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Commentary on the economic situation

The 1992 Budget: a futile exercise in so-called "fiscal stimulation"

Are budget deficits always "stimulatory"?

Mr. Lamont, his advisers and the financial press all clearly believe that increases in the budget deficit "stimulate" economic activity. The reasoning is simple, that higher public sector borrowing represents an "injection of demand" which boosts "spending, output and jobs".

Sadly, the effects of higher budget deficits are more complicated in the real world. The economic impact of tax cuts and/or higher government spending depends on how the increased deficit is financed. A standard textbook treatment differentiates between three cases - financing from the central bank, from the banking system and from non-banks - and argues that their macroeconomic consequences are sharply divergent. If the PSBR rises by, say, £5b. between two years and the increase is all borrowed from the Bank of England, the monetary base would expand by almost 25%. If the banks kept the ratio of base money to their liabilities stable, the overall rate of monetary growth (i.e., including bank deposits) would also rise by almost 25%. Obviously, central bank financing is highly stimulatory and, at least potentially, very inflationary. This is less true of financing from the commercial banks, when the money supply increases by only the amount of the fiscal injection, which is £5b. - or slightly over 1% of broad money - in our example. But, again, fiscal and monetary policy would be running in the same direction, and the overall outcome ought to be helpful for economic activity. The matter is altogether different if the Government finances the increase in the budget deficit outside the banking system. The money supply is then unchanged. The extra public debt may be willingly held only if some private debt and investment are "crowded-out", while people and companies have no new balance-sheet reason for boosting their consumption spending. The net effect of financing an increased PSBR by debt sales to non-banks is to leave aggregate demand more or less unchanged.

It depends on how they are "funded"

Here is the rub. The phrase "debt sales to non-banks" is our old friend from the mid-1970s, "funding", and a policy of matching the PSBR by debt sales to non-banks is our newer acquaintance from 1985, the "full funding rule". The point of our argument is that, as long as the Government adheres to the full funding rule, variations in the PSBR are futile as a way of influencing demand. So-called "fiscal stimulus" from the Chancellor is immediately neutralized by monetary deflation from increased official gilt-edged sales. Of course, if the Government relaxed the full funding rule, an increase in the PSBR would be stimulatory. But, if it did relax the rule, a stimulus could be administered without any increase in the PSBR simply by reducing official gilt sales. A move to underfunding would also have the important advantage of avoiding any medium- and long-term worries about fiscal sustainability.

Professor Tim Congdon — 5th March 1992

Summary of paper on

'How low will inflation fall?'

Purpose of the paper Inflation has fallen sharply in the last 18 months and has now returned to roughly the average level in the mid-1980s. The purpose of the paper is to assess whether inflation can decline further, on a sustained basis, to the lowest levels since the late 1960s.

Main points

* **In recent months the underlying rate of producer price inflation (as measured by the annualised three-monthly change in the index excluding foood, drink and tobacco) has fallen to beneath the lowest levels recorded in the mid-1980s. (See p. 7.)**

* **The short-term outlook for inflation is best judged by an analysis of cost influences and special factors, supplemented by survey evidence. With the CBI survey reporting the lowest balance of companies planning to raise prices since 1967 and pay settlements still falling sharply (see pages 8 and 9), these pointers suggest that inflation will continue to decline until at least early 1993.**

* **The medium-term outlook for inflation should be based on more fundamental determinants of inflation, such as monetary growth and the extent of spare capacity. (In this context it is broad money which matters. Narrow money is largely determined by the current level of spending, whereas broad money influences current and future behaviour.)**

* **Both monetary trends and spare capacity are very positive for the medium-term inflation outlook. Broad money growth has recently been at the lowest levels since the 1960s, while the margin of spare capacity at present is as great as at the troughs of the last two recessions.**

* **The conclusion of this survey is that inflation in 1992, 1993 and 1994 will be lower than in any three-year period since the late 1960s.**

This paper was written by Professor Tim Congdon.

How low will inflation fall?

