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Commentary on the economic situation

Intensifying financial pressure on the corporate sector

Further deterioration in company finances in first quarter

One of the best leading indicators of the economy is the financial balance of companies (i.e. the difference between undistributed income and outlays on investment and stocks). This is recognised by official statisticians, who include the balance in their longer leading index. Typically, company finances start to improve about a year before the trough of a recession. For example, in the 1974/75 downturn the peak in the financial deficit occurred in the third quarter of 1974, five quarters before the low point in GDP. Similarly, in the last recession the deficit peaked in the fourth quarter of 1979, while output continued to decline until the fourth quarter of 1980.

Against this background, first-quarter figures on company finances make extremely depressing reading. Earlier data had shown the financial deficit broadly stable between the first and second halves of 1990, which seemed consistent with the view that the economy would hit bottom during the second half of 1991. But according to the latest figures the deficit rose further in the first quarter, reaching a record £7.8b., equivalent to 6.4% of GDP. Companies' spending on investment and stocks was slightly lower than in the fourth quarter (after adjusting for the impact of the electricity privatisation). The reason for the higher deficit was a sharp drop in profits, particularly from overseas.

Balance sheets sliding into danger zone

This news comes at a time when company balance sheets are already extremely weak by historical standards. The ratio of financial assets to liabilities ended 1990 at 0.84, down from a peak of 1.15 in 1984 and below the trough reached in the last recession. In relation to the capital stock, net debt is now at levels not seen since the early 1970s. Meanwhile, companies' liquidity ratio (bank deposits divided by loans) fell further to 47% during the first quarter, which compares with an average of 60% over the last 30 years and is in line with previous historical lows.

Need for further large cuts in investment and stocks

Recent heavy rights issues represent an attempt by companies to rebuild their balance sheets. But until their financial deficit improves, they will be running to stand still. A decline in the deficit can come about in two ways: via an increase in demand for companies' products by other sectors, particularly the personal sector; or through reductions in company outlays. The prospect of an early recovery in consumer spending is remote. Consumer confidence is being undermined by the speed of the rise in unemployment, while the response of mortgage demand to lower interest rates has been feeble. The message is that further large cuts in investment and stocks will be required over the remainder of the year to bring company finances back towards a sustainable position. Hopes of a second-half recovery must now be dead.

Summary of paper on

'Monetary policy in the 1990s - part 1'

Purpose of the paper Many observers believe that Britain's membership of the ERM makes the reduction in our inflation to the average European level the appropriate goal of monetary policy at present. The European inflation norm is often taken to be 3% a year. The paper argues that an inflation rate averaging 3% a year would be a second-best outcome compared with genuine price stability.

Main points

- * If price stability had become established, the only justification for pay rises would be increased productivity. Automatic annual rises, to compensate for inflation, would become unnecessary and trade unions would lose one of their reasons for existence. Price stability would therefore be the best kind of "incomes policy".
- * Inflation complicates the interpretation of interest rates. Nominal interest rates have to be adjusted by inflation expectations to arrive at real interest rates, but inflation expectations are always subjective and may be falsified in practice.
- * Large and unexpected swings in real interest rates have arbitrary effects on returns to savings and investment, causing exceptional speculative profits at one time and large losses (often hitting the banking system) at another. These arbitrary swings impact on the profitability, and hence the capital adequacy, of financial institutions.
- * Financial markets in the USA and the UK had difficulty coping with the variations in inflation expectations and real interest rates in the 1970s and 1980s, even though inflation was in single digits most of the time. The problems with 3% inflation would be less serious, but a stable price level would be best of all.
- * If prices were stable, real and nominal interest rates would be the same, allowing interest rates to perform their signalling function far more effectively. The financial system would be more stable, and decisions about savings and investment would be better-judged.

This paper was written by Professor Tim Congdon. It is to be submitted to the Centre for Policy Studies for publication in a pamphlet on *Monetary Policy in the 1990s*. The second half of the pamphlet (to appear in next month's *Gerrard & National Monthly Economic Review*) will set out a proposal that the Bank of England be given more operational independence, while being made more accountable to Parliament.

