BRITAIN & OVERSEAS

A DIGEST OF NEWS AND VIEWS ON BRITAIN'S ECONOMY AND OUR ROLE IN OVERSEAS TRADE AND PAYMENTS

Winter 1997 Vol. 27, No. 4

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Published quarterly by

The Economic Research Council

239 Shaftesbury Avenue, London WC2H 8PJ

Price: U.K. £12 Australia $25 Canada $25 New Zealand $35 U.S.A. $25 Japan ¥4,000

ISNN 0045-2866

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CONTINUED LOW INFLATION
A Pleasant but Foolish Day-dream

The full text from which Professor Tim Congdon, head of Lombard Street Research, spoke to members of the Economic Research Council on Tuesday 28th October 1997.

Sweet and sour spots in the business cycle

Favourable macroeconomic outcomes in the last few years have surprised many observers. 1997 seems to have been particularly impressive. In the USA growth has been higher than expected at the start of the year, while inflation has been lower. The simultaneous declines in unemployment and inflation have led to conjectures that the economy has entered a "new era" and can now enjoy a "new paradigm" of inflation-free growth. In the UK comment has been more restrained. Even so, inflation in the mid-1990s was less than widely forecast. It has remained satisfactory in 1997, while unemployment has fallen to the lowest level since 1980. Mr. Bootle of the HSBC Group has written a book on *The Death of Inflation,* claiming that inflation has been permanently weakened, perhaps even brought to an end, by structural changes such as the reduction in trade union power, de-regulation and the intensification of foreign competition.

The central argument of this paper is that hopes of a "new era" of price stability are misplaced. On the contrary, the behaviour of output, employment and inflation in recent years can be readily explained – in the context of a simple theory of inflation and the business cycle – by past relationships between the main macroeconomic variables. There is no evidence of a significant break from previous patterns. Further, structural theories of inflation are misconceived and hopes of long-lasting price stability based on them will be disappointed. Instead a monetary theory of inflation is correct. More precisely, inflation is the result of the quantity of money increasing at a faster rate than the trend rate of increase in the quantity of good and services. As money supply growth has been higher in the last two-and-a-half years than in the early 1990s, inflation will be higher in the late 1990s than in the mid-1990s.

The paper starts by proposing a theory of the course of inflation over the business cycle. This account – which is necessarily very stylized – identifies four phases of the business cycle and two exceptional moments. The first such moment is a "sweet spot" of excellent macroeconomic outcomes, which provokes unjustified optimism about the economy's trend performance; the second is a "sour spot" of poor macroeconomic outcomes, which provokes equally unjustified pessimism.

An implicit microeconomic assumption in the first part of the paper is that inflation is determined in goods markets, which appears to suppress the role of money. But money is readily integrated into the economy's cyclical behaviour by recalling a well-known principle of macroeconomics, that the demand to hold real money balances depends in the long run only on real variables. Of these real variables, income is the most important. Phases of buoyant asset prices and above-trend growth in demand may be interpreted as a by-product of excess real money balances, and phases of asset price weakness and beneath-trend growth in demand as a consequence of deficient real money balances. Over periods of several cycles real money balances fluctuate around their "equilibrium" level, which can be estimated by the best-fitting long-run demand-for-money equation.

A theory of the business cycle

In his presidential address to the American Economic Association in 1967 Professor Milton Friedman proposed that there is only one rate of unemployment ("the natural rate") consistent with stable inflation. He denied the existence of a long-run trade-off between unemployment and inflation. He claimed instead that, when unemployment is beneath the natural rate, inflation rises year after year without limit. A corollary is that inflation keeps on falling indefinitely if unemployment is above the natural rate. In other words, the change in inflation is nil only at the natural rate and is positive (negative) when unemployment is beneath (above) the natural rate. Friedman's proposition was open to debate and has been much criticised. Nevertheless, the statistical evidence is undoubtedly that it comes closer to the truth than economists' earlier consensus, expressed in the famous "Phillips curve", that there is a stable relationship between the levels of unemployment and inflation.

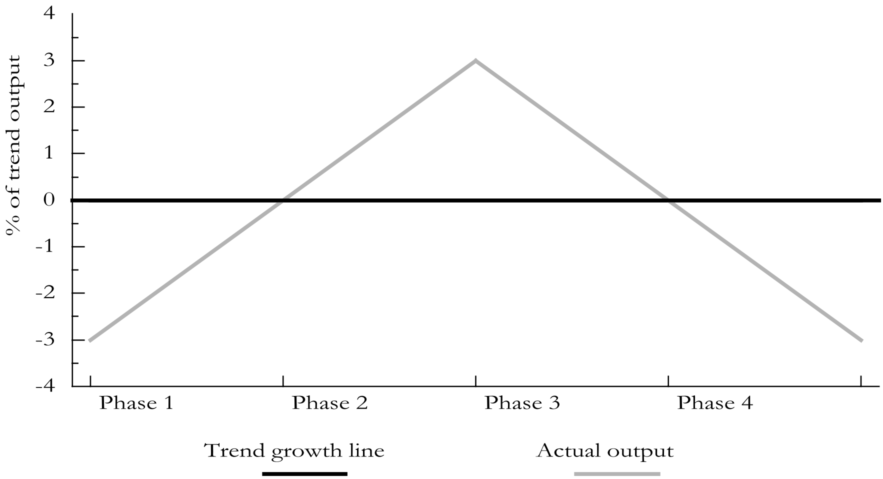
The concept of a natural rate of unemployment can be readily assimilated with that of trend output, and harnessed in a theory of the cyclical relationship between output and inflation. The natural rate of unemployment is that at which supply and demand in the labour market are balanced, so that inflation is stable. The trend level of output is to be understood as that where unemployment is at its natural rate. The related concept of an "output gap" can then be proposed. If actual output is above its trend level, the economy has a positive output gap; if actual output is beneath its trend level, it has a negative output gap. The trend rate of output growth is that which can be sustained indefinitely into the future, without changing the value of the output gap. If output starts at its trend level, the trend rate of output growth is that which can continue without causing either strain on productive capacity (and therefore rising inflation) or an increasing margin of spare resources (and therefore falling inflation). Of course, the trend rate of output growth depends on, among other things, the increase in labour productivity and labour force growth.