Why Britain is heading for the lowest inflation rates since the late 1960s

Widespread expectation of stable inflation close to current levels

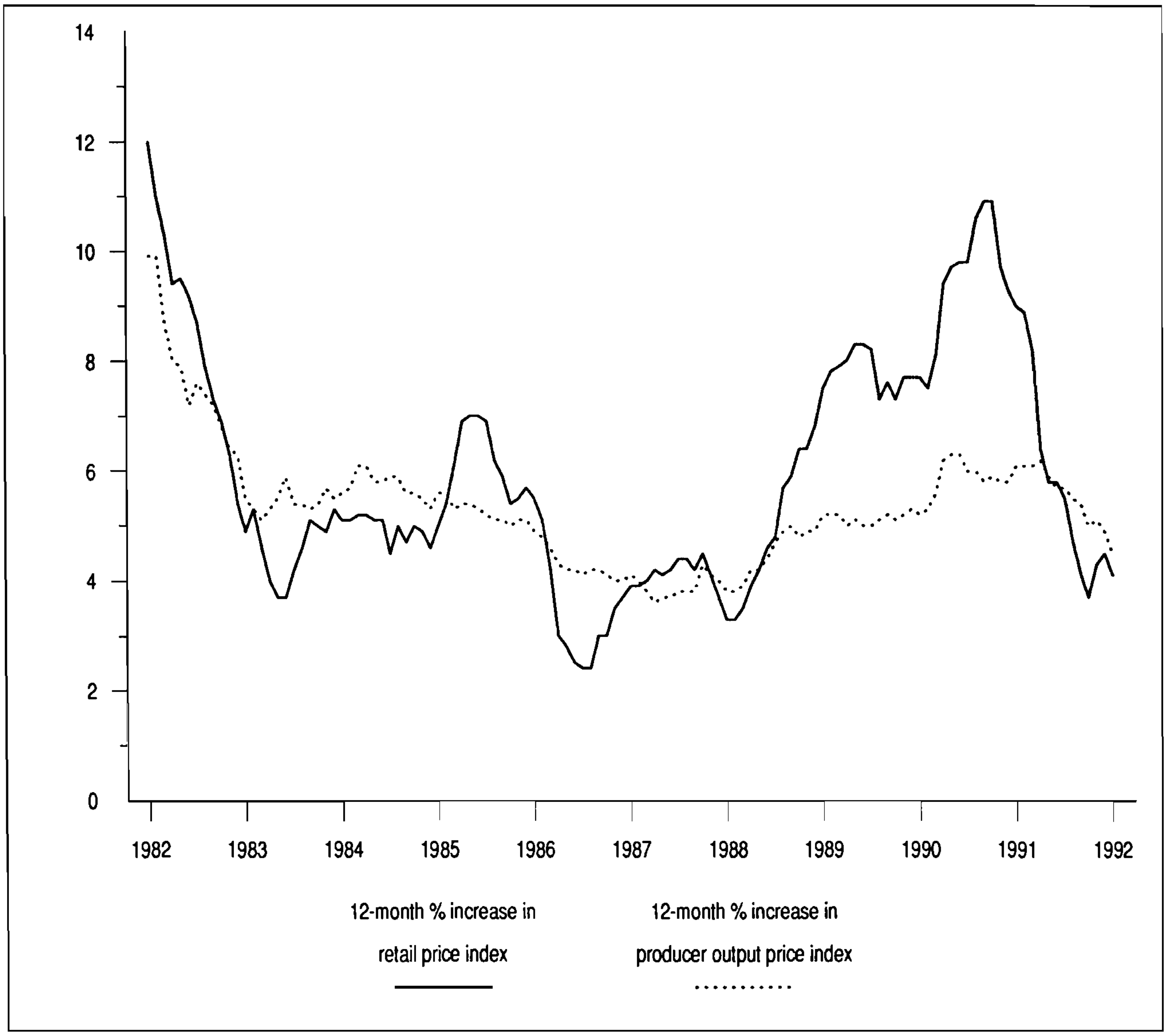
Inflation has fallen far and fast from its peak (on the twelve- month change in the retail price index) of 10.9% in September and October 1990. The increase in retail prices in the year to January was down to 4.1%. After a decline as steep as this there is an understandable tendency to forecast a stabilization of inflation followed by some increase towards the "normal" level. In today's context a normal level of UK inflation is 4% - 5%. The purpose of this survey of influences on the inflation rate is to suggest that the prospect is much better than that. Inflation in 1992, 1993 and 1994 is likely to be the lowest in any three-year period since the late 1960s, while there is as yet no reason for expecting an upturn in underlying inflation before mid-1994.

Causal influences on inflation are of two kinds, proximate and fundamental. Proximate influences include the special factors that affect the figures from month to month and the cost elements that enter into the accountancy of inflation, such as wages and raw material costs. They are obviously relevant in assessing the inflation outlook over the next three to twelve months and, of course, this defines the initial period for more long-term forecasts. However, they are not much help in judging the likely direction or force of inflation pressures more than a year out. The more distant the projection, the more important it becomes to watch the fundamental determinants of inflation. One line of analysis here is "Keynesian", i.e. to judge the strength of excess (or deficient) demand relative to a trend level of output (or employment), in order to obtain a feel for whether inflation will be rising or falling at a future date. The second approach is "monetarist", i.e. to look at (broad) money trends in the belief that the money supply determines inflation with a "long and variable lag", in Friedman's phrase. These two schools of thought are not necessarily inconsistent. For example, real broad money may determine whether the rate of real output growth is likely to be above- or beneath-trend in a year' time, and the direction of inflation in the second year from now may be seen as heavily dependent on whether the implied level of output is above or beneath trend.

But both proximate and fundamental influences argue that inflation has much further to fall

Two vital messages emerge from the charts on the following pages. First, inflation is headed much lower in the next six months to a year, because of the collapse in both CBI price-raising expectations and in pay settlements. (See pages 8 and 9.) Secondly, unless there is a radical change in policy (such as a large devaluation), underlying inflation pressures are likely to be weakening in both the second and the third years from now, i.e. during 1993 and 1994. Broad money growth, which influences economic activity with a lag of roughly a year, has slumped from the peaks of 1988 and 1989 and has not yet turned up convincingly (sse p. 10), while the negative output gap (see p. 11) will undoubtedly still be very wide in early 1993.

