E

PRIME MINISTER 13 June 1989

THE CAUSES OF THE PRESENT INFLATION

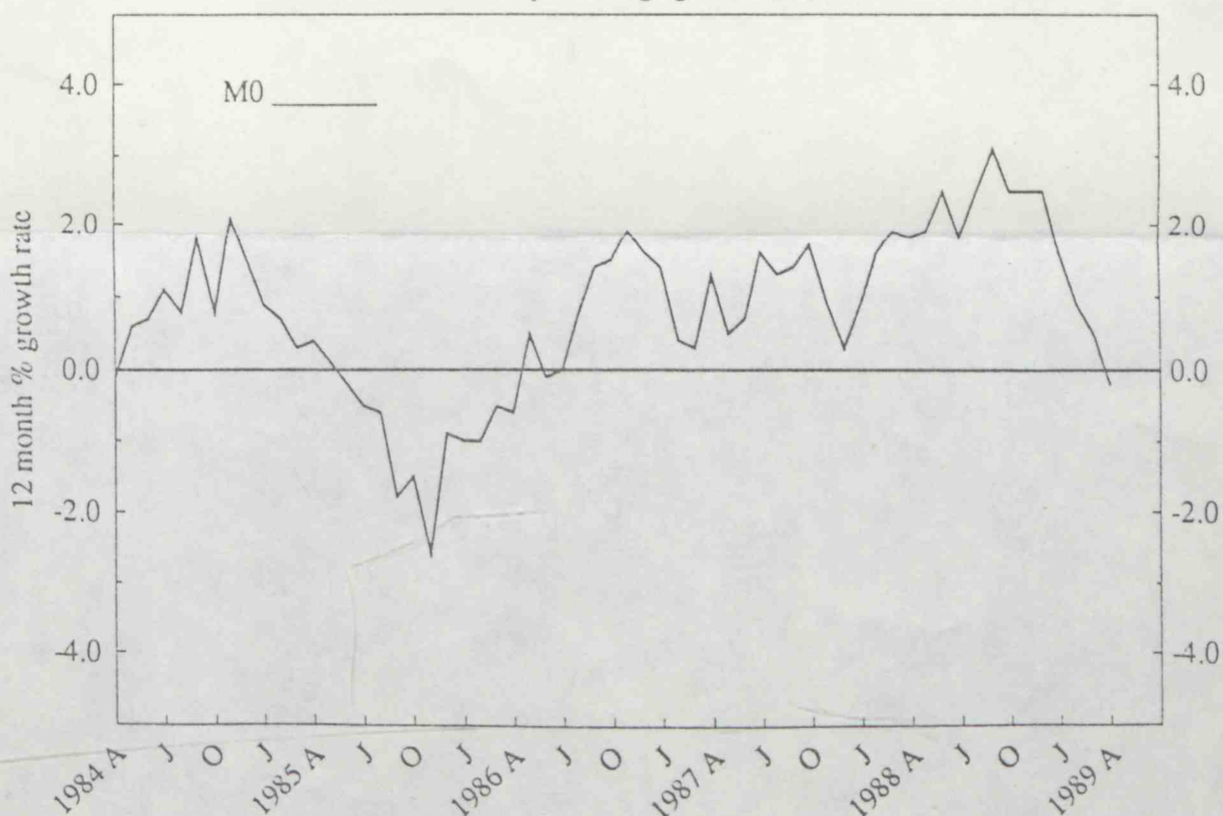
1. The Treasury point out that G6 is inflating but, as in the past, less than the UK. The reasons for G7 inflation listed by the Treasury include only the "usual suspects":

- monetary indicators awry because of deregulation;
- oil prices - oddly enough because of the fall in 1986 rather than the rise!
- remaining over-liquid well after the October 1987 crash.

The Treasury do not point out that such G7 inflationary periods have always followed attempts by major countries to target nominal exchange rates (in 1972/3, 1978/9 and 1986/7).

2. These reasons for G6 inflation are applied a fortiori to the UK. The main cause in the UK is, rightly, reckoned to be monetary growth. It is admitted that policy in the last three years should have been tighter "but it is difficult even now to say how much".

