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PRIME MINISTER

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3% INFLATION?

Lower inflation has been a priority of policy since 1979. The recent fall in oil prices might be expected to be a once-and-for-all help in reducing inflation.

Inflation forecast

But in the Treasury's latest forecast inflation gets stuck at 4-5%: they are expecting a fall from 5.7% now to 3.8% in May. But then it bounces back to 4% by the end of next year, and gets stuck in the 4-5% range thereafter.

Retail Prices Index

percent changes on a year earlier

December 1985 (published)	5.7
January 1986	5.6
February	5.0
March	4.6
April	3.9
May	3.8
Q3	4.0
Q4	4.0
Q2 1987	4.0
Q4 1987	4.5

Falling oil prices, interest rates and exchange rates

The Government's policy towards falling oil prices has been to allow the exchange rate to weaken rather than raise interest rates. This is the right policy. A lower exchange rate provides an incentive for increased non-oil exports to displace the oil, whereas an increase in the short-term cost of funds would affect the economy as a whole - not just exports.

But meanwhile the effect of the fall in oil prices on the general price level has been largely offset by the fall in the exchange rate. The fall in oil prices and the exchange rate is a boost to activity, but looks like doing little for inflation.

How to get 3% inflation

We are not on track for 3% inflation if we want it by 1987. To do this we would have to reduce the growth of money GDP next year. We would either have to raise interest rates now (and so reduce M_0 growth) or raise taxes in the coming Budget and cut the deficit by a significant amount. Almost certainly this would check output growth and raise unemployment on a temporary basis next year.

An alternative and less risky strategy is to live with inflation of 4% in 1987 by:

- i. allowing interest rates to fall, albeit slowly, letting the exchange rate rise ^X (say towards the higher 70s in terms of the trade weighted); and
- ii. pursuing a cautious Budget with a fiscal adjustment of £0.5 billion or so, and therefore comfortably hitting the MTFS target for the PSBR of £7.5 billion or even less.

A third option would be to allow interest rates to fall quickly and go for an expansionary Budget of £1½-2 billion. This will almost certainly damage inflation prospects.

Conclusion

Higher inflation and lower unemployment are not a choice in the longer run. But if we try and ensure 3% inflation in 18 months, we have to pursue what in political terms must be a very high-risk strategy. Similarly, if we go for a high PSBR, we risk inflation rising more rapidly than forecast.

Better to try for the second option and keep inflation at 4%, hope for continued growth which bites on the unemployment figures, and then attempt another major assault on inflation in the third term.

BLG

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X Brian believes this combination may be possible because the markets believe the fiscal stance will be looser than it will in fact turn out to be in the Budget.