# The case for price stability

In the inaugural LSE Bank of England lecture<sup>(1)</sup> the **Governor** discusses the case for price stability. Noting that persistent inflation is very much a post-war phenomenon, he argues that the United Kingdom should not be regarded as an inflation-prone economy. Rather, the inflationary experience of the post-war period resulted from attempts by governments to exploit an apparent trade-off between inflation and unemployment which does not, in fact, exist in anything beyond the short term. The Governor lists many of the costs of inflation—not only the well-known costs associated with perfectly anticipated inflation, but also the distortionary and redistributive effects of unanticipated inflation. Such costs, he argues, arise at any rate of inflation—so it is crucial to settle for nothing less than price stability, which he defines as an annual rate of increase in the published measure of inflation of 2% or less. This is also the lesson from history: some of the most eminent economists of the century stressed the importance of price stability as a way of reducing the amplitude of business cycles. Price stability will only be achieved if the policies aimed at this objective are credible. The ERM was a mechanism which helped build and maintain that credibility, but in the conditions that developed this year it had the effect of leading to an excessively rapid, and potentially damaging, disinflation. The departure from the ERM required a new framework, and one was outlined in the Governor's and Chancellor's Mansion House speeches. A key aspect of this is the Bank's commitment to the publication of a quarterly Inflation Report. This document, will be published in each Bulletin from next February. It will be a wholly objective and comprehensive analysis of inflationary trends and pressures and will set out the analysis in the context of the Bank's overriding commitment to price stability and its view that policy should be directed to that end.

We are at a critical juncture for economic policy in this country. Although the points I shall make today are timeless, recent developments have prompted questions about the conduct and objectives of economic policy. Plainly sterling's departure from the ERM involves a change in the framework within which monetary policy is conducted, at least for the time being. But, as the Government has made clear, it does not imply any change at all in the ultimate objective of monetary policy-price stability not simply as an end in itself, but as a necessary condition for stable growth of output and employment. And I want to take this opportunity to explain to you why we hold so firmly to this fundamental objective. I also want to persuade you that-whether in or out of the ERM-we have an opportunity. An opportunity to demolish the image of the United Kingdom as a second-rate, inflation-prone economy.

I am not going to talk tonight about our immediate policy preoccupations—important and pressing though these are. Rather, this is a lecture about the long run, which is also important. Over the very long run, there is no evidence that the United Kingdom is any more inflation-prone than other industrialised economies. Persistent inflation is a modern phenomenon. In the post-war period, and especially the 1970s and to a lesser extent the 1980s, our record has been far from impressive. But for many hundreds of years (apart from the period of the 'Great Tudor inflation') the price level was stable—in the sense that, although there were periods of rising or falling prices there was a tendency for

(1) On 11 November

the price level to return to its original level. (You can see this in Chart 1.) Even in the inflationary sixteenth century prices rose only by a factor of just under four, whereas since 1900 prices have risen over forty-fold.



This experience has not been peculiar to the United Kingdom. Far from it. The growth of fiat money and the opportunity thereby created for governments to finance spending in an apparently painless manner, led to increasing inflation throughout the industrialised countries of the world. On occasions inflation accelerated so rapidly that the resulting hyperinflations led to political collapse and monetary reform. During October 1923 the Reichsmark fell in value by a factor of 244—an inflation rate of over 20% a day. By the beginning of November of that year the German currency had lost more value in one month than had sterling since the arrival of William the Conqueror. That experience, and the hyperinflation which followed the end of the Second World War, led to the German commitment to price stability. We too should learn from that. Learning by watching is, in this case, surely preferable to learning by doing.

