resources" is really a polite and impersonal way of talking about unemployment. Casual remarks such as "unemployment needs to be higher if pay settlements are to be brought down" beg the politically awkward question of how much higher it has to go.

The last time that pay settlements were stable was in late 1987 when the unemployment rate was over 9 per cent. Assuming that the structure of the labour market is broadly the same now as it was then (which seems a sensible view to take), unemployment needs to move back towards this figure from its present level of about 6.5 per cent if pay settlements are to start falling again.

The implied 2.5 per cent increase in unemployment – from the present 1.8 million to about 2.5 million – appears to determine the amount by which actual output growth needs to be beneath trend to dampen inflation. If the trend growth rate is taken to be 3 per cent a year, actual growth of a little above 2 per cent a year for three years would seem to do the trick.

Unfortunately, a cyclical characteristic of the economy is that employment responds more sluggishly than output to changes in demand. As a result, output growth will have to be even weaker, at perhaps 1 per cent to 1.5 per cent a year over three years, to eliminate inflationary pay demands.

These numbers are hardly precise. They are informed guestimates, rather than exact econometric calculations. But, in view of the large errors made by econometric models in the last few years, this may not be a bad thing. At any rate, it is clear from recent experience that an unemployment rate of under 7 per cent is associated with severe labour shortages, rising pay settlements and deteriorating inflation. Somewhat higher unemployment cannot be avoided if inflation of 5 per cent or less is to be restored.

The extent of the desired reduction in the external payments deficit is, if anything, yet more problematic. The official view is that, while the Government is running a large budget surplus, the external deficit is entirely the result of private-sector decisions. Since the private sector is the best judge of its own interests, the deficit is not a policy problem and no corrective action should be taken.

Lawson: presiding over a big increase in unemployment?

This argument appears logically watertight. But practically it is open to several kinds of criticism. Perhaps the most important is that the payments deficit is at present being financed largely by short-term capital inflows. These inflows are motivated by the high level of sterling interest rates, which are determined by government policy, not private decision.

If sterling interest rates fall (as everyone hopes will happen eventually), it will be difficult to reconcile a current account deficit of about 4 per cent of national income with a stable exchange rate.

The Government would probably feel safer if the payments deficit were lower. No one knows exactly what constitutes a "safe" and "appropriate" deficit and, in any case, the Government cannot fix the deficit in a world of freely-flowing international capital. But suppose, for the sake of argument, that a payments deficit of 2 per cent of national income is regarded as suitable. It follows that – in each of the three years – the rate of growth of domestic demand has to be less than the rate of output growth by between roughly 0.5 per cent and 0.75 per cent of national income.

If the two requirements for an improvement in [illegible] inflation rate and the balance [illegible] payments are combined, the conclusion is that the growth rate of domestic demand needs to be held at under 1 per cent a year for three years. This contrasts with increases in domestic demand of 6.5 per cent in 1988 and 5 per cent in 1987, and an average increase in the six years to 1988 of more than 4 per cent a year.

It emphasizes just how difficult the task of macroeconomic adjustment facing the Government now is, as it ponders the run-up to both the next general election and the next phase of European financial integration.

The arithmetic set out in this article may seem harsh, perhaps implausibly so. A cross-check is given by looking at other periods of demand restraint. The two previous periods of adjustment were after the Barber boom of 1972-73 and the Healey mini-boom of 1978 and early 1979.

The downturns which followed those episodes of financial excess saw domestic demand *fall* by over 4 per cent in two years. The economic medicine prescribed here for the early 1990s is mild by comparison.

The author is economic adviser to Gerrard & National Holdings. This article is based on the September issue of the Gerrard and National Monthly Economic Review, *published today.*

PRIME MINISTER

ARTICLE BY TIM CONGDON

You may like to glance at the attached article by Tim Congdon in yesterday's Times. It provides a sobering and rather worrying assessment of the action necessary to achieve the inflation and balance of payment objectives. It could be said to be over-pessimistic, but I do not think it can be regarded as outside the range of plausible scenarios.

Would you like to have a Treasury assessment of Congdon's case, which you could then discuss with the Chancellor at a bilateral?

Yes please

PAUL GRAY
5 September 1989
KAYBAJ

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Sins of the father that can never be erased

Raymond Plant

The mind's eye is all