Inflation

In a speech to the Cardiff Business Club on 4 October 1993, the ***Deputy Governor*** *cautioned against declaring victory over inflation. Monetary easing might give a temporary fillip to the economy but would, in the long term, feed through to inflation which in turn would be damaging to the real economy. He warned against allowing this sequence to be repeated; amongst other things, future growth and jobs depended on keeping a constant guard against inflation.*

You will not be surprised to hear that tonight I want to concentrate on inflation. Nobody can doubt that, since 1990, we in the United Kingdom have made encouraging progress in reducing inflation. Enough, certainly, to justify a small glass of something, but not nearly enough for a party. It is too easy to misunderstand or misconstrue the nature of what has been achieved, and therefore all too easy to underestimate how much remains to be done.

It is almost a year since the government set itself a firm target for inflation. Now, an inflation target may seem like little more than commonsense, but we had never had one before. Over the years, targets have been set for several different measures of monetary growth, and for public borrowing, and for the exchange rate—not for their own sakes, but in the belief that they would, in due course, affect or determine the inflation rate. But defining the target in terms of the target—that was new.

We are now beginning to see the merits of novelty. With an explicit target range for inflation, there is nowhere for policymakers to hide: we are going to be judged by what we produce, and we cannot blame the tools we use. The task is simple and clear. In the words used by the Chancellor at the time: 'For the remainder of this Parliament, I propose to set ourselves the objective of keeping underlying inflation within a range of 1%–4%, and I believe by the end of the Parliament we need to be in the lower part of the range'.

But simplicity and clarity were not the only new ingredients added last year. The government also asked the Bank of England to report regularly on the outlook for inflation, and to publish its views. This we do every three months, in our *Inflation Report*, and we take this responsibility extremely seriously. The *Inflation Report* is our best judgment of what will happen to prices over the next 18–24 months. We base that judgment not on any narrow reading of the behaviour of a particular indicator or group of indicators, but on an analysis of a catholic collection of data. We look at various measures of the money supply; we look at figures on prices of many kinds, on wages and on earnings; we look at international conditions; we look at many variables from the real economy—output, sales, employment and so on; we look at the exchange rate.

The result, as I say, is a judgment; it is not science. There is quite enough evidence from the past to show that, in this field, there is no such thing as 'hard science'. Experience, intelligent interpretation, a fierce objectivity—these are the qualities the Bank brings to bear, and we would be falling down on our duty if we did anything less.

It is still too early to judge how well this approach will work. So far, however, the three *Inflation Reports* we have published have all pointed to inflation remaining below the 4% ceiling. And the markets seem to be encouraged by the long-term prospects: yields on twenty year gilts have fallen by more than two percentage points since the new arrangements began, and now stand at their lowest level for 26 years. So why do I nonetheless argue for caution rather than celebration?

Part of the answer lies in the past, and part in the future. History is full of examples of people declaring victory over inflation, only to be swept aside a few years later by a new army of price rises. It is worth reminding ourselves that, in the four years 1958–61, inflation in the United Kingdom averaged only 2% a year. By the end of the 1960s, though, it was up to 5%. And in the 1970s, the average annual rate was 13%.

By the end of the 1970s, popular opinion—and therefore political opinion—had moved strongly against inflation. The rate peaked at 22% in May 1980, but firm macroeconomic restraint brought it down to 4½% a year in the five years 1983–87. Yet it was towards the end of that time, when the country had a government with a genuine loathing of inflation, that the next surge was being put in place. In 1989, retail prices rose by 7¾%, in 1990 by 9¼%. Surely that episode is enough to convince all of us that there is no such thing as 'final victory' over inflation. Few countries succumb to hyper-inflation, thank heavens, but all are prone to hydra-inflation.

The future, too, gives cause for caution. To repeat one part of the Chancellor's inflation target, we are seeking to get down to the 'lower part of the range'—that is, to 1%–2½%—'by the end of the Parliament'—that is, just a few years from now. In my view, this second bit of the target matters more than the initial 1%–4% range. It is only through progressive reductions in the inflation rate that people will come to believe that another surge is not just around the corner—and it is only then that the full benefits

of stability will come through in the form of better investment decisions, greater equity between savers and borrowers, and significantly lower long-term interest rates.

So it is right that 1%–2½% should shortly come to be seen as the true target, and 1996 or 1997 as the true timetable. But it would be quite wrong to pretend that these next few years will be simple. Getting inflation down by a couple of percentage points is much harder to achieve when the rate is already quite low than it is when inflation is at 10% or so. We have had the easy bit. Now we must prepare for the hard part.

That sort of remark is often met with a groan. Central bankers can easily be caricatured as killjoys, whose actions hold back economic growth and damage employment. Anybody who makes that charge is, I suggest, either seeking a scapegoat for mistakes made elsewhere or is fundamentally mistaken about the nature of economic growth. I am opposed to inflation for many reasons, but above all because I am in favour of growth and jobs and a dynamic economy. It is inflation that is the true killjoy.

This argument needs exploring a little, and I can best elaborate by referring not to some abstract and arcane theory but to the down-to-earth reality of economic experience in many countries over many years. In the United Kingdom itself, the fundamental cause of the recession we suffered in 1990–92 was not recession elsewhere in the world, or membership of the exchange rate mechanism, or any other diagnosis that relies on coincidence of timing. We had recession in 1990–92 because we had rising inflation in 1989–90; and we had rising inflation in 1989–90 because we allowed demand to grow too rapidly in 1987–89. That was the simple, crucial sequence, and it had happened before in 1978–82 and before that in 1972–76. Give or take a few years, the same sequence has happened in varying degrees in almost every OECD country, and in dozens of developing countries too.

The sequence—excessive expansion, rising inflation, then recession—is itself based on a fundamental truth about economic behaviour. There is no doubt some temporary fillip to be had from letting go of the monetary reins; for some months, perhaps for a year or two, economic growth speeds up and unemployment falls rapidly. But these benefits are purely temporary. The only long-run effect of excessive monetary ease is on prices, in the form of rising inflation. And that then has poisonous effects on the real economy, because it distorts incentives and creates all kinds of uncertainty, which then inhibit productive investment. Sooner or later, its disruption must be brought to an end. The longer a country, or a government, or a central bank, refuses to act, the more will inflation accelerate. Many governments have recently come to accept this fact; here we discovered the truth in the 1970s, which is why we have lowered the peaks of inflation in three successive cycles.

I draw some comfort from that, but not much. The reason is that even the relatively mild inflation of 1989–90 had painful consequences. Every sequence of excessive monetary expansion and rising inflation has ended with damage to the real economy: jobs lost, firms bankrupted, hopes dashed. It is precisely because recession is such a brutal business that the sequence should never be allowed to begin. Anybody who, as I do, wants the flame of growth and jobs to burn brightly in this country should be on 24-hour guard against inflation.

At the Bank of England, we have such a guard. When I joined the Bank earlier this year, I soon came to realise that I was joining a place where there is often vigorous internal debate about the right means to achieving particular ends. On some issues, there is also disagreement about just what are the right objectives of policy. On inflation, however, there is remarkable unanimity.

All the senior people in the Bank believe that inflation's roots lie in excessive monetary expansion. We all believe that inflation is deeply damaging to the real economy of jobs and output and spending and growth. We all accept that the way to avoid that damage is through monetary restraint. And we are all determined to ensure the proper restraint: not just now, not just tomorrow, but for many years to come.