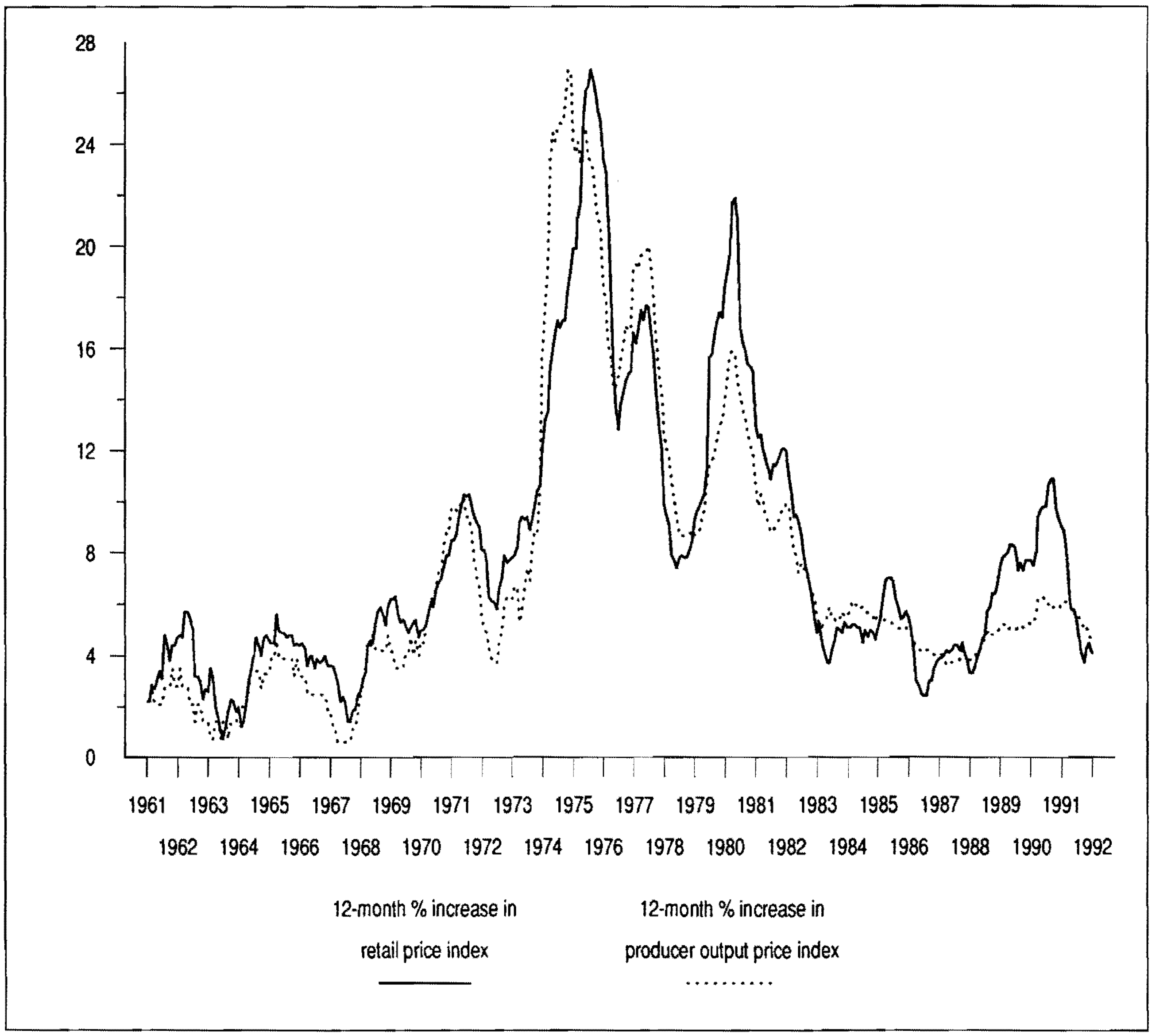
Recent inflation performance



Comment:

Inflation fell sharply during the first half of the 1980s. Helped by lower oil prices, the annual increase in retail prices reached a trough of 2.4% in July 1986. The previous autumn the Chancellor of the Exchequer, Mr. Nigel Lawson, had scrapped broad money targets in favour of a policy of following the exchange rate. Inflation only really took off in 1988. The peak in RPI inflation, of 10.9% in October 1990, was exaggerated by mortgage rate changes and the introduction of the poll tax. But PPI inflation, which reached 6.3%, probably understates the true picture, because it excludes services prices, which were rising rapidly. Another measure of prices, the GDP deflator, grew at a peak annual rate of 9.6% in the third quarter of 1990. After a sharp fall last year, RPI inflation has stabilised at about 4% in recent months.