A stylized account of a "typical" business cycle now follows quickly. The behaviour of the labour market and, in particular, the idea of a natural rate of unemployment are very important in the background, but superficially the two kindred notions of a trend level of output and a trend rate of output growth do all the work. As already explained, inflation is stable when, and only when, output is at its trend level (i.e., the output gap is nil) and output growth runs at its trend rate. More normally, the level of output differs from its trend and inflation is changing, while output growth is faster or slower than its trend rate.

For the purpose of the discussion, the starting-point can be a cyclical trough in which output is beneath its trend level. Inflation has therefore to be falling. Neither the government nor the central bank want inflation to fall for ever. In the standard textbook manner, interest rates are reduced, taxes are cut and the politicians boost public expenditure. Output grows at an above-trend rate.

Chart 1 The "typical" business cycle

Chart shows stylised four-phase business cycle.
Note that inflation falls when output beneath trend and vice versa



1. Above-trend growth, falling inflation; 2. Above-trend growth, rising inflation;
3. Beneath-trend growth, rising inflation; 4. Beneath-trend growth, falling inflation.

Despite the absorption of spare capacity and declines in unemployment, inflation keeps on falling for some time, until the level of output has returned to trend. So phase one of the cycle is characterised by a beneath-trend level of output (i.e., a negative output gap), an above-trend rate of output growth and a declining inflation rate.

Unless policy is changed here or something else rather unusual happens to the economy, output growth continues to run at an above-trend rate. The level of output goes above its trend level, perhaps by quite a wide margin, and inflation accelerates. When output is only fractionally above its trend level, the upturn in inflation may be imperceptible. But the higher that output goes above its trend level, the more pronounced is the acceleration in inflation. Phase two of the cycle therefore sees an above-trend level of output (i.e., a positive output gap), an above-trend rate of output growth and a rising inflation rate.

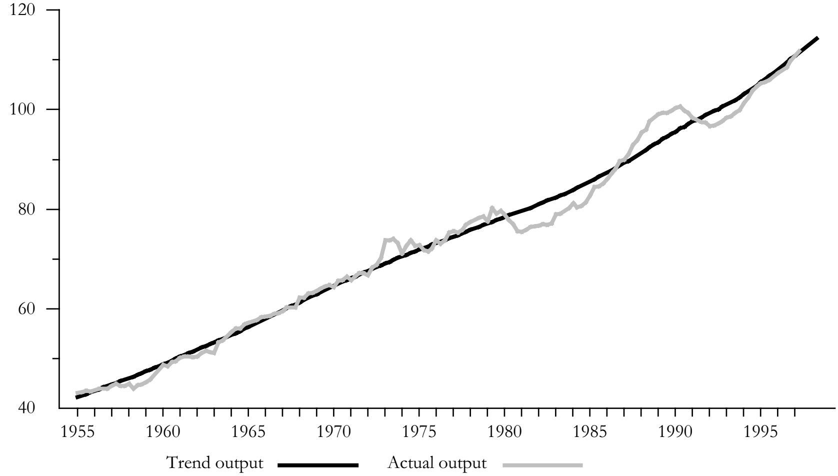
Sooner or later the acceleration in inflation becomes unacceptable. Interest rates are raised, taxes are increased and the politicians curb public expenditure. The rate of output growth falls beneath its trend level, unemployment starts to rise and capacity utilization weakens. However, because the level of output remains above its trend level, inflation continues to accelerate. At best it remains stable at the high rate established in the closing stages of the boom. Phase three of the cycle is marked by an above-trend level of output (i.e., a positive output gap), a beneath-trend rate of output growth and a high, probably rising inflation rate.

Of course, policy-makers must persevere with beneath-trend growth. Eventually the level of output again falls beneath its trend level and inflation begins to moderate. When output has only just dipped beneath its trend level, this moderation in inflation may be difficult to identify and unconvincing. Output growth may remain beneath its trend rate for some quarters or even years, until the decline in inflation is clearly established. Phase four has a beneath-trend level of output (i.e., a negative output gap), a beneath-trend rate of growth and a falling inflation rate. Eventually inflation drops to a politically acceptable rate, monetary policy is eased, interest rates fall and the upswing first phase of the cycle resumes.

The stylized four-phase business cycle can be portrayed in a diagram, with trend output (i.e., a zero output gap) represented by a straight line through the origin (see chart 1 on p. 5.) In the real world the trend level of output is rising over time, at a rate which varies only slightly from one cycle to the next. Chart 2 – which relates to the UK – shows the fluctuations of output around its trend level, identifies periods when output was above and beneath its trend (i.e., when the output gap was positive and negative). Chart 3 shows the

Chart 2 Actual and trend output in the UK 1955–97

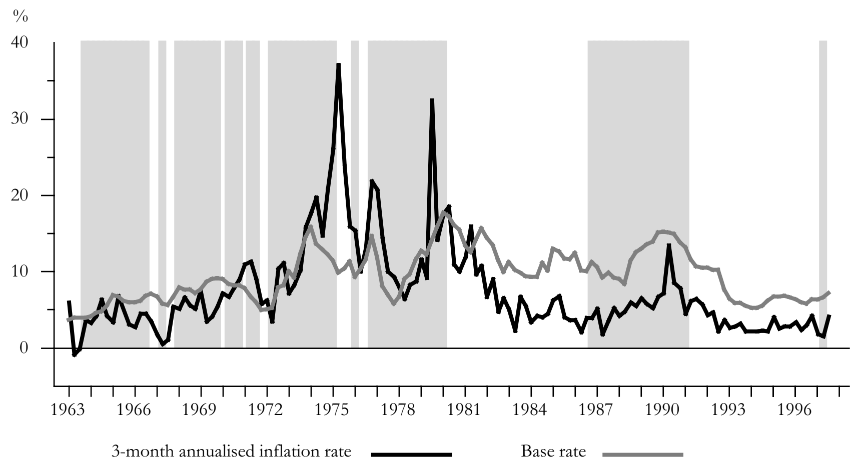
Chart shows the index of actual non-oil GDP (1990=100) and Lombard Street Research's estimate of trend GDP.