In this country, inflation became a serious problem only after the Second World War. Creeping inflation at an average rate of around 3% a year in the 1950s and 1960s caused concern but little revival in official circles of the traditional view that inflation was a monetary phenomenon. In the 1970s inflation rose rapidly and prices more than trebled. Progress was made in the 1980s with the adoption of firm counterinflationary policies. Nevertheless, we should not forget that prices rose by more between 1970 and 1990, than they had done in the previous 200 years. Some of you here tonight are part of a generation-the inflation generation-which grew up believing that rapid rises in prices were an inevitable feature of a growing economy. I want to persuade you that inflation is not a natural condition. Far from it. It is a condition which derives from a combination of outdated economic theory and flawed policy implementation. And now that both theory and practice have been immeasurably improved, it is a phenomenon which should be confined to the history books once more.

## **The Phillips curve**

The failure of policy in the early post-war period was to assume that it was possible to reduce unemployment by accepting some upward pressure on the price level. The role of policymakers was to specify the rate at which they were prepared to trade higher inflation for lower unemployment. Models of the economy would then tell them the optimal values of the instruments—monetary and fiscal—to achieve the preferred combination of objectives. At first the empirical evidence appeared to support this view. In a famous article, Bill Phillips—an LSE economist himself showed that the rate of increase of wages in the United Kingdom was inversely related to the rate of unemployment. Governments, it seemed, could choose at which point on this 'Phillips curve' they wished to operate.

But events did not prove so simple. Attempts to exploit a trade-off between inflation and unemployment led to increasing rates of inflation, the costs of which, by the 1970s, were only too apparent. Over time the apparent trade-off between inflation and unemployment deteriorated. If we divide the UK post-war experience into discrete decades and compare the Phillips curves for each decade separately, it is possible to see that there is some short-run trade-off between inflation and unemployment within each period (see Chart 2 opposite). But over time the curve has shifted outwards. And if we were to plot the whole period

on a single chart we would find an apparently random pattern, with no significant correlation between inflation and unemployment. In other words, the attempt to exploit a trade-off has revealed that, in the long run, there is no such trade-off. Whether this is an example of the Lucas critique, Goodhart's Law, or good old Murphy's Law, I leave you to judge. Some have argued that, although there may be no long-run trade-off between inflation and output, in the long run we are all dead, and politics is, after all, merely a succession of short runs. To them I say that each period is also the long run of some short-run expediency of long ago.

## **Lessons from history**

The events of this summer culminating in Black Wednesday on 16 September have been argued by some to mirror closely the events of 1931. The decision that Britain had left the gold standard was announced on Sunday 20 September, the same date, you will recall, as the French referendum this year. Many of the analogies drawn between the events of today and those of 1931 are rather superficial. But it is instructive to ask what the great economists of the time had to say about those events and what were the lessons which they drew for policy from the experience of the boom and bust cycle of the 1920s and 1930s. I should like to draw your attention to the contributions of two great economists of that period, Irving Fisher and Maynard Keynes, arguably the best economists of this century from the United States and United Kingdom, respectively. It is instructive, I think, to observe that they drew the same conclusion. It was that instability in the aggregate price level had been the main source of business cycle fluctuations. They pointed to the experience of the nineteenth century. Unlike some commentators today, they did not draw comfort from the fact that at the end of the nineteenth century the average price level had been the same as that at the beginning. Rather, both Fisher and Keynes argued that the case for price stability had been inadequately understood. It had been unexpected variations in the price level which had led to business cycles, in part because unexpected changes in prices affected the relative positions of debtors and creditors. Fisher was moved to plot a chart of the price level during the period 1860-1932 to show the 'dance of the dollar'. (See Chart 3 on the top of page 444.) Although the price level in 1932 was almost the same as that in 1860, there had been significant variation over that period. He commented that 'this crooked line should some day serve as an inscription on the gravestone of unstable money'.

In two little-known lectures delivered at the London School of Economics in 1921, Irving Fisher pleaded the cause of stability—stable policy and a stable monetary standard. These two sorts of stability were inextricably interrelated, he argued, and he went on to say:

'There is scarcely a nook or cranny in human life which has not been touched and transformed in some degree by this hidden, powerful factor, the fluctuation in the purchasing power of money. It turns the contracts of bond holders and stock holders into a game of heads and tails. It makes a gamble of every contract.'