A long-term perspective

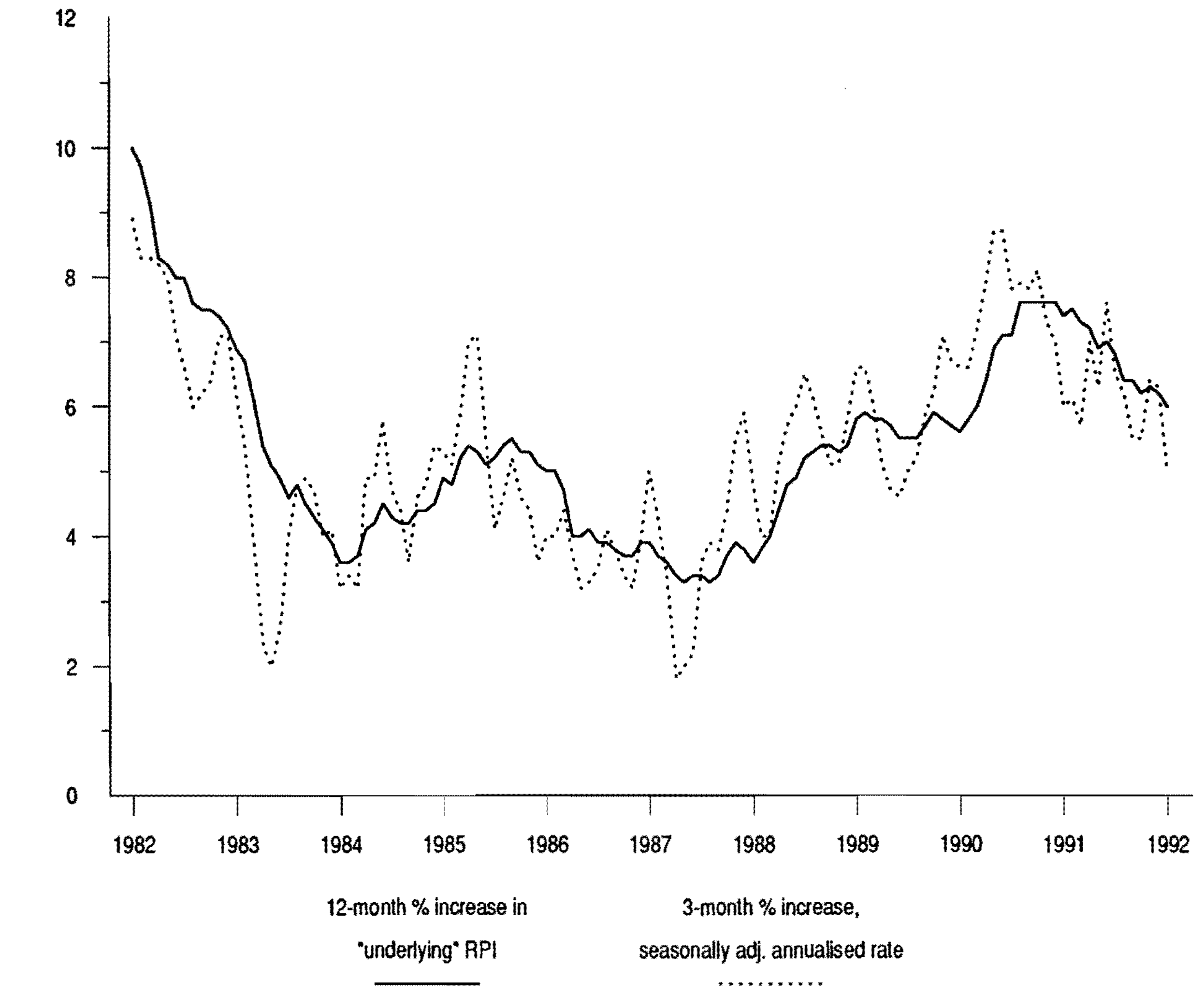


Comment:

There is broad correspondence between cycles in inflation and in the economy. The peaks in inflation in 1971, 1975, 1980 and 1990 were preceded by peaks in activity in 1969, 1973, 1979 and 1989. Similarly, inflation troughs in 1972, 1978 and 1983 followed up to three years after major recessions. With the divergence of GDP from trend (i.e., the output gap) yet to hit bottom in the current cycle, inflation is unlikely to reach a low point until 1993 or 1994. Charts on subsequent pages show that disinflationary pressure is now as great, if not greater, than in the early 1980s. Since the inflation peak in 1990 was much lower than that in 1980, there ought to be scope for inflation rates to fall well below the levels achieved in the mid-1980s. Yet most commentators expect inflation to stabilise at 3% - 4% over the next few years.