Source: *Office for National Statistics. OECD*

Chart 3 Inflation and interest rates in the UK 1963–97

Shaded areas are periods with a positive output gap.



direction of inflation and interest rates during these periods. The correspondence with the theory is not exact, but it is highly suggestive.

Some features of the business cycle: counter-intuitive phases and the sweet spot

The theory of inflation and the business cycle outlined here builds on simple ingredients. The key empirical relationship is that between the change in inflation and the level of the output gap. A number of statistical tests have been carried out at Lombard Street Research and are reported in an appendix (not published here). The results are broadly as expected, conforming with the earlier empirical validation of Friedman's hypothesis on inflation and the natural rate of unemployment. Crucially, the change in inflation is much better explained by *the level of the output gap* than by *the change in the output gap*.

But – despite the simplicity of the theory – it has consequences which at first glance are rather odd. The first is that years of above-trend growth are not necessarily years of rising inflation and years of beneath-trend growth are not necessarily years of falling inflation. In fact, in phases one and three the economy's behaviour is counter-intuitive, because unemployment and inflation are changing in the same direction. The apparently counter-intuitive behaviour is however altogether logical. It is based on the dependence of the change in inflation on the level of, not the change in, the output gap. To repeat, this idea – the central motivating idea behind the theory – enjoys clear support from historical data.

The discussion suggests that moment in the cycle when the economic news is at its best. Plainly, at the start of phase two the economic data relate to phase one, when above-trend growth (probably with profits growing faster than output) and falling unemployment were combined with low and perhaps declining inflation. If output is only marginally above trend, the underlying deterioration in inflation may be modest and perhaps concealed by special factors, such as help from lower indirect taxes, falling commodity prices and so on. This is the "sweet spot".

A further aspect needs to be emphasized. It should not be expected that, in the real world, the phases of the cycle are all of the same length. There is at least a possibility that periods when output is beneath trend are longer than periods when output is above trend, and vice versa. Phase one – when output is beneath trend and output growth is at an above-trend trend – may extend over several years, with low and falling inflation coinciding with good news on the "real side" of the economy (i.e., in terms of output growth and employment). Looking backwards from the start of a phase two which follows an extended phase one of this kind, the economy's macroeconomic performance may seem magnificent. This would be the sweetest of "sweet spots". It might be the occasion for politicians – such as Mr. Nigel (later Lord) Lawson in 1987 – to trumpet about their "miracles". It might also stimulate economic commentators to make claims about "new eras", "new paradigms" and such like.

The sour spot

The correct way to test claims of "new eras" is to examine the data on the relationship between the change in inflation and the output gap, and to see whether recent values of the change in inflation are lower than those estimated by the equation which best fits the data over the previous 10, 20 or 30 years. If they are lower, there may have been an improvement relative to those previous periods. When this exercise is carried out on recent UK numbers, no improvement is found. The good macroeconomic outcomes of the last few years are in line with the normal cyclical pattern; they do not imply any radical structural changes in the trend rate of growth or in the relationship between the output gap and inflation. (Incidentally, much the same comment is also true in the USA.)

Unhappily, if the business cycle has sweet spots, it also has sour spots. If the sweet spot is at the start of phase two when the output gap has been negative for two successive phases (i.e., with inflation being damped, possibly for some years, by excess supply in goods markets), the timing of the sour spot is obvious. It comes at the start of phase four, as the level of output has just dipped beneath its trend level. Inflation has been rising for some time, because the output gap has been positive for two successive phases, while phase three has been characterised by beneath-trend growth, rising unemployment and disappointing company profits. Indeed, after periods of extremely incompetent and inflationary demand management, which may have driven peak output 3% or 4% above its trend level, phase three may have suffered from rising inflation *and falling output*. If that seems so perverse as to be impossible, remember the UK's sorry plight between mid-1974 and mid-1975, in 1981, and between mid-l990 and mid-1991. These dreadful years experienced the worst imaginable combination, rising inflation, rising unemployment and falling output. They were the sourest of sour spots. Even so it would be wrong to think that the sour spots of the last 25 years reflected a major deviation from normal relationships. Both the sweet and sour spots seen in the UK economy in this period fit the standard cyclical pattern. Further, the good macroeconomic outcomes since 1993 and, in particular, the current sweet spot do not signal the death of inflation.

A trap for economic commentators is to base their macroeconomic projections on either extrapolations of the numbers in the last few years or on averages of these numbers with a little tweaking to reflect the commentator's hunches. Such practices may seem crude, but – dressed up with computer print-outs and jargon – they are rather common. The result of such extrapolating, averaging and tweaking is obvious: at sweets spots the commentators will be very optimistic and at sour spot they will be very pessimistic. If the description of the stylized business cycle given here is correct, commentary on these lines is worthless. In the real world optimism at sweet spots and pessimism at sour spots is likely to be misguided, even disastrous. At sweet spots commentators should warn of storms ahead and at sour spots they should say that the clouds are dispersing.