## Chart 2 The Phillips curve in the post-war period

## Phillips curve 1950–59



## Phillips curve 1970–79













#### Chart 3 'The dance of the dollar'



I cannot resist describing an incident that occurred during Fisher's visit to the LSE to deliver those lectures. During his stay he visited the Bank of England in person to try to redeem a five pound note. He was unhappy with the elaborate fiction, as he saw it, that the Bank redeemed its paper currency in gold. Fisher was referred from one person to another until he reached an official who greeted him with the 'most excruciating politeness and patience' and asked Fisher why he wanted to redeem the note. Fisher asked whether his motive made any difference? 'Oh yes', said the official, 'we are clothed with full powers to ask particulars as to the purpose.' 'I want it as a Christmas present for my wife', responded Fisher. 'I am sorry sir, but the purpose for which you wish the gold is not sufficiently important.' 'For what purpose would you let me have it?' 'Oh, my dear sir, I could not attempt to answer that question.' The conversation continued in a vein that would have made even Sir Humphrey proud, and Fisher departed without his gold. But at his second lecture Fisher spotted the Bank official in his audience. And when an LSE student subsequently visited the Bank she duly returned with her gold.

Irving Fisher conducted a life-long campaign for price stability. In the aftermath of the Great Depression he wrote in 1934:

'It seems to me as inevitable as anything human can be . . . that the world will wonder why so simple a project as stable money should ever have met any opposition.'

And Keynes, too, joined him in a belief that price stability was the key to eradicating alternating booms and slumps. There is no more powerful case for price stability than Keynes' Tract on Monetary Reform. In the preface to that work, Keynes argued that a market economy

'cannot work properly if the money, ... as a stable measuring rod, is undependable. Unemployment, the precarious life of the worker, the disappointment of expectation, the sudden loss of savings, the excessive windfalls to individuals, the speculator, the profiteer—all proceed, in large measure, from the instability of the standard of value'.

And Keynes dedicated that book to the Governors and Court of the Bank of England, who 'now and for the future have a much more difficult and anxious task entrusted to them than in former days'.

One of Keynes' concerns was the need to prevent prices falling. You will recall that prices in Britain fell by almost 10% during 1930. It was stability that Keynes was after and in 1933 Keynes wrote an open letter to the newly installed American president, President Roosevelt, urging him to hold fast to 'a long-range policy of stable prices'. The New Deal should aim to get the economy moving, but not in a way that might prove inconsistent with long-term price stability.

## The costs of inflation

Since the war the economic literature on the costs of inflation has expanded greatly. Many of the costs of inflation are, as Fisher and Keynes believed, associated with its uncertainty, and I will return to this in a moment. But even if inflation were perfectly anticipated there would still be important costs:

- the cost of economising on real money balances (the so-called 'shoe-leather' effect);
- the cost of constantly revising price lists (often referred to as 'menu costs');
- the costs associated with the operation of a less than perfectly indexed tax system; and
- the problems of front-end loading of the real burden of servicing nominal debt contracts.

These costs are well known, and efforts have been made to minimise their effects. Interest is now paid on highly liquid funds; computer technology lowers the cost of changing price lists; the tax system is indexed in a number of ways; and building societies and banks have introduced low-cost start-up loans.

But there are other, much more significant, costs of inflation—those which arise when inflation cannot be anticipated. They fall into three categories. The first is microeconomic in nature and concerns the allocation of resources. The second concerns the distributional effects of unanticipated changes in inflation and the consequent effects on total demand, output and employment. And the third concerns the effort that is directed towards anticipating inflation and offsetting its unwelcome effects.