Monetary policy in the 1990s - part 1

Why Britain should aim at price stability in the coming decade

The 1980s saw progress against inflation, but a setback in the second half of the decade

The 1980s was a decade of considerable progress against inflation. The average annual increase in the retail price index in the ten years to 1980 was 13.8%, whereas in the ten years to 1990 it was 6.5%. More loosely, the Thatcher Government succeeded in reducing the trend inflation rate from 15% a year in the 1970s to 5% in the mid-1980s. However, inflation was not conquered in the 1980s. Instead the relaxation of monetary policy which began in late 1985 was followed by a boom in 1986 and 1987, and an upsurge in inflationary pressures in 1988 and 1989. The return of an inflation rate of over 10% in 1990 was a sad consequence of the extremely high rate of monetary growth recorded in earlier years. The rise in inflation in the late 1980s warned, once again, of the need for constant vigilance in monetary policy.

It also posed the question of the appropriate goal for monetary policy in the long run. What should monetary policy try to achieve in the 1990s? The purpose of this paper is to argue that the right objective is price stability. Price stability is to be understood here in the literal sense, namely the stability of a price index of goods and services over an indefinitely long period of time. The ideal would be a situation in which people thought that the value of money would never change, so that the very notion of "inflation" became strange and unfamiliar. If all went well, people might in the 21st century read in history books about "inflation" as one of the main features of the incompetent 1970s and 1980s. The word would need explanation in a glossary, just as "bimetallism" and the "gold standard" do in modern texts on 19th-century financial history.

"Full employment" an illusory goal

There are two main challenges to price stability as an objective of monetary policy. The first is that monetary policy, as part of macroeconomic policy in general, should be used to promote full employment rather than directed at an inflation target. This view will not be discussed at length. It will be taken for granted that a well-rehearsed argument of the 1970s, that there is no long-run trade-off between employment and inflation, is correct. This argument, first presented in Friedman's presidential address to the American Economic Association in 1967, implied that attempts to reduce unemployment to an artificially-defined figure for "full employment" would fail because of ever-rising inflation. Accordingly, the only feasible aim in the long run was to stabilize an inflation rate or the price level, with the level of unemployment determined by structural characteristics of the labour market.

Attractions of "low" inflation sometimes urged

The second challenge to price stability is more surprising. It is that many economists do not believe that the resolute pursuit of a stable price level is worthwhile and would instead be happy to keep inflation running at a low level. They may not be very lucid about what constitutes an acceptably "low" rate of

inflation, but they are nevertheless clear that the goal of price stability is too doctrinaire and emphatic. A preparedness to tolerate inflation has been common over the last decade, although it has been expressed in different ways and in a variety of contexts.

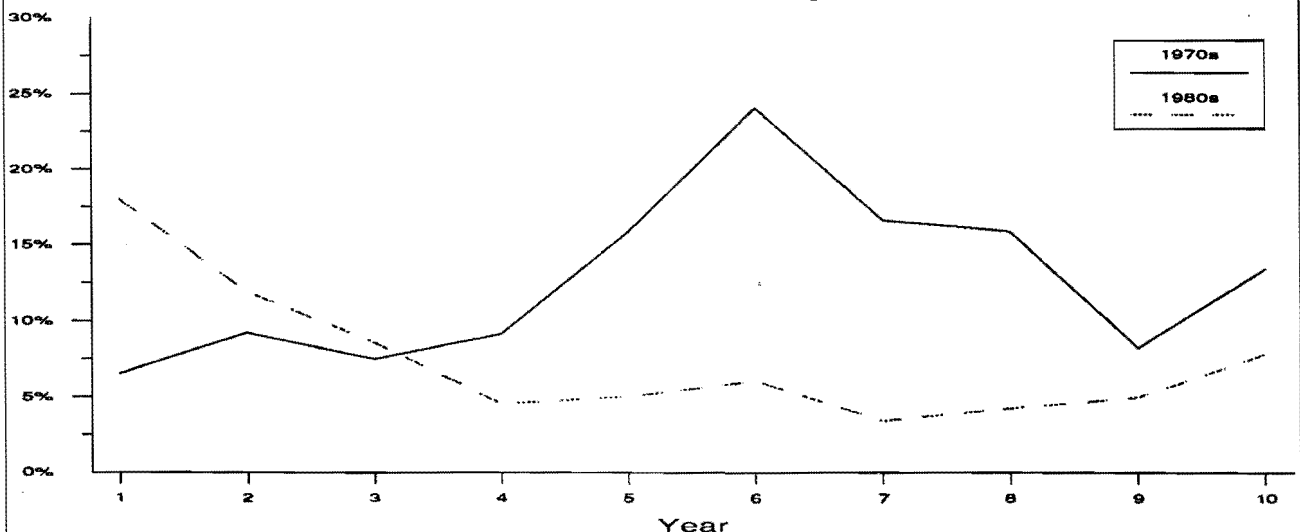
An extreme example is provided by Professor Frank Hahn in his evidence to the Treasury and Civil Service Committee in 1980. He said that, "We should not start out with the presumption that inflation is bad in itself...What would be the objection to the Government setting its monetary targets so as to make them consistent with say a 15% inflation rate?". As if this were not startling enough, he went on to argue that almost any stable inflation rate would be better than the costs - in terms of lost output and employment - of reducing inflation. It is perhaps not surprising that Professor Hahn was one of the two Cambridge economists who organized the famous letter from 364 economists to *The Times* in 1981. The letter was highly critical of the determined anti-inflation policies of the Thatcher Government in its early years.