From an analytical standpoint, the correct approach is to assess where output is relative to its trend level (i.e., to estimate the output gap) and to forecast whether output growth in coming quarters will be at an above- or beneath-trend rate. On this basis the UK economy is now at an interesting juncture. Output may be marginally above its trend level, perhaps by ½% or at most 1% of trend output. (Shortages of skilled labour are starting to hamper manufacturing output, while the amount of spare capacity and empty commercial property is dwindling.) Over the last year output growth has undoubtedly been above its trend rate. If above-trend growth continues, the positive output gap may reach over 1% of GDP and could move up to the 2%- or-more figures seen at some previous cyclical peaks. If so, quite a nasty sour spot might follow, say in 1999 or 2000, with inflation returning to over 4% and possibly to 5%. A period of beneath-trend growth would be necessary to bring inflation back down to the 2½% official target.

Introducing money

One way to obtain insight into the future path of demand and output, and to appraise the medium-term inflation prospect, is to look at money supply data. Interpretation of money supply data is complex, but virtually all macroeconomists accept that in the long run the demand to hold real money depends only on real variables. (In other words, a nation cannot make itself rich by printing more bank notes.) If excess real balances are created by an acceleration in nominal money supply growth, the inflation rate must increase sooner or later. The increase in inflation erodes the real value of the increase in nominal money. Ultimately, both the stock and the growth rate of real money balances have to be the same as they would have been if the acceleration in nominal money supply growth had not occurred.

Researchers have found that the personal sector's demand to hold money balances is more stable than that of the rest of the economy, with the level of personal incomes being the most powerful independent variable in the demand-for-money function. Initially an acceleration in money growth has negligible direct effect on personal incomes. So the upturn in money growth is unlikely much to change the rate of increase in personal sector money holdings. Instead the extra money balances have to be concentrated elsewhere, in the hands of companies and financial institutions. In fact, over the last 25 years a repetitive accompaniment of large fluctuations in aggregate money growth is even larger fluctuations in the money holdings of companies and financial institutions. The amplitude of the fluctuations has been greatest for financial sector money.

The macroeconomic significance of these fluctuations has been much discussed in policy-making circles recently, notably by the Monetary Policy Committee of the Bank of England. The reason for official concern is that a step-change in the rate of UK money growth occurred in early 1995. The annual growth rate of M4 increased from about 5% in the three years to the end of 1994 to about 10% subsequently. In line with the previous cyclical patterns, the acceleration in the growth of financial sector money holdings has been far more pronounced for that of aggregate money holdings. If financial sector liquidity is a plaything of securities houses and investment banks, and if its recent rapid expansion is due to artificial additions to both sides of financial institutions' balance sheets, this phenomenon is of no importance to the macroeconomic outlook and the upturn in M4 growth does not imply a future increase in inflation.

On the other hand, if the higher growth of financial sector money has given the financial institutions excess money holdings, the economy today suffers from a condition of "too much money chasing too few assets". The higher rate of aggregate money growth since early 1995 can therefore be described as the main causal influence on the stock market gains of the last two years, the sharp increases in London house prices (as people sell shares to buy London houses), the return to moderate house price inflation across the country (as people sell their London houses to buy houses elsewhere in the UK), higher prices for unquoted businesses such as restaurants and pubs (as people switch from housing equity into unquoted corporate equity) and so on. As asset prices move up throughout the economy, there are favourable "wealth effects" on consumption, investment and aggregate demand.

Since the middle of 1996 demand has indeed been growing at an above-trend rate, and unemployment and spare capacity have been falling. Happily, the level of national output in early 1996 was probably a shade beneath trend, and so it was possible in late 1996 and early 1997 to combine above-trend growth with low, even falling, inflation. But phase one has come to an end. If output is now above its trend level, the economy has entered phase two of the cycle and continued above-trend growth will lead to inflationary trouble. The sweet spot of mid-1997 will be followed by disappointing macroeconomic outcomes, particularly in 1999 and 2000. There will be a sour spot two or three years from now. (Of course, any precision about the timing of the sour spot and its exact characteristics would be spurious.)

The debate on the macroeconomic significance of the acceleration in M4 growth, and the associated explosion in financial sector liquidity, will go on for months. It will be largely resolved by events. The current cycle may continue to follow previous patterns, with excess institutional liquidity spurring higher asset prices, and higher asset prices stimulating above-trend growth of demand and output, and eventually being succeeded by goods price inflation. Or it may follow another path, with excess institutional liquidity somehow being confined to the economy's financial sideshow.

Even if inflation does increase, another recurrent feature of the British business cycle might come into play. It would be for the economists who deny the macroeconomic importance of the money supply in general terms to question. (They will always find other culprits, like wages, oil prices, tax rises, trade unions and so on.) But on this occasion they might at least have the courtesy – unlike their predecessors after the Heath-Barber boom, the Healey boomlet and the Lawson boom – to accept that they got it wrong.

Are structural influences on inflation irrelevant?

The emphasis on the monetary determinants of inflation in this paper may appear too exclusive. A more balanced approach might be advocated, to allow some room for the structural considerations discussed by Mr. Bootle in *The Death of Inflation*. But how, if at all, can these considerations be integrated into the analysis? Are the economy's structural characteristics still relevant in some way?

In the analytical framework developed here, inflation is due to the quantity of money rising at a faster rate rather than the quantity of real output. This familiar statement is often appended to the well-known Friedmanite remark that inflation is a "monetary phenomenon". But it is in fact even-handed between two influences on inflation; it refers to the quantity of real output as well as to the quantity of money. For any given quantity of money, the price level will be lower (higher), the higher (lower) is the quantity of real output. Where more output is available as a consequence of supply-side reforms, then these reforms can be described as favourable structural influences on the inflation rate.

But an important distinction can be drawn. With the concepts of the natural rate of unemployment, the output gap and the trend rate of output growth, two types of supply-side improvement can be differentiated. First, and most simply, the trend rate of output growth may be higher than before. If output starts at its trend level (i.e., the output gap is zero), and if the trend rate of money supply growth is unchanged, the higher trend rate of output growth implies a lower inflation rate. The acceleration in the trend rate of output growth may be due to a faster rate of improvement in the efficiency of labour and capital usage, with the natural rate of unemployment unchanged.