The *distortionary* effects of inflation go to the heart of a market economy. Unanticipated inflation makes it much harder to distinguish changes in relative prices from changes in the average price level. The traditional theory of efficient

resource allocation, with which you are so familiar, concerns relative prices. But we use money for transaction purposes to avoid the inefficiencies of a Robinson Crusoe economy in which goods can only be exchanged directly. The indirect exchange of goods for money and money for goods greatly enhances the ability of a market economy to exploit the division of labour and to raise economic growth. It is crucial to this process that agents be able to observe the signals which are conveyed by relative prices to increase or decrease investment in particular productive activities. And it is relative not absolute money prices which perform this function. It is important, therefore, that agents be able to distinguish between relative and absolute price changes. The empirical evidence suggests that high rates of inflation tend to be associated with a greater degree of relative price variability. But that observation could be consistent with a common factor (such as energy prices) driving both inflation and relative price variability, or even with relative price variability giving rise to inflation. Some recent work, for example, suggests that where the distribution of price changes is skewed (that is, owing to menu costs, large price changes are more likely to be made than small ones), large changes in relative prices may shift the aggregate price level. Despite the ambiguous nature of the evidence, it seems highly likely that relative price signals will be confused by inflation—especially if it is high and variable. This strikes at the heart of a market economy, in which money pricesof goods, capital and labour-are a signal to the efficient allocation of resources.

Identifying changes in aggregate, rather than relative, prices is most important in distinguishing between nominal and real rates of interest. In an inflationary world, investors and savers cannot know the real interest rate, or rate of return, with any degree of certainty. This makes for inappropriate investment decisions and could have significantly adverse consequences for growth. It is the real interest rate against which firms must measure the likely return on their investments. It is the benchmark on which asset valuations are based. It is the means by which capital can be best directed towards the most profitable investment opportunities. If we do not know-or cannot estimate-the real interest rate, then many of our longer-term decisions will be no more than houses built on shifting sands. When the Bank publishes figures for the term structure of nominal interest rates, it is seen as an exercise in statistical reporting. When we publish figures for real interest rates, they are, quite rightly, regarded as speculative estimates and subject to wide margins of error. When inflation is unpredictable, the real rate of interest loses the simplicity of a Greek symbol in an economist's equation, and becomes a major source of uncertainty.

The second type of cost is the loss in output and welfare resulting from the distributional effect of unanticipated changes in inflation. Sharp variations in the price level from that which was expected can have a major impact on the distribution of income and wealth, notably between debtors and creditors. An unexpected rise in inflation reduces the real burden of debt and damages creditors. Similarly, an

unexpected fall in inflation or the price level increases significantly the burden on debtors and reduces that on creditors. The essence of inflation is that it is a tax on financial wealth. This has long been understood in terms of the seigniorage revenue earned by government on the issue of fiat currency. In practice, however, seigniorage is rarely a major source of government revenue. And it is unpredictable inflation that leads to the largest redistributions of wealth. It is difficult to imagine how a market economy based on private property could long survive a system in which the government levied a wealth tax at an unpredictable-almost a random-rate. Yet this is precisely what happens when there is no commitment to price stability. Like theft, inflation is just the redistribution of income by stealth. We do not permit the one, so we should not encourage the other.

In a world of variable inflation it should not be surprising that firms are more willing to invest in projects with short-term pay-offs. Uncertainty about inflation is likely to discourage agents from entering long-term monetary contracts, and will thus remove the assurance that such contracts are designed to provide, in the context of investments where the pay-off period is long. The use of floating-rate borrowing (which is equivalent to shortening the effective duration of contracts as inflation increases) may reduce uncertainty about the real value of interest payments over the lifetime of the contract, but it also removes the possibility of hedging against future movements in the real rate of interest. Inflation will tend to reduce the rate of investment by companies and to lead to investment in short-term assets. And savers and lenders may respond to uncertainty by demanding a risk premium, thereby increasing the real cost of funds for borrowers.