Should the European inflation rate be our norm?

More familiar today is the claim that Britain should reduce its inflation rate to European levels and keep it there. The thinking is that, with Britain a member of the European exchange rate mechanism, our inflation rate will have to be similar to that in the rest of Europe. As everyone knows, if our inflation rate were higher, our export prices would become uncompetitive and we would have to devalue. Less discussed is the possibility that our inflation rate might be systematically lower than in other European countries and that we might have to revalue, but revaluations would also be incompatible with ERM membership. It seems to follow that, now we are in the ERM, we must accept the inflation rate given to us from outside. Moreover, we must abide by it, regardless of whether persistent inflation is desirable or not.

Retail price inflation in the last two decades

Chart shows much lower annual inflation rates in the 1980s compared with the 1970s.



European inflation typically expected to be 3% p.a.

This willingness to take the European inflation rate as the norm stems partly from a sense of national economic inferiority. On average, the European Community had a lower inflation rate than the UK in the late 1980s. The European inflation average is typically taken as about 3% a year, markedly less than the inflation figures recently recorded in Britain and even lower than the 5% number which had such appeal in the mid-1980s. For example, in an article in the February 1991 issue of the *National Westminster Bank Quarterly Review*, Walter Eltis concluded that, "It is worth considerable sacrifices to get inflation down towards the 3% level which is being achieved today by Belgium, Denmark, France, Germany, Ireland, Luxembourg and the Netherlands, the core members of the European exchange rate mechanism which the UK has now joined." Because a 3% inflation rate would be an improvement on our own recent record and would be consistent with our continued membership of the ERM, it is seen as respectable and right.

So the argument is between price stability and 3% inflation

The argument of this essay is that a 3% inflation rate is not respectable and right, even if it has the endorsement of our European partners. Instead the only respectable inflation rate is zero, a condition of absolutely stable prices. The case for preferring price stability to low inflation will be based on an examination of the costs of inflation in the three main kinds of market in free-enterprise economies - the market in goods and services, the labour market and the market in financial instruments.

There is nothing original in our analysis. It draws on ideas which have been around, in much the same form, since the 1920s. The classic statement of the costs of inflation was in the opening chapter of Keynes' *Tract on Monetary Reform*, which was published in 1923. More rigorous and up-to-date presentations are in such books as Arthur Okun's *Prices and Quantities* (1981) and Alex Cukierman's *Inflation, stagflation, relative prices and imperfect information* (1984), and there is now a rather large academic literature on the subject. If there is anything new in our discussion, it is in the emphasis of the argument rather than in the ideas themselves. We shall suggest that the heaviest social costs of inflation arise in financial markets rather than in the goods or labour markets, and that a 3% long-run inflation rate - with occasional cyclical fluctuations around that figure - would still be a serious problem to savers and investors.