But, secondly, the supply-side improvement might consist in a decline in the natural rate of unemployment. This decline might occur suddenly, because of an abrupt change in trade union legislation or the benefit system (such as the introduction of the Jobseekers Allowance in the autumn of 1996), or it might occur over several years because of a sequence of reforms. If the decline were sudden, it would be best represented – in analytical terms – as a once-for-all positive change in the output gap. Even with the trend rate of output growth unchanged, inflation would be better than would otherwise have been the case. For any given money supply growth rate, inflation would continue to be better than before until above-trend growth took the level of output back to trend. Thereafter, the trend inflation rate implied by the trend growth rates of money and output would be restored. (Note also that – in interpreting the data over a series of years – it would be difficult to identify the separate effects of the two kinds of supply-side change.)

So there are two ways – an acceleration in the trend rate of output growth and a cut in the natural rate of unemployment (and an associated positive effect on the output gap) – that benign structural changes to the supply-side of the economy could lower inflation. However, the possibility of such changes in theory does not imply that they explain current low inflation in practice. The evidence is instead that the world-wide decline in inflation since the mid-1970s is overwhelmingly to be explained by the world-wide decline in money supply growth. In the industrial world as a whole the trend rate of output growth is lower now than in the 1970s, while the natural rate of unemployment is undoubtedly higher, mainly because of adverse institutional changes in continental Europe. Inflation in the industrial world will increase if money supply growth accelerates once more. Money supply growth has in fact accelerated since early 1995.

Clearly, the analysis in this paper argues strongly against the claim that inflation is dead. However, it may be possible to rescue part of Mr. Bootle's thesis. In the last 15 years there may have been favourable policy moves towards greater labour market flexibility, and a consequent fall in the natural rate of unemployment, in the USA and the UK. In this respect Mr. Bootle would be right that structural reforms have reduced inflation. But the anti-inflationary effect of a lower natural rate can be interpreted conceptually as a once-for-all change, which cuts the inflation rate in a discrete time-interval. It does entail a permanent fall in the inflation rate. In any event, the gain would be trifling compared with the fluctuations in money supply growth seen in a typical business cycle.

Conclusion: inflation is not dead

The good inflation performance of the last few years must not be misinterpreted. It can be seen as the result of an extended period in which national output was beneath its trend level (i.e., the output gap was negative), following the severe recession of mid-l990 to late 1992. Further, the failure of output to return rapidly to its trend level after the recession was largely due to the longest period since the 1950s in which the annual rate of money supply growth was under 5% a year. With real money growth between mid-1990 and late 1994 at nil or low single-digit rates, asset prices – particularly in the over-supplied commercial and residential property markets – were weak, and investment struggled to return to its levels in the late 1980s. However, since early 1995 money supply growth has accelerated to a double-digit annual rate, company balance sheets have improved strongly, asset price inflation has revived, and since mid-1996 demand and output have been growing at well above trend rates. The level of output has now gone above its trend level (i.e., the output gap is positive). Continued money supply growth at a double-digit rate will therefore lead to accelerating inflation. The years 1999 and 2000 will see another cyclical "sour spot". Economists (or, at any rate, some economists) will wake up to the recognition that, once again, a monetary explanation of inflation has been successful. They will also look back on all the talk about "the death of inflation", motivated by favourable structural changes to the supply side of the British economy, as a pleasant but foolish day-dream.

EXPANSIONIST ECONOMIC POLICIES

A reply by Mr John Mills to points raised in the Autumn 1997 edition of Britain & Overseas

Richard Hadfield and Alan Shipman both produced interesting commentaries in the Autumn 1997 issue of Britain and Overseas on the discussions which have taken place recently at ERC meetings on macro-economic policy. Although I agree with much that both of them had to say, here are some comments on matters where they disagreed with the line which I put forward.

Richard Hadfield cites the Barber and Lawson booms as examples where monetary expansion did not produce conditions where growth could be sustained. There is no doubt that each of them achieved large increases in output by the British economy while the booms lasted - 8.3% growth across the two years between 1971 and 1973, and 9.3% between 1986 and 1988. The problem in each case, however, was that the boom took the form of an unsustainable increase in consumer expenditure, fuelled by asset inflation, rather than export led growth. The brief drops in the exchange rate which occurred in both 1973 and 1986/87 were quickly offset by interest rate rises and government inspired action to push up the value of the pound. The result in both the mid 1970s and the late 1980s was that expansion of British output, and our ability to export profitably, was sacrificed, leading inevitably to balance of payments crises. The subsequent high interest rates and consequent deflation then pushed up inflation, leaving us with the worst of all worlds: stagnant or falling output and rapidly rising prices.

The Tiger economies undoubtedly were helped by a movement from the land to manufacturing industry, allowing productivity to rise very rapidly in both sectors. There is also a persuasive argument that long periods of political stability tend to lead to social and economic sclerosis. The critical issue, however, is whether it is possible to use well thought through macro-economic policies to generate continuing growth even when obviously favourable conditions are not necessarily in place. In particular, can this be done without inflationary pressures undermining other policy requirements, such as low interest rates, an accommodating money supply and a low and competitive exchange rate?

The record of economic advance, particularly since World War II, provides the answer. There is no historical experience of rapidly rising output unaccompanied by some increases in the overall price level. Even in Germany, during the 1950s and 1960s, with memories of the 1923 hyperinflation still alive, and with a legendary degree of social consensus, inflation averaged 2.7%

per annum. During the long post war boom in Japan, while the growth rate averaged 10% per annum, domestic prices rose by an average of 4% per annum. There is also, however, little historical evidence that, with competent economic management, inflation tends to take off exponentially. On the contrary, inflationary pressures tend to get soaked up by productivity increases, producing a steady but reasonably stable increase in the price level.