Given the cost imposed by high and variable inflation, it is no surprise that considerable effort is expended to hedge against its effects, or to anticipate it more accurately. The resources thus expended could be put to more productive use if there were price stability. As I have already noted, even when inflation is known with certainty, there are costs associated with changing prices and disseminating information about such changes, and with conducting annual wage rounds. The distortions which arise from variable inflation encourage individuals to find ways round them, or ways to exploit them. Such initiative and ability could no doubt be put to uses far more beneficial to society as a whole, but no less profitable to the individuals, in a world of price stability.

The current state of the housing market affords a good example of the costs of obtaining information about inflation. It is difficult at present for sellers of houses to know exactly what price they should be willing to accept. Sharp changes in the rate of inflation—and the associated uncertainty about changes in the average level of house prices—make it very much more difficult for buyers and sellers to know an appropriate price for a particular dwelling. It is hard to believe that this effect has not significantly reduced turnover in the housing market and reduced the efficiency of that market itself. I have heard it said that the housing market will not recover without a bout of inflation. I must say that, in the long run, it is more in need of a bout of price stability. For we must ensure that we never again experience the boom and bust cycle which has caused so much misery, to so little purpose.

## Why not settle for 5%?

Many of the costs of inflation to which I have drawn attention concern the *unpredictability* or the variability of inflation. Because of this it has been suggested that we should rest content with an inflation rate of, say, 5% a year, and not attempt to reduce inflation further. This, I believe, is completely to miss the point. It is certainly true that if we could be confident that inflation would every year be exactly 5%, no more no less, then I would find it difficult to convince you that the economic costs of inflation would be large. But equally there would be absolutely no reason to continue with a monetary unit whose value in terms of goods and services were to decline by precisely 5% a year. For money is a measuring rod, a standard by which we judge the value of goods and services in transactions. Consider an example closer to home. Just suppose that each evening you were to visit the LSE bar and consume a pint of beer to recover from the rigours of the day's lectures. And suppose that the size of a pint were to shrink by 5% a year. Does that mean that LSE would become a more sober place? Not at all. I am quite confident that you would quickly adjust to the fact that to satisfy your thirst you would need to order 1.05 pints next year, and 1.10 pints the year after that and so on. But it is obvious that in such a situation we would stop using the traditional pint as a measure of volume. We would start using the new LSE pint which would be defined as the traditional pint adjusted by 5% a year in order to maintain a stable standard of capacity.

The same is true with money. If money were to decline in value by precisely 5% a year then we would simply change the unit in which we were to denominate transactions. Indeed, this observation has, over the years, led some economists to advocate a commodity standard for money. But the main point is that the choice is not between zero inflation and a stable rate of 5% a year. If we could achieve the latter then we could surely achieve the former.

I know there are some who argue that the costs of disinflation, especially when inflation is low, outweigh the benefits of price stability. Consequently, they argue, we should settle for low and stable inflation. I am afraid I do not believe that such an option exists. Whenever inflation is viewed as acceptable, it is possible to settle for an alternative rate which is just a little higher. The end result is an inflation rate which is high and rising, and which is costly to reduce. It may even be that in societies where inflation is tolerated, disinflation becomes more costly because of the need to extinguish long-held expectations of inflation. There are countless examples among the industrialised economies of once apparently stable inflation rates rising sharply, and the disinflationary episodes which follow are always painful. Given that there is no long-run advantage to the tolerance of inflation, the arguments for settling for nothing short of price stability would appear to be overwhelming. The simple choice is thus between a variable and unpredictable inflation rate caused by instability in monetary policy, and a more stable monetary policy framework that delivers price stability.

What, then, is price stability? The essence of price stability is conveyed by the now familiar quotation from Alan Greenspan that:

'For all practical purposes, price stability means that expected changes in the average price level are small enough and gradual enough that they do not materially enter business and household decisions.'

This definition conveys the essence of what is meant by price stability—namely that the rate of inflation anticipated by economic agents is unimportant to savings, investment and other economic decisions. Such a definition does not imply any particular precise value of inflation as measured by a specific index. Inflation is a rise in the general price level. Indices of inflation as conventionally measured report the rise in the cost of a particular basket of goods and services. There are as many definitions of such a basket as there are members of this audience tonight. Nevertheless, it is helpful to provide some idea of the order of magnitude of measured inflation by which the authorities would judge their success in achieving price stability.