1. Costs of inflation in markets for goods and services

The costs of inflation in markets for goods and services are of two kinds - the costs of changing prices and the costs of resource misallocation caused by inflation-distorted prices. In an inflationary economy the price of any individual product reflects two sorts of influence, the scarcity of the particular product in question compared with other products (underlying market forces) and the need to keep the particular price in line with prices in general (inflation adjustment). Price changes are costly, partly because of simple administrative hassle, but more fundamentally because every price change requires businessmen to

exercise judgement, and to devote thought and time to the problem. In an economy without inflation, price changes are needed only in response to market forces, and businessmen can concentrate on improving their products and meeting customers' requirements. Any positive inflation rate, whether it be 3%, 15% or 1,500%, requires them every now and again to consider how much their own particular prices should adjust to general inflation. This is a distraction and interferes with proper business management.

Of course, these problems - of costly price changes and resource misallocation because the price mechanism is not working well - are hardly dramatic with an inflation rate of 3%. For many products, notably basic commodities, market forces are so volatile that they frequently motivate price changes of 10%, 20% or 30%, upwards and downwards, within a year. The difficulties of adjusting to general inflation are minor by comparison. Indeed, it is true that the humdrum parts (farming, street markets, taxis) of Latin American economies seem to cope with inflation rates at the Hahnian level of 15% or 20%. A tourist to Latin American countries, on a short visit of one or two weeks, may be duped into thinking inflation is not much of a problem. However, the relative ease of adjustment in markets for goods and services is misleading. Inflation is very much a problem in other areas of these economies, particularly - as we shall see - in financial intermediation.

2. Costs of inflation in the labour market

Inflation causes most damage in markets with two characteristics - first, where the costs of determining prices and setting are high; and, secondly, where the inflation adjustment is an important element in the price compared with the influence of underlying market forces. Some parts of the labour market certainly have these characteristics. In some industries an extensive apparatus of collective bargaining has been set up, with much of trade unions' time devoted to analysing the overall inflation rate to ensure that their members are keeping pace with other workers. Managements and unions can disagree for many reasons, but it is obvious that in an inflationary economy one source of disputes is how much any particular group of workers has lost or gained ground relative to workers in general. It is hardly surprising that the number of days lost through strikes tends to be greater in a high-inflation than in a low-inflation economy. The contrast between the heavy incidence of strikes in the 1970s, with its average inflation rate of almost 15%, and the very low level of strikes in the Thatcherite late 1980s, when core inflation was so much less, is instructive.

Fewer strikes with lower inflation

The difference between 3% inflation and absolute price stability is, of course, less marked than that between 15% and 5% inflation. If absolute price stability ever is achieved, it is unlikely that the fall in strike activity would be so sharp as that between the 1970s and 1980s. But there is one general point which argues that price stability would be a very worthwhile step forward. Even in an economy with an inflation rate as low as 3% the concept of an automatic annual pay increase is entrenched. Sooner or later the pay of every worker has to be

adjusted for the fact of inflation. The inevitability of pay adjustments therefore gives trade unions a justification for their existence, as well as obliging managements to think about the inflation problem from time to time.

No reason for automatic annual pay rises in an economy with stable prices

But in an inflation-free economy unions and management would have no reason to alter pay rates in a regular, automatic way. The only valid reasons for changing pay would be increased productivity or the operation of market forces, because of a favourable shift in demand away from other products. For the economy as a whole demand shifts between industries would be neutral in their effects, meaning that better productivity would be the sole justification for pay rises. Some years ago Mr. Peter Walker, a long-standing critic of curbing inflation by monetary means, advocated an incomes policy in which the one legitimate criterion for pay rises would be increases in productivity. He may not have understood that, if price stability became an assumption of business activity, that sort of "incomes policy" would be in force without any need for specific legislation or control machinery. Price stability, based on skillful monetary policy, would be the best version of "incomes policy". It would be simple in concept, self-administering and consistent with the free operation of market forces.

Labour markets, like markets in goods and services, would therefore work better if there were price stability than if the price level increased by about 3% a year. Nevertheless, trade unions and employers could undoubtedly work together with 3% inflation. The improvement in the efficiency of collective bargaining from moving to an absolutely stable price would probably be less than that already achieved by reducing inflation from 15% to its current level. The greatest advantage from eliminating inflation entirely would accrue not to labour markets, but to financial markets. It is in the financial sphere that inflation has wreaked most havoc in the past and it is here that the benefits from price stability would be most worthwhile.

