Chapter 9 Controlling Inflation; How Successful Can Lawson's Policies Be ?

Raymond Doody & Colm Ryan

Introduction

The U.K.'s current Chancellor of the Exchequer, Mr Nigel Lawson, has, if nothing else, learnt one very important lesson during the last six months. Success, just like failure, can bring a multitude of problems and a tide of criticisms upon those responsible for it. Ten years of Conservative government, which promised to 'roll back the frontiers of socialism', has seen a transformation of the British economy. Unemployment is falling, real growth and income levels have been consistently rising, many firms and industries are operating at, or close to, their productive capacities, taxes on income have been reduced and, in next month's budget, Mr Lawson has a budget surplus in the region of £14bn, partially due to the successful privatization of many public utilities over the last four years.

However, despite being at the helm of such a flourishing economy, Mr Lawson is unlikely to have many fond memories of this past summer nor, indeed, is he likely to relish the months to come. The last eight months have seen the re-emergence of every monetarist's worst nightmare, inflation, and current monetary policy in Britain has concentrated almost entirely on reducing both it and the sizeable current account deficit on the balance of payments that has developed over the last year in the U.K.

Inflation is like a small helium balloon; once your grip on it is lost, it tends to rise very quickly and becomes very difficult to retrieve. While the British economy is at present only feeling minor inflationary tremors, Mr Lawson has been intent on ensuring a halt in the upward trend of the retail price index (R.P.I.), the main statistical measure of inflation in the U.K.

This paper has been written at a time when Mr Lawson has come under quite heavy criticism, firstly for allowing the economy to overheat to the extent that inflation has once again become a threat to its well being, and secondly, for his reliance on the raising of short-term market interest rates to dampen consumer demand in order to reduce the overheating in the economy and, hence, bring down inflation and eliminate the trade deficit that Britain is currently running. This paper has two main purposes. Firstly, to illustrate why inflation has re-appeared in the U.K. economy and how it has manifested itself, and secondly, to discuss and comment on the methods which can be used to combat and control such an inflationary surge.

We will analyse the mechanism by which interest rates work to alleviate inflationary pressures in the economy and the advantages of such a policy viz-a-viz its main alternative, namely a policy of fiscal rectitude in the form of an increase in taxes.

Why the surge in inflation?

The first possible cause of the present inflationary surge is rooted in the stock market crash of October 1987. The unprecedented fall in stock prices eroded peoples wealth. The authorities, believing wealth was a vital component of demand, feared a depression on the scale of the 1930's. Thus, in an effort to avoid a 'second great depression', they flooded the market with liquidity in order to keep consumer demand buoyant. However, we believe the monetary authorities

overestimated the effect of real wealth on expenditure patterns. The 'crash' must be viewed in the context of the previously inexorable upsurge in share prices and the relatively small proportion of wealth held in equities viz-a-viz a booming real estate market. In fact, post-crash share prices were only marginally lower than those at the start of 1987. Secondly, 75% of stock exchange investment is institutional. Thus, the effect of the crash on the consumer was not direct.

Nevertheless, the monetary authorities, fearing recession, flooded the market with high powered money. In hindsight, this turned out to be an over-reaction. The increase in liquidity more than compensated for the minor erosion in people's wealth during 1987. This was a mistaken monetary stimulus to the economy. In the Chancellor's own words, "the loosening of monetary policy in the wake of the stockmarket crash, with the benefit of hindsight lead to subsequent difficulties" (1).

A subsequent inflationary stimulus to the economy came from the Chancellor's own March budget of 1988. Buoyed by a massive budget surplus, he decided to implement widespread tax cuts. Indeed, he went so far as to reduce the highest British marginal tax rate from 60% to 40% and the standard rate to 25%. One of the few areas of agreement between Keynesians and monetarists is that consumption is inextricably linked to income, be it current or permanent. Thus, the effect of the Chancellor's budget was to increase the consumer's disposable income, thereby providing a dramatic fiscal stimulus to the economy.

Although it seems almost paradoxical, the current British budget surplus is also providing an inflationary stimulus to the economy. The current surplus for fiscal '88 is in the region of £14bn. Thus, instead of the now notorious P.S.B.R. that we run in Ireland, Britain has the opposite, a public service debt repayment (P.S.D.R.). Thus the Bank of England is able to redeem much of the government debt at the short end of the gilt market, financed by the budget surplus instead of the usual method which is the issue of gilts at the long end of the market. The net effect of these redemptions is similar to an 'open market operation' purchase of gilts, i.e. it increases the stock of high powered money in the economy.