Indeed, the evidence tends to suggest the reverse of much of the conventional wisdom. Interest rates in Britain were high during much of the late 1970s, and rose to Draconian heights under Geoffrey Howe, with Bank Rate at 17% for eight months from November 1979. The economy quickly collapsed into such a deep recession that inflation fell back to much lower figures. Was all the damage that was done in the meantime by high interest rates the only way of curbing inflation, however, or did high interest rates themselves contribute substantially to the very problems of rapidly rising prices which they were supposed to be solving? The combination at the time of much lower interest rates in most other economies in the world with much better growth and inflation records tells an uncomfortable story for British policy makers.

On Alan Shipman's point about whether it is the costs of capital and labour which are most important to achieving competitive exports, the fact that in Britain almost 70% of the GDP is made up of labour costs, must indicate how important they are. Non-labour costs are, however, also significant, not least because in total they make up the other 30% of total costs. Alan Shipman then suggests that it is not possible to maintain for any length of time a combination of a low exchange rate and low domestic rates of interest. His main argument is that once the markets sense that the government's policy is to offset any decline in competitiveness by further devaluation, they will insist on an interest rate premium to offset further expected exchange rate falls.

The strength of this argument, however, depends on it being necessary to have continuous devaluations to keep the economy competitive. I would argue strongly that this is not necessary. Indeed, I believe that the reverse is true. All the evidence surely shows that once economies have established themselves with export led growth, their investment in tradable manufacturing and services output goes up, and they become progressively more competitive. Even if they have some domestic inflation, their export prices barely rise at all, and may even fall. In these circumstances, far from further devaluations being necessary, their problem is to stop their currencies appreciating, thus undermining their competitiveness. In these circumstances, low rates of interest are easy to maintain. If there is a premium at all, it could well be a reverse premium. Nor, in these circumstances, is there any necessity for capital controls to keep interest rates low in the domestic economy. On the contrary, low interest rates may well be necessary to head off the capital inflow which would otherwise push up the exchange rate to unwanted levels.

The problem in Britain is that we have had the opposite to this experience. For many years we have used high interest rates and a restrictive money supply to keep up the value of sterling. This has made exporting of goods and services progressively more difficult, as years of low investment and bleeding talent out of export orientated activities have taken their toll. Too high an external value for sterling has, however, proved time after time to be unsustainable. The inevitable result has been a steady fall in the value of sterling against other currencies. In these conditions an interest rate premium for sterling is all too likely to materialise, damaging just those investment prospects for the future which we so badly need. This is exactly the dilemma from which we so badly need to extricate ourselves.

THE SOUTHERN BOOM
Powered by the Service Sector

Since the "Advance Factories" (industrial assistance) legislation of the 1930s Britain has struggled to maintain prosperity, largely founded on manufacturing, outside of the South East, in the face of London's evident vitality, largely driven by service activity.

Serious regional policies were abandoned after EEC entry. The results for the South East are well described by Brian Groom and Richard Wolffe:*

> The south-east is securing more jobs in high-value sectors such as professional and financial services, while the north's biggest gains are in part-time and lower-paid employment in sales, catering and hotels. If the economy overheats, it may be seen first in the capital, where the London Chamber of Commerce and Industry forecasts that earnings will grow by 6.4 per cent in 1998, potentially threatening the government's 2.5 per cent inflation target.
>
> The two-speed economy is seen even in the Thames Valley, a cauldron of high-technology growth. "People keep phoning me to say how horrible it is because of the strong pound," says Mark Sharman, policy manager at Thames Valley Chamber of Commerce. In this area, however, the

* "Quick, quick, slow" *The Financial Times* 6/1/98

difference is between rapid growth in manufacturing and even faster growth in services.

Unemployment in some parts is as low as 1.4 per cent, but still the jobs keep coming. US software giants Microsoft, Computer Associates and Oracle plan to hire a further 2,000 staff by 1999. Wage increases of up to 10 per cent are reported for information technology jobs, and up to 6 per cent for other jobs. Poaching has returned for the first time since the 1980s and there are signs of some companies passing on wage rises in prices.

Some employers are bussing people into the Valley. Legoland Windsor, the theme park, hired 10 per cent of its staff from abroad. "Towards the end of last season when we couldn't rely on students it was difficult to get staff. We were bringing them in from a long way," says Joanna Oswin, marketing manager.

In London, manufacturing exports are down but services are expanding: £5.6bn worth of arts, heritage, sport and leisure projects are planned or under way, a bigger bout of development than in the 1980s. Terry Harding, research analyst at the London Chamber, believes the capital is better placed to cope with growth because it is as much part of an international economy as a national one and can draw on overseas resources. For example, ABN Amro, the Dutch bank, flies in dealers from Amsterdam daily.

Small wonder then, that whilst, during the past year, the price of UK leisure *services* has risen by nearly 6%, the price of leisure *goods* has fallen by nearly 1%.

EUROPEAN AND MONETARY UNION – THE CHOICE FOR BRITAIN

Aims of Industry 1998

A single currency for the EU can only work in the longer term if, to compensate for lost exchange rate flexibility, the more prosperous regions are prepared to subsidize massively those with high unemployment and if all Europeans learn to speak one language allowing them to achieve labour mobility comparable with that exercised by individuals in the USA.

I don't know how many times this has to be said and one gets rather tired of screaming it at deaf megaphones intoning non-credible assertions, but anyway this report of four talks certainly does 'say it again'.

Perhaps the interesting point is simpler. It is an answer to those who have been calling for 'leading businessmen' to make their judgements public. And whilst it is of little value to listen to Japanese industrialists fishing for favours in Brussels or food company chairmen hoping for a knighthood, we ought perhaps to listen to Lord Boardman, former Minister and Chairman of the National Westminster Bank, Sir Stanley Kalms, businessman and academic, author and consultant Michael Ivens and Sir Nigel Mobbs, a member of the Council of the Institute of Directors.