3. Costs of inflation in financial markets

This claim may seem surprising. Surely, financial markets are among the most flexible it is possible to imagine, with dealers changing prices at negligible cost from minute to minute. Since the prices of financial securities can be changed so cheaply, why should the need to adjust for general inflation be a particular problem?

Fluctuating inflation, even at low average rate, complicates the meaning of "the" real interest rate

The answer lies in our earlier observation that inflation causes most damage where inflation adjustment is itself an important element in price determination. The key price in financial markets is the interest rate. The interest rate is supposed to serve a vital signalling function, guiding people and companies on when they should take such major decisions as buying houses, investing in factories and so on. In most societies the real interest rate has been between 2% and 6% in the very long run, and a figure of this sort must reflect the underlying market forces (of thrift and productivity) at work. In an economy where prices

are expected to rise indefinitely, the nominal interest rate has to compensate for inflation. Obviously, any positive inflation rate - even an inflation rate as low as 1% or 2% - is significant compared with a real rate of 2%, 4% or even 6%. Moreover, once the inflation rate is over 10%, the inflation adjustment in any nominal interest rate is much larger than the real component.

The relevance of these points is most clear with long-term contracts which include interest rates (or other "prices") fixed in money terms. Indeed, the risks of entering into such contracts are now so well-known that many companies and financial institutions try to avoid them. Britain, like other inflation-ridden societies, has moved away from fixed-rate contracts to contracts with variable interest rates or indexation. This switch reduces the vulnerability to large changes in the inflation rate. But it should be emphasized that there has already been a cost, namely that fixed-rate contracts have been discouraged. Such contracts are particularly convenient for planning purposes, since the lender knows exactly how much cash must be stumped up on a sequence of future dates. With variable-rate or indexed contracts, there is not the same degree of certainty.

Variable rate contracts still do not stabilize real interest rates

Variable-rate or indexed contracts are supposed to guarantee some stability in the distribution of real returns between the parties involved. But they do not achieve this. A contract with a variable interest rate ought to respond to changes in the inflation rate, leaving the real interest rate roughly unchanged. But once inflation reaches any noticeable level at all, even 2% or 3% a year, questions arise about what the "true" rate of inflation (headline?, underlying?, retail?, wholesale?) really is and how long it will continue at that level. Often, after a large lurch in inflation upwards or downwards, people do not expect it to persist. They keep on taking decisions as if the future inflation rate were likely to be similar not to the current figure, but to the average over a number of years in the past. (Technically, their expectations are "adaptive" rather than "rational".) As a result, variable-rate contracts are associated with high real interest rates after a sharp fall in inflation, but with low real interest rates after an abrupt increase.

Indexation leads to problems of distinguishing between the "principal" and "interest" elements in loans

Indexation ought to overcome this problem. However, it creates new difficulties, for example, in aggravating the uncertainty about the actual amounts of cash required to meet interest (or other) payments at particular dates. In theory, it ought to be possible to adjust the relative size of principal on the one hand and accumulated interest (and indexation) on the other, so that financial outcomes in a highly inflationary but indexed economy are the same as in economy enjoying stable prices. But that is not the case in practice. For example, in a Latin American economy with 100% inflation, it is obvious that after a few years the indexation element in a home mortgage is much larger than the original loan. Are borrowers then expected to pay each month interest, a small capital repayment and indexation, or merely interest and a small capital

repayment? How can they pay indexation, which would be massive as a proportion of income with 100% inflation? (Indeed, if the typical home mortgage were three times income, the indexation payment with 100% inflation would be larger than income.)

When inflation is very high, inflation uncertainties reduce the financial system to a casino

When economies descend into inflation rates of over 100% a year or finally into hyperinflation (usually defined as above 50% a month), the financial complications in any contract are such that the returns to guessing the inflation rate next month can be much greater than the rewards to productive activity. But, from society's viewpoint, guessing the inflation rate is a pointless activity. If one person gains because he makes the right guess, someone else loses because he makes the wrong one. The economy becomes a zero-sum game. The higher the inflation rate, the more that people devote their business lives to predicting unstable macroeconomic variables and the less to increasing productivity. The difficulties of financial intermediation are such that the banking system disintegrates and ratios of bank assets and liabilities to national product collapse. Decisions about allocating savings into investment are increasingly difficult, particularly where investment is in long-term, capital-intensive projects. If such projects are done at all, they tend to be done very badly and with heavy social waste. In general, societies suffering from chronic inflation resemble casinos. Because of the extreme unpredictability of real returns, financial institutions cannot perform their tasks properly, and any form of saving and investment is a gamble. Most Latin American countries have very poor financial systems, even though street-markets and taxis work perfectly well.