A fourth and fundamental reason for the present inflationary pressures is rooted in a change in consumers' tastes and preferences. The savings ratio in Britain has fallen substantially over the last decade. This savings ratio is a net concept composed of two components.

Firstly, there is gross savings, i.e. money lodged in deposit accounts and building societies. The tendency to save has fallen recently. This means that more income is being spent currently, rather than being saved and used for consumption in the future. The effect of such a fall in gross savings is increased current consumption demand.

The second component of this 'net savings' concept is borrowing. Lending by the banks in July of 1988 reached an all time high of £9bn. Thus, the public are obviously willing to bear the risk of adapting a more leveraged position. As Alan Budd put it, "the mistake was the failure to recognize the extent to which people were prepared to borrow to finance their spending" (2). This tendency to borrow was further fuelled by the deregulation of financial services. This resulted in increased competition among financial institutions which were almost "tripping over one another" to lend the consumer money. Hence, if a consumer wanted to borrow, he had no difficulty in finding a willing lender. Thus, the fall in gross saving, accompanied by the rise in borrowing, led to more money being available for current spending, resulting in increased demand and rising prices.

The fifth, and final, reason for the current inflationary tendency would come under the umbrella of what would be termed 'wage inflation'. For reasons stated previously, demand was booming. Firms were pushing on their production capacities. Skilled labour was becoming more difficult to find. These were ideal conditions for employees to seek wage increases. Profits were high and so increased labour costs would not hurt. Also, management were reluctant to risk industrial action when demand was high. In the year to June 1988, average manufacturing wages rose by 9%. Thereafter, inflation meant that employees sought pay increases to meet projected future inflation rates. Such a situation was rather like putting the 'cart before the horse'. However, whatever the reasoning, the effect was indisputable. Increased disposable wages led to increased demand which pushed prices up. This led to claims for wage increases to keep pace with inflation and so a vicious circle was created.

It soon became apparent that the monetary conditions had now been laid for an inflationary spiral to occur. Money supply statistics reinforce the viewpoint that monetary conditions were now out of control. M_0 grew by 12% in the year to July 1988. Although this was curtailed later in the year, to a growth rate of 7.7% for the year to December 1988, such figures are still outside the target growth rate of 1% to 5%. Broader monetary measures, M_1 and M_3, grew by 17.6% and 22.0% respectively. These monetary stimuli meant the consumer now held more cash balances than he desired. The monetarist framework of the economy holds that consumers will tend to rid themselves of their excess cash balances by increasing expenditure. This leads to an increase in demand for a wide spectrum of goods and services. Figures show that real consumer demand was far outstripping real G.D.P. growth. Some have put the divergence between the two as high as 3%. Clearly, consumers' increase in demand relative to supply must lead to inflation.

The most obvious manifestation of this rapidly expanding demand lies in the Balance of Trade figures. Department of Trade and Industry (3) figures for 1988 show a trade deficit of £14.3bn or approximately 3.5% of G.D.P. This represented a fivefold increase in the deficit for 1987. The reasons for this are clear. Firstly, there was an increase in the level of imports to meet the excess demand that domestic industry could not meet. Secondly, domestic producers switched production, intended for export, to the domestic market, as higher prices could be obtained on the home market due to the unprecedented demand. Thus, rising imports and falling exports meant a rapidly widening trade deficit traceable to the original monetary stimuli given to the economy.

Interest rate curbs and their logic

Margaret Thatcher had swept to power in 1979 promising to fight inflation. Nine years later, that same Conservative government could not, either from an ideological or political viewpoint, stand idly by and watch inflation spiral towards double digits. In April 1988, the Chancellor, realizing that the inflationary pressures would not magically disappear, decided to do something. The chosen method of control (for reasons that will be explained later) was interest rates.

We see interest rates controlling inflation through three main channels. The first and most immediate way that higher interest rates help to lower inflation is through borrowing and lending. Increasing base rates mean that the opportunity cost of spending money now, rather than later, has increased. This fact does not merely apply to money put on deposit in the bank but to a broader range of

financial assets. Thus, raising interest rates creates a greater incentive to save or invest in certain types of financial assets, thus meaning that less money is spent currently and hence reducing upward pressure on demand/prices.

Higher interest rates also reduce the attractiveness of borrowing to finance expenditure. In their choices, consumers weigh up the utility/return they will derive from the consumption of goods or services. If they are borrowing to finance any purchases, then it is the net return that is all important; higher interest rates reduce this net return.