I welcome, therefore, the announcement by the Chancellor that by price stability he means a rate of inflation—as measured by the RPI excluding mortgage interest payments—of 2% a year or less. There is one very good reason for not aiming at 'zero inflation' as measured by such an index. Despite the valiant attempts of our statisticians to correct observed prices for changes in the quality and availability of goods and services, there is no doubt that some aspects of both are ignored by these calculations. Estimates for the United States suggest that the inability to adjust fully for quality changes may have added around 1<sup>1</sup>/<sub>2</sub>% a year to the growth of consumer durables prices between 1947 and 1983.

## The challenge for policy

Following our recent exit from the ERM, we shall now have to follow the road of price stability without formal external guideposts. In concluding my address tonight I should like to expand a little on how the recently announced changes in the framework for policy will enable us to do that.

In a famous remark, Milton Friedman said that inflation was always and everywhere a monetary phenomenon. In the immediate sense he was of course perfectly correct. Inflation is an erosion of the value of money. The appropriate policies to eradicate inflation are monetary policies. But it is worth going a little deeper and asking why it is that governments accommodate inflation. It is, I venture to suggest, because inflation is symptomatic of a much deeper and more difficult problem, namely the allocation of scarce resources among alternative uses and the distribution of income among competing groups. It is never easy, either individually or, even more so, collectively, to face up to the fact that there is no free lunch. It is possible to fool some of the people for quite a long time, and many of the people for quite a short time. And inflation can, for a while, conceal the nature of the choices that have to be made. As Henry Wallich has written, 'Inflation is like a country where nobody speaks the truth'. That is why there is a moral element to controlling inflation. Inflation is about the *honesty* of government policy.

Understanding the political aspects of inflation is of considerable importance in ensuring a return to price stability. That is why I am particularly glad to be delivering this lecture to the London School of Economics *and* Political Science. And it is essential for us to think carefully about the institutional arrangements for the conduct of monetary policy. Because expectations influence economic behaviour, it is not only current but also anticipated future policy actions that affect the economy. Policy therefore has to be seen as a strategy, not a series of isolated tactical decisions.

Governments that are tempted to behave in a short-sighted manner follow policies which economists describe as 'time-inconsistent'. By this is meant that the policy action which the government claims it will take at some future date will not in fact be carried out at that date by a government pursuing its own interest. *Ex ante*, governments are better off by promising not to generate inflation—people thereby save and invest and are willing to buy government debt at lower interest rates. *Ex post*, however, the government gains in the short run from breaking these promises. The solution is for the government to pre-commit to a policy of price stability. But mere promises are not credible. Mechanisms to create credibility are, therefore, valuable additional policy weapons. Like Ulysses, it pays to tie oneself to the mast.

The ERM was one such mechanism. But-in the particular circumstances following German reunification-it became very much a double-edged sword. It certainly offered a very visible sign of our commitment to price stability-a sign that could be easily understood, and which would thus influence favourably expectations in the private sector. But an increasing divergence emerged between the domestic policy needs in Germany and elsewhere in Europe, including in this country, and this was forcing us into unduly rapid disinflation. There was a real risk of these disinflationary forces doing quite unnecessary damage to the real economy. Although we would have achieved price stability very quickly-indeed there is reason to believe we might have reached that position during 1993-there was a real danger that the deflation which was already apparent in certain sectors of the economy (notably asset markets) would have become much more widespread. It was not necessary to compress the transition phase to price stability into such a short time span and could well have been counterproductive in the longer term. Our concern, instead, was to achieve that transition more gradually at lower economic cost. The

ERM, when we entered, seemed to offer that possibility. And for the next eighteen months or more, it contributed to that end. But, the growing divergence between the monetary policies appropriate to Germany following reunification and ourselves with the legacy of high debt burdens, meant that the costs of rapid transition became unacceptably high.