J.B.

YUGOSLAVIA – AN AVOIDABLE WAR

By Nora Beloff
New European Publications 1997

One reads this short book with a sence of incredulity, relief and alarm. Incredulity because it undermines the rather clear picture of causes and culpability with which we in Britain have been presented. Relief because this candid and informed account both confronts and responds to those parts of the story one doubts, and what little discordant independent thought one has been able to muster, and shows that this tragedy is at least as two sided and intrigue ridden as any other war. Alarm because it shows the crucial and, as it turned out, deadly role played by German foreign policy - a policy to which we in Britain are committed through our membership of the EU.

This review cannot summarise an account already brief and to the point. The fact that Nora Beloff should have struggled to complete it (partly at her own expense) just before her death is testament to the signifance she herself, as one of the most experienced and respected experts on Eatern European affairs, attatched to giving us this account. The foreward by Sir Richard Body is a call from his heart to us all to read it and take careful note. Too many European lives have already been lost and the lives of our soldiers are still at stake.

J.B.

LETTERS

Engineering in Economics from Mr Hugh Walton

Sir,

Being an engineer rather than an economist, I find that my own views and experience depart from the received wisdom in several respects (and to judge by B&O correspondence I am not alone).

There are two issues that I for one would like to see debated in the near future. The first is the perennial question of whether inflation is caused or defeated by raised interest rates.

As I once suggested at an ERC meeting, both propositions may be (and are) true, operating on different timescales. In system terms the effect of two such contradictory forces operating at the same time could be to create long term instability, or not, depending upon circumstances and upon other time delays in the system.

I have in the past given demonstrations of this particular control principle using an electrical "analogue".

To me there is no doubt that some kind of "systems engineering" background is necessary (call it "cybernetics" if you will) if one really wishes to understand how inflation has varied in the past. This is because Economics does not seem to be at its best when dealing with the dimension of time!

The other important issue arises from Tim Congdon's thesis that because we have reached a particular point in the economic cycle that he has defined, there will inevitably be a traumatic switch into the next stage of the established cycle.

We should in my view look far more closely into the nature of the "switch", again using control terms to understand what is happening. In this context I found that TC's account of a transition, occurring because output had crossed a long term trend line defining "capacity", to be too abbreviated. How can any event in the real world be caused by a statistic of which no one has direct knowledge at the time?

A more realistic, if oversimplified, account of the "switch" he is talking about might go as follows: when industrial managers perceive that an expected rise in output has failed to occur but that cost is continuing to rise, they must raise their prices to meet forecast costs or go broke. Once a few managers have so acted, the prices they have imposed react upon the costs to be met by other managers, triggering them to take similar action. This spreading circle of price increases is the proximate cause of inflation.

Since perception of future costs is crucial, Trades Unions play an important role given that historically they have sought not only to offset a rise in the cost of living, but to anticipate it.

The achievement of the Major government was to realise that EMU membership reduced inflationary expectations, arguably for long enough to break the cycle. This begs the question of what sort of cycle would operate were we permanently so engaged (yet another subject for debate!) .

I actually had the experience of working on Stock Control models, in a variety of companies, round about 1973–4 when stop-go was particularly violent. This gave perhaps an unusual insight into the nature of "switching" phenomena. There has over recent years been a parallel development of "catastrophe theory", expressing the same ideas in a different way.

25 Shorncliffe Crescent
Folkestone
Kent.

Comments on Britain & Overseas, Autumn 1997 from Mr Brian Lewis

Dear Sir,

I was interested in a number of comments in your Autumn 97 edition.

While I can see that a sufficient degree of "growth" might indeed be a solution to unemployment, in the long run it does not seem logical to promote growth for ever. There must be a point where we all individually have enough or the resources begin to run out (as they may be doing even now). All I really need is a guarantee of two meals a day, a dry bed, reasonable health, and intellectual stimulation. Unfortunately, I too consume much more than I really need!

I am to some extent convinced that we now have manufacturing processes well under control. It seems to me that in the 1920s unemployment rose at the same time as businesses went bankrupt for lack of technical and marketing knowledge. In effect, the absolute level of wealth fell, whether you were a business or an employee, through ignorance, and to some extent these were tied to each other. Today that particular link has been broken. It seems to me that our ability to create wealth is improving all the time, even as unemployment rises. I wonder therefore whether society is not in fact quite able to survive and flourish on the total wealth available – as compared to the 1920s? Perhaps the problem is that a new means must be found to distribute fairly the wealth which we are now able to produce.

I suspect that with sufficient capital, I could arrange to produce almost anything you want for a satisfying life. I do not think that was true 70 years ago. Mention has been made of the new "winner-take-all" society where wealth accumulates in very few hands. Intellectual property laws seem designed to protect the few. I am not sure Bill Gates needs that sort of protection! If there is a concealed unemployment problem, then I think the clever ones will soon work out a (political) solution!

For the first time, people like me do not need ever to retire (at least not until our health breaks down). Once retired, my father was immediately cut off from his former life, or any other life for that matter. With my computer, I need never be cut off either from my former employer (who may not like that!), or from communicating with the world at large. Indeed I am not sure you can now tell how old I am. Today the assumption must be that most older people just do not want to work, despite what is implied.

I suspect I will be able to work until well into my seventies, because my 2000 health will be equivalent to that of a fifty year old in 1920. We do not realise that yet, but we will! If you want to work, you can. I am not sure where the idea has come from that you have to sit around and wait for someone to offer you work. That is not the way it happens. The implication is that five retired men – a scientist, a lawyer, an accountant, a businessman and a pilot – could not start up a business together over the age of 60 and thrive. If it doesn't happen, it is because they are not interested.