Interest rates also work through 'squeezing' those who have mortgage interest payments to make. Higher base rates mean higher mortgage rates. Thus, the home owner who has financed his house purchase by mortgage finds himself having less discretionary income to spend on goods and services. Early on in the summer of 1988, mortgage rates stood at 9.5%. They now are in excess of 13%. What better way to curb spending, and hence inflation, than by reducing funds available for consumption?

Higher interest rates also have an effect on the business sector. Those companie's that are highly leveraged (i.e. have a high debt/capital ratio) are now faced with making higher interest rate payments on their flexible interest debt capital. This leads to profits being 'squeezed'.

Business profits are also squeezed from another direction. Higher interest rates mean that internationally mobile funds are attracted to London because of the higher returns available there. These investments have to be made in sterling. This creates a high demand for sterling, pushing its price upwards viz-a-viz other currencies. Higher exchange rates adversely affect businesses. Those producers involved in the export trade find their produce less competitively priced abroad. Also, foreign substitutes for domestically produced goods are now cheaper on the home market. The combined effect of uncompetitive exports and incresingly competitive imports squeezes the profits of many British companies.

But how does this squeeze on profits through higher interest rates and a stronger exchange rate help curb inflation? Management has to make a 'satisfactory' profit on capital invested to the owners of the company. In booming times, when demand is high, this is no problem. However, if demand is squeezed a little, management seeks ways of reducing costs. Thus, they will show a greater resolve to resist employee wage claims. This breaks the vicious wage-created inflation circle, where higher wage settlements lead to inflationary pressures which lead to claims for even higher wages.

Having discussed the re-emergence of an inflationary threat in the U.K., and the mechanism by which interest rate rises work to curb this phenomenon, we now wish to examine the rationale behind this choice of policy. The claim that raising interest rates reduces inflationary pressures has been so often repeated by members of the British government that it is difficult not to consider it a self-evident truth. However, there are other policy options open to the Chancellor which many economic commentators feel would halt rising inflation in a faster and less painful manner, and it is to these alternative combative measures that we now wish to turn our attention.

With inflation currently running at 7.5% in Britain the Chancellor currently has three main priorities. Firstly, he must reduce consumer expenditure by a significant amount in the next six months. The root of the U.K.'s current inflationary problem lies on the demand side of the economy. To achieve a simultaneous reduction in the rate of inflation and an improvement in the trade

deficit, domestic demand has to grow by less than the economy's productive potential. While long-term sustainable growth for the U.K. is estimated to be about 3% per annum, domestic demand has been growing at a rate in excess of 7% per annum (4), and it is excess consumer demand that is responsible for the upward pressure on prices. The Chancellor's second priority is to induce a reduction in the growth of the Treasury's targeted money supply, M_0, since it has been growing at an excessive rate and adds to inflationary pressures in the economy. Thirdly, Mr Lawson will want to halt any upward trend in wages since it will stop the vicious circle of rising prices and wages which leads to an upward spiralling of the inflation rate.

In choosing to raise interest rates as a policy measure to counteract rising inflation, Mr Lawson has made it clear that the re-imposition of credit control in the U.K. economy is not a policy under consideration for solving its problems. Controls to limit excessive credit expansion normally take the form of credit ceilings on loans, or taxation of debt, or interest, repayments. However, credit controls are extremely difficult to maintain and are rarely leak-proof. Aggressive financial institutions almost always find ways of working around controls which limit the amount of credit they can issue and this has the effect of distorting many of the economy's most important statistical figures. Another factor working against the introduction of credit controls on financial institutions in the U.K. is the fact that, as E.C. countries approach 1992, Mr Lawson is anxious to avoid adversely affecting the competitiveness of British banks and financial houses viz-a-viz their main European counterparts.

Where criticism of Mr Lawson should be directed is at his failure to get to grips with the overheating of the U.K. economy early on. Signs of credit-financed overheating in the U.K. economy should have been recognized and dealt with at much earlier stage than was the case. 1988 has been a torrid year for Mr Lawson's economic forecasters. Between March and October of last, year the Treasury's yearly estimate for the current account deficit on the Balance of Payments was more than trebled, and monthly forecasts for the trade deficit since then have continued to be over-optimistic.