A measure of "underlying" retail price inflation

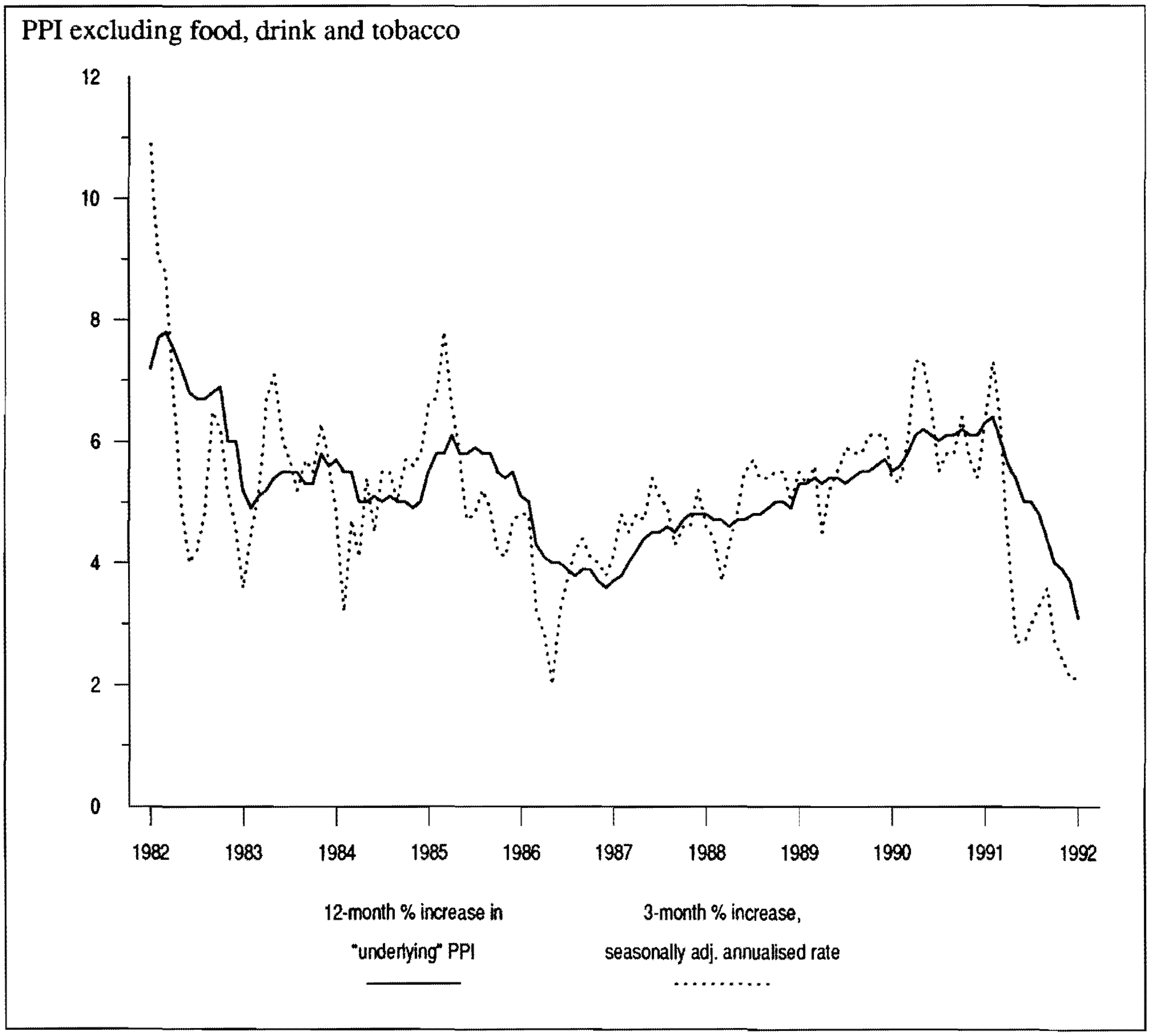
RPI excluding mortgage interest, poll tax, petrol and seasonal food



Comment:

There are a number of possible ways of calculating "underlying" RPI inflation. The measure used here excludes mortgage interest payments and the poll tax, on the grounds that neither are really prices. It also omits petrol and seasonal food prices, since these are often volatile and can distort short-term index movements. A further adjustment has been made for the increase in VAT in April 1991. The resulting series has a much smoother profile than headline RPI inflation, shown on page 4. The annual increase reached a peak of 7.6% in late 1990 and has since declined to 6.0% by January this year. The three-month annualised rise has shown a more pronounced downward trend recently, falling to 5.0% in January. But this is still well above the trend in producer prices and reflects the slower adjustment of utility and services prices.

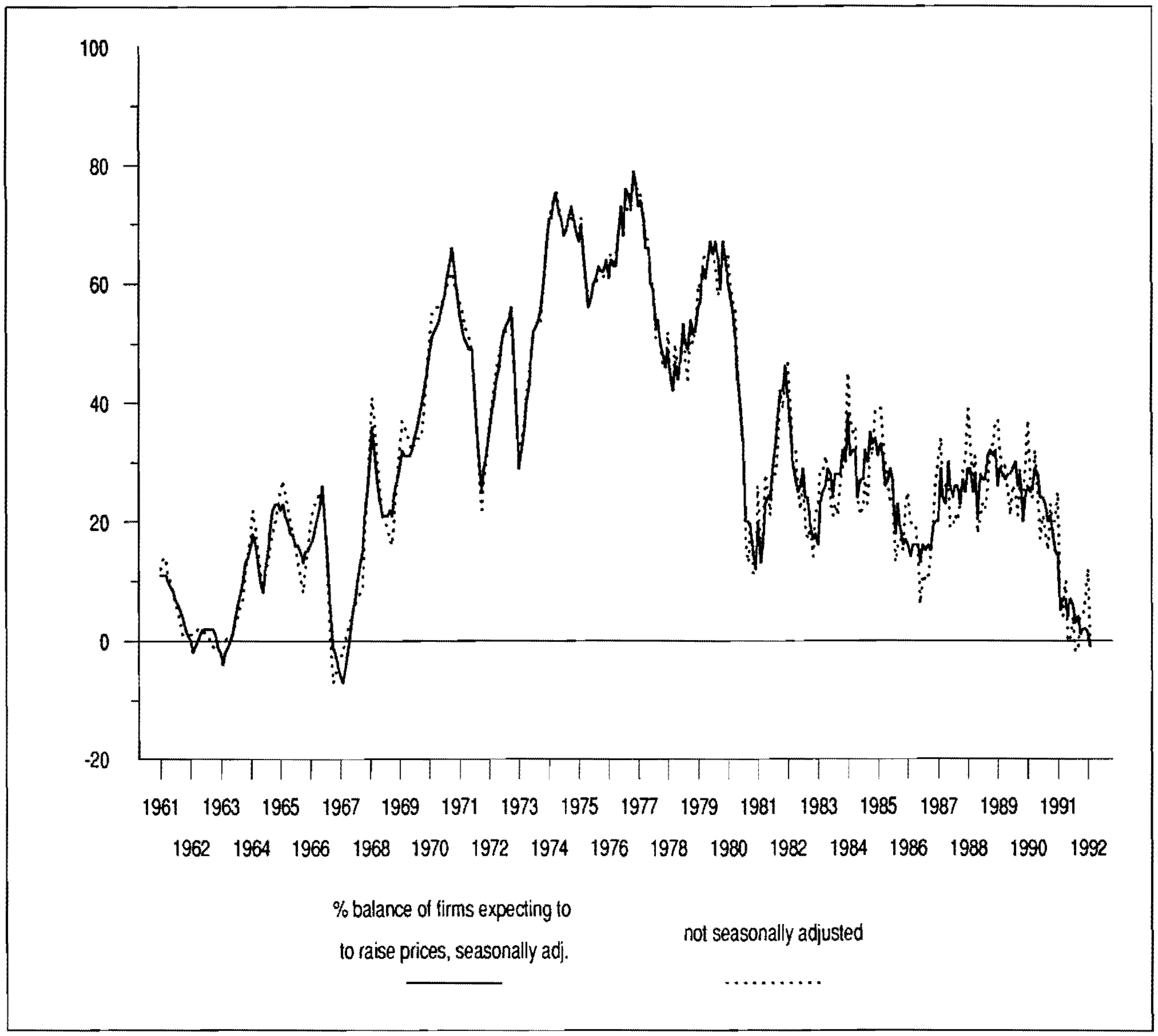
A measure of "underlying" producer price inflation