I think it not at all logical to retire everyone at 50, and then complain there are not enough workers to support the aged and the children in generations to come. Most of my colleagues have degrees in engineering and science; none of them will be offered jobs teaching in schools when they retire, yet in the 1939–1946 war period I was very well taught by men in their sixties and seventies. Adults old enough to be grandparents are available to help with children, yet do not seem to be asked to help. These people might be happy to be employed at modest salaries. The reason they are unemployed is that society does not like the idea of competition, not that the idea is impossible.

I suppose it is heresy to say so in a Society dealing with economics, but the idea that all will be well if we tinker around with interest rates – when that is what we have been doing for the last 50 years – seems to ignore the fact that there are many of us around who have got great satisfaction out of life by just working – without ever having given much thought to interest rates! If the country is doing badly, it is because we are not working together well or logically. That and that alone is the fundamental cause of the problem, not exercises in simple arithmetic.

PO Box 5101,
Riyadh 11422,
Saudi Arabia.

The CBI and the EMU from Lord Vinson

(This letter was published in *The Times* on 12 November 1997)

Sir,

The CBI seems to have forgotten that economic prosperity depends on political stability. Man does not live by bread alone.

Our democratic system is no doubt imperfect, but we simply cannot take it for granted that, if we alter it on a major scale – which is precisely what Maastricht, followed by European economic and monetary union, will do – the system will hold.

Currently, our democracy just works. People do feel that they can, to some extent, affect their future and right wrongs with the present system. We are represented by one MP to approximately 75,000 voters, but power is passing to Brussels and in the European Parliament there is one member to some 500,000 voters. So there will be little chance of the elector seeing his elected at a surgery on Saturday morning.

There is also little likelihood that his Euro-MP can nobble some Brussels official to put right a wrong; or that the MEP will have sufficient time to answer his enormous correspondence; or that he himself can affect the issues as part of a small minority in the European Parliament.

Without serious debate, we shall have so stretched the democratic elastic that it will surely snap. Like the French lorry-drivers, people may resort to taking the law into their own hands.

It is precisely because Eurosceptics like myself seek peace coupled with prosperity that we are fearful of the consequences of a fully federated Europe.

Yours sincerely,
NIGEL VINSON,
House of Lords.
November 11.

Ticket tax break for rail commuters *from Mr Jim Bourlet*
(This letter was published in *The Times* on 23 November 1997)

Sir,

Tax relief for firms that pay for rail season tickets for their staff (report, November 21) cannot be justified on economic grounds, however hard the railway companies may lobby for it.

Fundamentally it is in the general interest for people to live closer to, rather than further away from, their place of work. There are savings of time, transport costs, congestion and pollution, mothers have less need to be taxi drivers for their children, and time saved on distance commuting can be devoted to more worthwhile activities. For some, the stress of long-distance commuting leads to early retirement.

The public interest is best served by people returning to and thus rejuvenating central city areas, and they are beginning to do so in encouraging numbers – witness the current growth of new residential accommodation in London.

Why therefore should transport and tax policy discriminate against this in favour of dormitory suburbs? At present the taxpayer subsidises commuting: the season ticket holder from Northampton pays just 15p per mile for his travel, whilst the Central Londoner pays on short journeys over £1 per mile. To give tax relief on the 15p whilst denying it on the £1 would add insult to injury.

Yours faithfully,
JIM BOURLET,
Economic Research Council
239 Shaftesbury Avenue, WC2
November 21.

Competency or Democracy from Mr Anthony Kestin

Sir,

Just by way of 'obiter' Henry McLeish told me that he thought Gordon Brown was very brave to hand over Interest Rate Policy to the Bank of England – he himself would have been quite incompetent to deal with this matter. So, it follows, competency rather than popularity (by election) should be the basis of government. Applied to that of the European Union this means that the 'democratic deficit' therein is a matter of little importance. As long as the government of Europe is competent that's all that matters. However, the small problem arises as to who is to be the judge of its competence – not the Commission, as being by far the strongest legislative and executive body in the Union, it would, thereby, be a judge in its own cause – not the Council of Ministers, they are too busy rubber stamping the Commission's legislative proposals, making treaties or 'beefing' over agricultural and other matters. This leaves us with the European Parliament; though it has eyes it lacks teeth to put into effect any judgement it may come to about the competency of European Government. The problem we thus have is compounded by the fact that before the end of the Millennium the European Central Bank will to all intents and purposes be in charge of Europe's economic policy. What body will serve as the European Bank's watchdog to whom the Bank will be accountable for economic policy in Europe?

20 Chichester Street,
Chester
CH1 4AD

NEW MEMBERS

The Council, as always, needs new members so that it can continue to serve the purposes for which it was formed; meet its obligations to existing members; and extend the benefits of members to others.

Members may propose persons for membership at any time. The only requirement is that applicants should be sympathetic with the objects of the Council.

OBJECTS

i) To promote education in the science of economics with particular reference to monetary practice.

ii) To devote sympathetic and detailed study to presentations on monetary and economic subjects submitted by members and others, reporting thereon in the light of knowledge and experience.

iii) To explore with other bodies the fields of monetary and economic thought in order progressively to secure a maximum of common ground for purposes of public enlightenment.

iv) To take all necessary steps to increase the interest of the general public in the objects of the Council, by making known the results of study and research.

v) To publish reports and other documents embodying the results of study and research.

vi) To encourage the establishment by other countries of bodies having aims similar to those of the Council, and to collaborate with such bodies to the public advantage.

vii) To do such other things as may be incidental or conducive to the attainment of the aforesaid objects.

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Prospective members should send application forms, supported by the proposing member or members to the Honorary Secretary. Applications are considered at each meeting of the Executive Committee.

APPLICATION FORM

To the Honorary Secretary
Economic Research Council
239 Shaftesbury Avenue
LONDON WC2H 8PJ.

Date ....

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REMITTANCE HEREWITH ....
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NAME OF PROPOSER (*in block letters*) ....
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