3. Although agreeing that MO is the best indicator of monetary policy, the Treasury argues that it would not have given early enough warning of the demand pressures (paragraph 10). There is some truth in this. But I find it difficult to square with the following (Treasury) figure on real MO. This shows clearly the expansion in the rate of growth of real MO from mid 1986 onwards. [See Chart 4 attached]



4. The Treasury are however right to reject broad money (Congden) as a cause; it has cried wolf too often since 1980. Similarly the policy of not over-funding was not a contributor to inflation. I agree also with the main thrust of paragraph 13 that we cannot (and I believe should not) use monetary policy to attempt to eliminate the effects of shocks. Its job is to keep inflation low and stable.

5. On exchange rates, the Treasury seem to be confused. An axiom of policy is that our monetary policy, relative to those of our trading partners, is an important determinant of our market exchange rate. However, market exchange rates are also influenced, sometimes dramatically, by a myriad of other factors - political upheavals, foreign wars, disasters, oil, rumour and report. Clearly we should not adduce exchange rate declines due to troubles in China as evidence of monetary ease in the UK. In my view, we do not know how to sort out, even less measure, the effects of monetary policy from all the other influences on the market rate. So, for judging monetary conditions, the market exchange rate has been and is a treacherous yard-stick.

6. The market exchange rate is one of the vehicles (and a very important vehicle) through which monetary policy affects inflation. But it is only a vehicle and, contrary to the Treasury's paragraph 15, it has no separate effect on inflation. Of course one may fix an official exchange rate and vary interest rates or monetary growth in order to maintain the official rate. But still, it is monetary policy, duly subservient to the official exchange rate target, that determines inflation. Monetary policy is jigged to deliver a market rate equal to the official peg.

7. The Treasury's arguments for holding sterling up were the <u>same</u> as when they rapidly changed to holding it down

(paragraphs 16-17)! It is of interest to note that the BIS report has warned that "focussing on nominal exchange rate stability when differentials in inflation and productivity growth persist at best [leads to] real exchange rate changes in the wrong direction, the erosion of competitiveness and ... the aggravation of external imbalances. At worst, it leads to an irresistible appreciation of the 'wrong' currencies with high interest rates and to even worse ... imbalances." Amen.

8. Paragraph 18 argues that, since intervention is, on any definition, sterilized, it has no effect on money supply or interest rates. If it is all sterilized contemporaneously, then it has no effect (except for a day or so at most) on exchange rates. But if the ineffectiveness of intervention to contain the rise in the Dmark in early 1988 lead the Treasury to reducing interest rates with consequent expansion of monetary growth, the end effect is much the same. In any case, it is difficult to see any, except the most fleeting and transitory, role for sterilized intervention.

9. The Treasury's basic excuse is that everyone was inflating, and that our errors were only a little, if anything, worse than the G6. This attitude does not learn from the fact that United States monetary policy since 1987 has avoided the errors we made and appears set to deliver a soft landing. As distinct from our policy, for example, the Fed reigned back very rapidly the liquidity to deal with October 1987. Nor has the Fed markedly relaxed its policy to keep the dollar down in recent months: domestic conditions have been paramount. Similarly, we can learn from the Bundesbank experience: they changed from a monetary base target to a wide money target (which they have since exceeded). Partly this was due to French pressure in the EMS and partly to other factors. But Germany now has what they regard as

a serious inflation problem - hence the decline of the Dmark. The variation of experience between the G7 is informative, but alas is ignored by the Treasury.

10. TREASURY CONCLUSIONS

The thrust of the conclusions (i e with all the excuses too loose a monetary policy) is correct. But the phrasing is on occasion incomplete and opaque. For example, they conclude that [21(g)] "excess depreciation ... remains an essential ingredient". But what defines excess: with respect to where the pound is at present?; purchasing power parity (however measured)?; the market rate?; "sustainable" current account deficits? and so on. It is meaningless. One man's excess is another's success.

11. MY CONCLUSION

Although many of the conclusions are sensible, the supporting argument is weak and resembles special pleading. It aims to show that, at the time, they did the right thing ... only with the benefit of hindsight, etc. This is not good enough. We must acknowledge and learn the lessons.

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