Departure from the ERM has signalled the need to put in place an alternative mechanism for building and maintaining the anti-inflationary credibility of policy. Experience leads us to believe that policy cannot be conducted with reference to a single target variable. The overriding objective of monetary policy is price stability. Therefore policy must be conducted with reference to our expectations of future inflation. There is no reason to suppose that one indicator is everywhere and always a superior indicator of potential inflationary pressures. The information content of economic data will change as economic circumstances change. Consequently, policymakers should make use of every possible variable, with the importance attached to any given variable at any point in time dependent on its value as a guide to prospective inflation. But in such an eclectic framework it is possible for the underlying rationale of policy to be lost in a welter of statistical confusion. That is why we have opted for a policy of openness.

The Chancellor and I, in our Mansion House speeches, outlined new steps to enhance the degree of public scrutiny of public policymaking. From the Bank's point of view the most significant of these is our commitment to the regular, quarterly, publication of a report on inflation. I am pleased to announce tonight that the first issue of the Inflation Report will be published in February in our Quarterly Bulletin but it will also be available separately. The Report will offer a comprehensive guide to inflation. It will discuss in detail the past performance of a number of measures of inflation. And it will analyse, within a well-specified economic framework, the behaviour of the key determinants of inflation. It will not be restricted to discussion of the past. In order to arrive at well-informed policy decisions we must also take account of likely future developments, in both the short and medium terms, especially in the light of our own actions. The Report will do precisely that. Our aim will be to produce a wholly objective and comprehensive analysis of inflationary trends and pressures, which will put the Bank's professional competence on the line. Of course, when our Report is published there may be those who will disagree with our economic analysis. And we shall invite our critics to join in a debate on these technical matters. What will never be in dispute, however, is our overriding commitment to price stability, and our unwavering effort to direct policy to that end.

You may feel that these changes do not amount to much. But I can assure you that, while they may appear to be a small step for Britain, they are a giant leap for the authorities. They go some considerable way in making policy more open and accountable to both Parliament and the public.

## Conclusion

I began by noting that policy had reached a critical juncture, and I have explained to you why we believe price stability is essential to the efficient functioning of our economy-even although at times such as these it may be tempting to question our ultimate objective. But let me reassure you that we are well on the way to achieving that objective. Indeed, the rapid progress we have made persuaded us that policy could be eased in the short run without compromising our goal. But let me also assure you that if this easing of policy were to begin to threaten our goal of medium-term stability, we would have no hesitation in reversing it. We intend to escape from the boom-bust cycle of previous years. So no one should believe that easier policy now necessarily means easier policy forever. What we need is a national consensus that inflation is not something that we must live with or accept, but that price stability is both achievable and desirable. And if people plan on that basis, we can all look forward to a more stable economic environment in the future.

I hope you will allow me to conclude with a quotation from a distinguished economist and former director of the Bank of England. It was Sir Josiah Stamp—incidentally another LSE graduate and later Chairman of the Court of Governors here for twenty-six years—who wrote the following in his introduction to the English edition of Irving Fisher's book *The Money Illusion*:

"Money, as a physical medium of exchange, made a diversified civilisation possible . . . and yet it is money, in its mechanical even more than its spiritual effects, which may well, having brought us to the present level, actually destroy society."

The founders of this great School set up the LSE to promote, in the words of Beatrice Webb, 'hard thinking'. I hope that I have cc. vinced you that hard thinking does not lead to the conclusion that inflation is yesterday's problem. I sincerely hope that in years to come *my* successor will be able to come here and address *your* successors not as the inflation generation, but as the generation who achieved stable prices and stable policies, and, as a result, were able to direct their talents towards the wider economic and social policies that are so important to our country, and from which our attention has so often been diverted by the need to control inflation. Indeed, in a world of price stability you might not think of inviting the Governor of the Bank of England to address you.