Inflation does more harm to the financial system than to markets in goods and services, and the labour market

The purpose of the argument has been to demonstrate, as vividly as possible, that inflation does more harm to the financial system than to markets in good and services, or to the labour market. The discussion may nevertheless have seemed rather lurid and exaggerated if we are talking about the difference between an inflation rate of 3% and price stability, instead of that between a Latin American and European inflation rate. In fact, our conclusion is relevant to low inflation rates in the industrial countries as well as to Latin America, even though it is not so overwhelming in its practical significance. Over the last 40 years inflation in most industrial countries has, on average, been in single digits. There were only a few years, in the mid- 1970s and early 1980s, when double-digit inflation rates were common in industrial countries. But the last 40 years have seen all too many examples of misjudged decisions on savings or investment, where success or failure pivoted on small differences in the inflation rate. Even at inflation rates typically of 5% or so people have made or lost fortunes because they have been right or wrong in their inflation guesses. There has been a casino element in the low-inflation advanced economies, just as in Latin America.

The damage is evident at low inflation rates with long-lived assets and contracts lasting many years

As we have seen, mistakes in guessing future inflation are most troublesome for assets with very long lives or contracts lasting for many years. The extreme example of a long-lived asset is a debt with no specific redemption date whatever, such as an undated gilt-edged security. Whereas a change in interest rates from 2% to 3% reduces the nominal value of a one-year government security by 1%, it cuts that of an undated security by a third. The change from a society with a long-run expectation of stable prices to a society with a long-run expectation of 3% inflation may not sound radical, but it actually means the decimation of a particular category of saving. In the 1950s and 1960s many savers in Britain did not realize quickly enough that an era of continuous inflation had started. At the end of the Second World War Britain's national debt was twice the size of its gross national product. The erosion of the real value of that debt by inflation was the most drastic redistribution of wealth ever perpetrated by the British Government, even though inflation averaged only 2.9% in the 1950s and 4.0% in the 1960s. It was, in effect, large-scale legalized robbery.

It might be objected that, once the inflation rate were stable at 3%, no further robbery could occur. But let us contrast the reactions of financial markets to 1% fluctuations around an inflation rate of 3% with 1% fluctuations around a stable price level. Let us start with the 3%-inflation economy. Suppose that, after two years of 3% inflation, favourable accidental circumstances make possible a year of 2% inflation. If achieved once, some people might think that it would be maintained for a few more years, perhaps even indefinitely. If the yield on the undated security fell from, say, 6% to 5%, the price would rise by 20%. On the other hand, suppose, again after two years of 3% inflation, that adverse shocks push inflation up to 4% and the yield on undated securities from 6% to 7%. Then the price would fall by 14%. Very small changes in inflation expectations can be associated with wide swings in the price of undated securities.

Asset price volatility in an economy with fluctuating inflation rates

Consider, by contrast, 1% fluctuations around a stable price level, where investors have absolute confidence that price stability will be preserved in the long run. With price stability guaranteed, there would be little point in markets changing the price of an undated security. If yields on undated securities did alter much, it would be only because of changes in the real returns available on competing assets. The example may seem something of a curiosity, because undated securities are such a tiny part of the gilt-edged market. But the yield on undated gilts moves in parallel with that on long-dated gilts, while gilt yields serve as a benchmark for all investment decisions. After adjustment for risk, the total return expected on other very long-lived capital assets, including land, commercial and residential property and equities, has to match that on long-dated gilts. If the yield and price of gilt-edged securities gyrate from one extreme to another, the yield and price of these assets are also necessarily very volatile. This complicates investment decisions and makes mistakes more likely. In general, a society where the prices of long-lived assets oscillate in a

band of 20% plus or minus from one year to the next will be less efficient in allocating investment resources than one where these prices vary only marginally over time.