It is only recently that the Treasury seems to have realized the significance of the problem it is now facing. The appetite of the British consumer is proving extremely difficult to quell and, while Mr Lawson warned the public that a tightening of monetary policy in the form of interest rate rises would take time to dampen demand, he now seems slightly mystified as to the appropriate tightness of policy in the light of a continued worsening of inflation figures. His most recent increase (to 13%) of short-term interest rates would seem to indicate that he does not believe that seven successive rises during the summer months have had an adequate deflationary effect on the economy.

This paper will now examine the question of future economic policy in Britain. In the light of recent economic developments and the forthcoming budget in March, should Mr Lawson review the question of fiscal policy in the form of tax increases as a means of curbing consumer expenditure and rising inflation? This is the principal policy alternative to interest rate increases and seems to be gathering support among many economic commentators in Britain.

The National Institute, in a recent review of economic policy in the U.K., took the view that deflation through higher tax takes would be better than deflation through higher interest rates since it would be less damaging to investment in the

long-run (5). A recent test of this proposition was carried out by Professor Alan Budd on the London Business School model of the U.K. economy (6). His results proved quite interesting. He found that while high interest rates bear more heavily on consumption rather than investment in the short-run (though not in the long-run), and while income taxes increases bear more heavily on consumption rather than investment in both the long- and the short-run, the latter measure takes far longer to achieve a deflationary result. To achieve the same slow down in the economy that a 1.5% point rise in base rates causes after six months would require a 5p rise in the basic tax rate. However, while interest rate impacts tend to flatten off after a short period, higher taxes continue to depress growth for years afterwards. There is also much evidence to suggest that British firms and industries are largely insensitive to interest rate levels when considering how much to borrow or invest, especially if interest rates are expected to fall in the medium-term once the threat of inflation has receded. Such results would seem to justify Mr Lawson's reliance on interest rate increases to curb consumer expenditure.

A second justification for an interest rate policy can be made on the following grounds. The only tax increases certain of having a short-term effect on the economy are increases in excise duties and V.A.T. Those who criticize interest rate rises for feeding directly into the R.P.I., thereby increasing the very phenomenon the policy is designed to reduce, are typically taking a short-term view of the interest rate mechanism and forget that excise and V.A.T. increases suffer from exactly the same problem. Furthermore, they do not tackle the real inflationary problem in the U.K. at present which is the credit boom and the apparent reluctance of the British consumer to save. Interest rate rises reduce the amount of currently in circulation by making it more attractive to save and less attractive to borrow. Income tax or national insurance increases, which do not have the effect of 'swinging' the R.P.I., are difficult to impose quickly and are equally difficult to reverse in a speedy manner.

A frequent criticism of interest rate rises is that, by inducing a flow of capital funds into the country, it strengthens the exchange rate and diminishes the competitiveness of British export industries, thereby worsening the trade deficit. However, there is little evidence to suggest that British firms are suffering through uncompetitiveness on export markets. The trade deficit is a manifestation of excess domestic demand and will remain until this excess demand is choked off. Interest rates work to dampen consumer expenditure while keeping the value of the domestic currency at a firm and strong level which keeps import costs low. High interest rates and a firm pound should also ensure modest, if any, rises in wages as companies begin to feel a squeeze on their profits.

It should be remembered that interest rates are still below the levels to which they were raised in 1985 when the U.K. economy last encountered an inflationary surge. Indeed, the real beauty of interest rates is their flexibility. When better figures loom out of the murky future, the base rates can be reduced quickly and efficiently. The indication is that, during 1989, the trade figures should begin to improve steadily and we believe inflation will peak at below 9.5%. The main reason for this is that the finances of many households should feel the effects of the build-up of mortgage payments around this time. Considering that there has been a near doubling of rates since May, it can be expected that household budget constraints will shift quite markedly inwards. Already, retail sales figures for January are markedly down on last January while holiday companies have

reported very large decreases in their sales volumes. It seem that Mr Lawson's 'application of the brakes' to the U.K. economy has indeed begun to slow it down.

Footnotes

1. Chancellor Nigel Lawson in a 'Financial Times' interview, January 1989.
2. Professor Alan Budd in an article published in the 'Financial Times', January 1989.
3. British Department of Trade and Industry figures (provisional) released 27 January 1989.
4. Bank of England Quarterly Bulletin, August 1988, Economics Division.
5. National Institute of Economic and Social Research Quarterly Review, August 1988. (The Institute has been one of the more outspoken critics of Mr Lawson's interest rate policy).
6. Professor Alan Budd now works with Barclay's Bank and was one of the developers of this particular model.