Difficulties in assessing real interest rates have caused disasters in property investment, even at moderate inflation rates

The significance of this conclusion emerges most obviously in investment in such long-lived assets as office buildings, warehouses and so on. The high rates of inflation recorded throughout the industrial world in the 1970s came as a surprise to most people. Real interest rates were unusually low, or even negative, in countries such as the USA and the UK in the mid- and late 1970s. Investors in long-lived assets therefore did well, particularly if they had borrowed to acquire the assets. Many of them assumed that a similar pattern would continue in the 1980s. The last decade has therefore seen exceptionally strong booms in office construction in both the USA and the UK. These booms rested on a particular set of expectations about the macroeconomic environment, notably about the level of real interest rates. In practice, the macroeconomic surprises of the 1980s were the scale of the reduction in inflation in the first half of the decade and governments' preparedness to keep nominal interest rates at remarkable levels in order to combat any resurgence in inflationary pressure. Whereas the 1970s was a decade of low real interest rates, the 1980s was a decade of exceptionally high real interest rates. The office building booms in the USA and the UK have ended in disaster, with bankrupt developers and huge amounts of empty space. The bankruptcies have caused heavy loan losses, wiped out banks' capital and so reverberated on the financial system. In Britain the clearing banks have tried to recoup some of their losses by widening margins on their loans, including loans to small businesses. This has provoked hostile newspaper comment, notably from *The Sunday Times*, which has harmed the public image of the financial system as a whole.

Even with inflation as low as 3% p.a., the real interest rate is not transparent

In summary, errors in expectations about inflation and the level of real interest rates encouraged certain companies and individuals to gear up in the property market. Developers were placing bets, in Latin American style, as if the economy were a casino. The result has been great waste to society and disruption of the financial system. All this has happened with inflation rates of between 5% and 10% in the USA, and between 5% and 15% in the UK. Inflation did not have to reach Latin American levels for it to be a social calamity. Sure enough, these misfortunes would not be so serious in a nation where the average inflation rate was 3%. Nevertheless, there would still be greater uncertainty about the future path of real interest rates in a society with 3% average inflation rate than in one where the price level was stable and expected to remain so.

Price stability equates real and nominal interest rates

Even with an inflation rate as modest as 3%, nominal interest rates would not be an unambiguous signal of the relative cost of the past, present and future. There would still be difficulties in interpreting real interest rates and these difficulties would impact on the financial system. Banks might still be artificially profitable in one year and suffer abnormal loan losses a few years

later. By contrast, in a society where prices are more or less totally stable, with variations of a mere 1% a year around a constant average level, the nominal interest rate would be the same as the real interest rate. The meaning of the interest rate - and of any interest-rate term in any contract - would be very clear. Financial systems would no longer have to think about this awkward and crucial problem.

Price stability is undoubtedly superior to continuing inflation at about 3% a year. It should be the central objective of British monetary policy in the 1990s. Of course, if Europe as a whole kept on inflating, there would be a problem of inconsistency between monetary policy here and in the rest of Europe. This inconsistency would be different from usual, because sterling would be systematically strong relative to other European currencies rather than chronically weak. Much would depend on the attitudes and behaviour of the Bundesbank. It had difficulty pursuing its own preferred goal, also of absolute price stability, in the 1980s because of loose monetary policies in other members of the ERM. It would surely welcome supportive policies in other countries in the 1990s.

Some commentators might reject the goal of price stability as impossibly utopian, a counsel of perfection which would never be achieved in the real world. But remember that Britain reduced inflation from a trend rate of 15% in the 1970s to 5% in the 1980s. Moreover, further progress to 2% or 3% is in prospect in the next year or two because of the (unintended) depth of the current recession. After the deflationary agony already suffered, the costs of reducing inflation from 3% to nil would be modest. Arguably, the elimination of the last residue of inflationary expectation would be of more benefit than all of the previous hard work in controlling inflation. Once the price level had been stabilized for a couple of years, it would probably be easier - from a technical management standpoint - to keep it stabilized than to manage a moderate inflation rate. Britain should aim at genuine price stability in the 1990s. It would be a far more worthwhile ambition than merely matching the average European inflation rate.

**Price stability
more worthwhile
than an average
3% inflation rate**