Comment:

Because food, drink and tobacco prices are affected by changes in excise duties, the PPI excluding these items is normally used as the best measure of "underlying" producer price inflation. Recent improvements have been dramatic. From a peak of 6.4% in early 1991, the annual increase had fallen to 3.1% by January, the lowest since August 1969. The three-month annualised rise is pointing to further progress, reaching only 2.1% in January. Why has PPI inflation slowed much more than RPI inflation? One reason is that the degree of competition is greater in manufacturing than service industries, so pressure on profit margins has been more pronounced. In addition, labour costs make up a greater proportion of total costs in services, so that these industries have been more affected by falling labour productivity as output has declined.

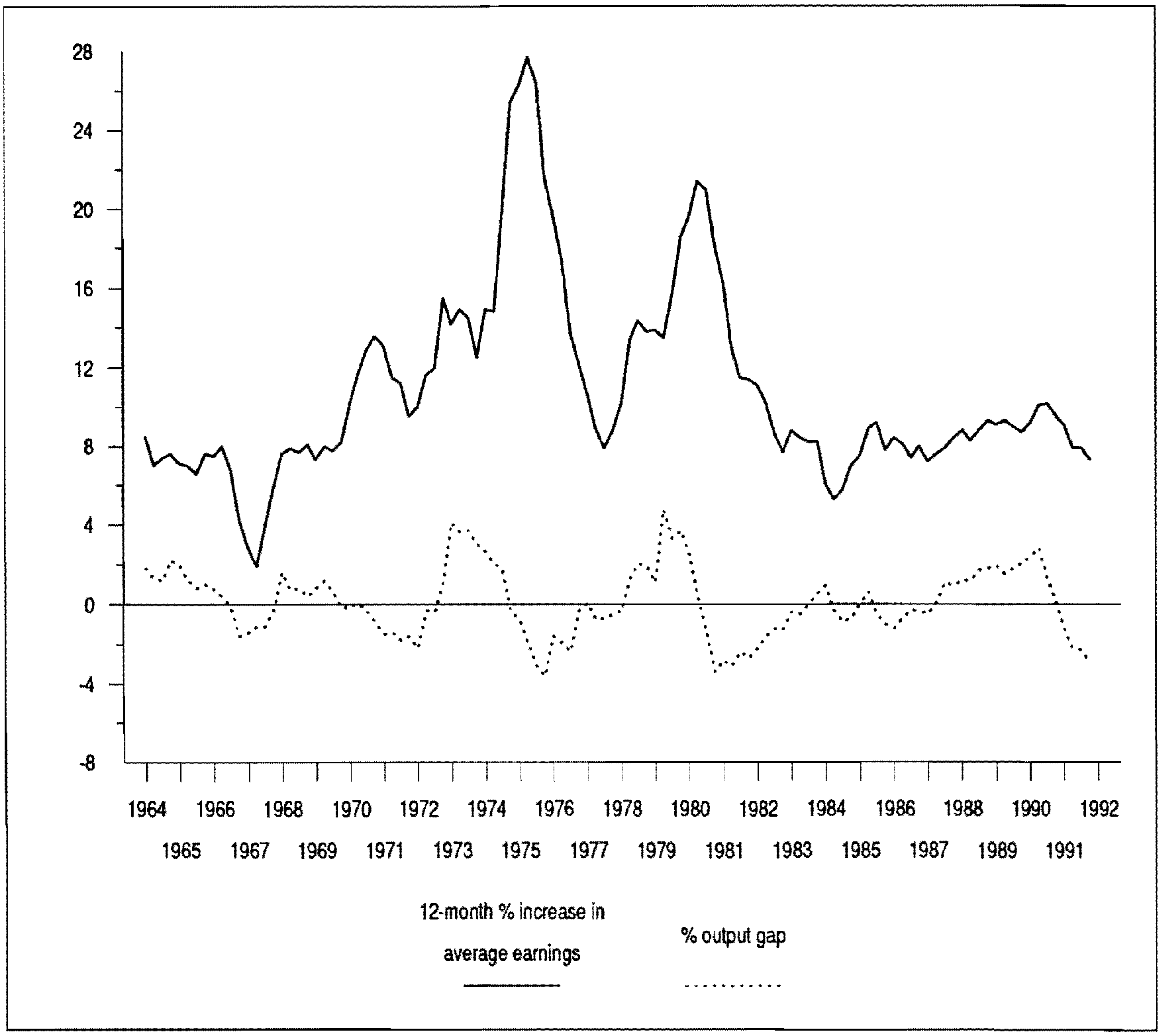
CBI price expectations balance



Comment:

For many years, the CBI has included a question in its regular *Industrial Trends Survey* about the expected movement in domestic prices over the next four months. Initially, the survey was conducted three times a year, then quarterly and from 1975 on a monthly basis. As the chart shows, the monthly series exhibits a pronounced seasonal pattern and it is necessary to correct for this to judge the underlying trend. Recent results have been quite remarkable. The seasonally-adjusted balance actually turned negative in the February survey, i.e. more firms now expect to reduce prices over the next four months than to raise them. Negative balances were last recorded in the 1960s, in 1962/63 and 1967. On both occasions, annual PPI inflation subsequently fell below 1%. Near-price stability, at least in manufacturing, now appears a realistic prospect.

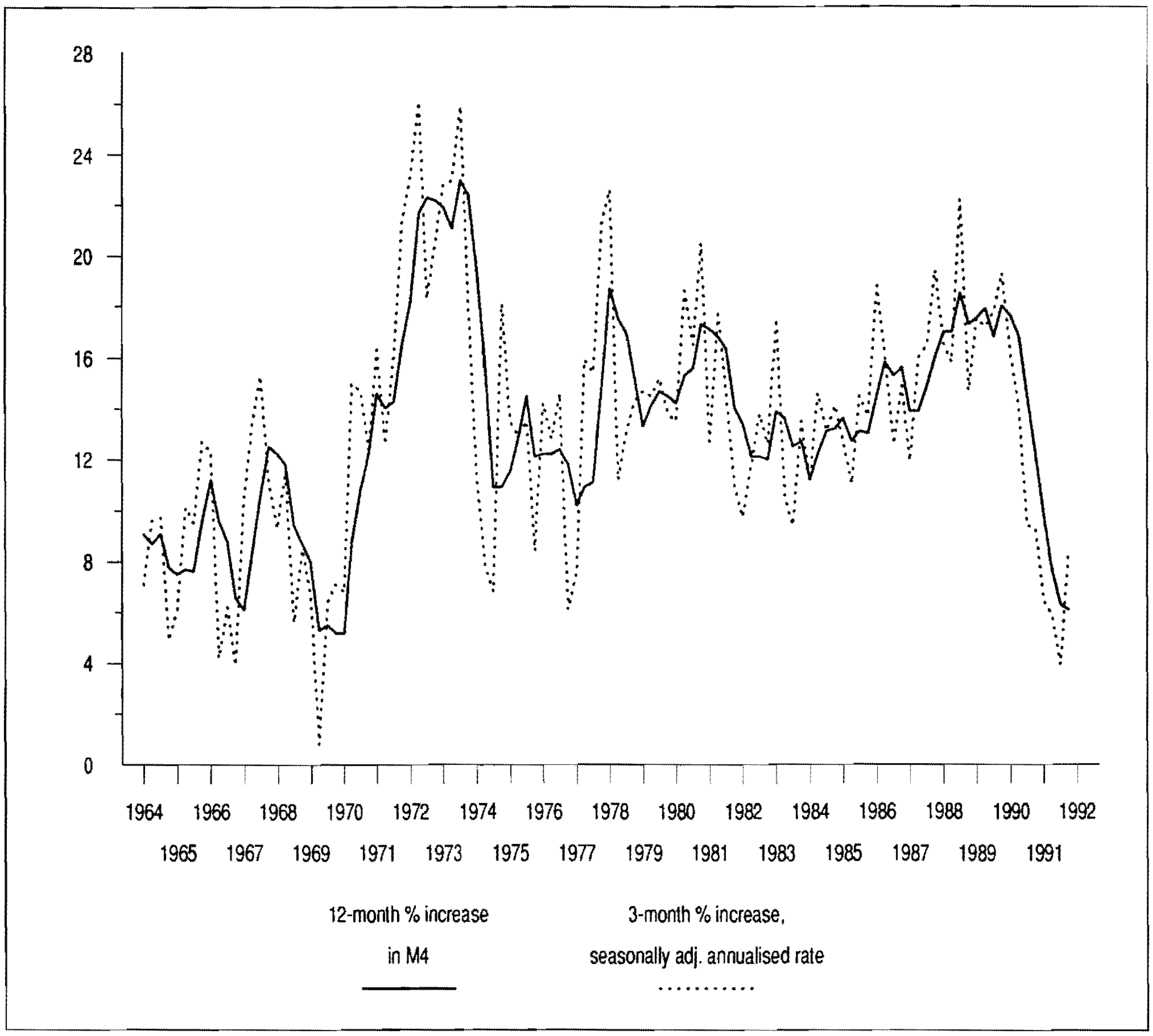
Average earnings growth



Comment:

Annual growth in average earnings has fallen from over 10% in mid-1990 to 6.6% by December. Except for a period in 1984, when figures were distorted by the miners' strike, this is the lowest since the 1960s. Economic theory suggests that pay settlements will rise so long as unemployment is below its "natural" rate, but will fall steadily once unemployment goes above this level. The trouble is that it is impossible to observe the "natural" rate. An alternative is to use some other measure of labour market pressure, such as the "output gap" explained on page 9. The chart confirms that earnings growth has tended to rise during periods of a positive output gap and fall when the gap has turned negative. Since the gap is unlikely to close before late 1993, wage settlements should continue to decline *over the next two years.*

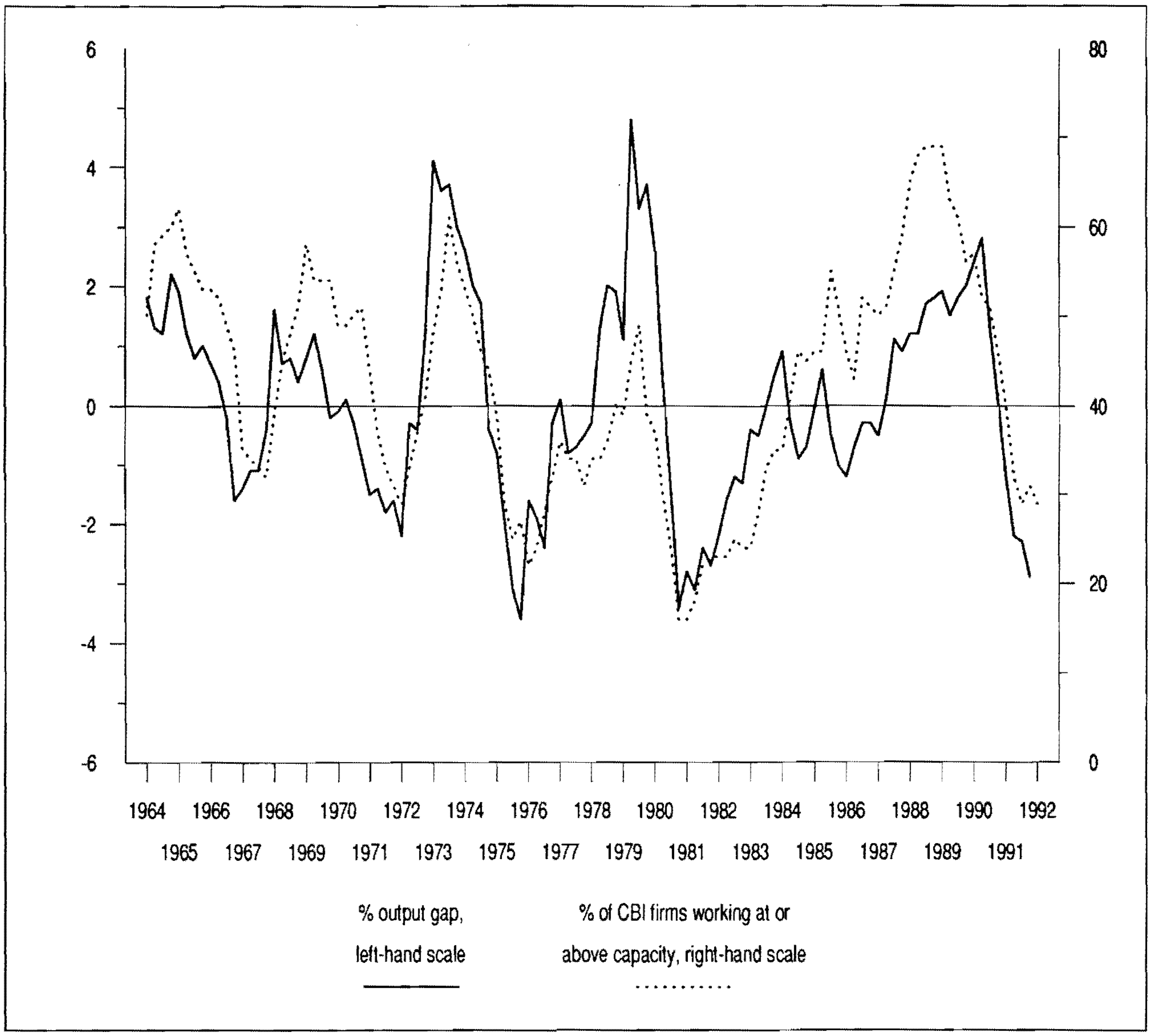
Broad money growth



Comment:

The link between money and inflation is imprecise and characterised by "long and variable lags", in Friedman's phrase. But money clearly does matter. The inflationary upsurges in 1975, 1980 and 1990 were all preceded by a marked acceleration in broad money growth. The low inflation rates of the 1960s were associated with much slower monetary expansion. The recent collapse in M4 growth has been unprecedented in post-war history. The annual increase is now close to the lows reached in the 1960s. The three-month annualised rise recovered somewhat in the final quarter of 1991, but it is unclear whether this will be sustained. The main determinant of M4 expansion is bank and building society lending, but credit demand has yet to show any revival. The "full funding" rule prevents an increased PSBR from boosting M4 growth.

Two measures of capacity utilisation

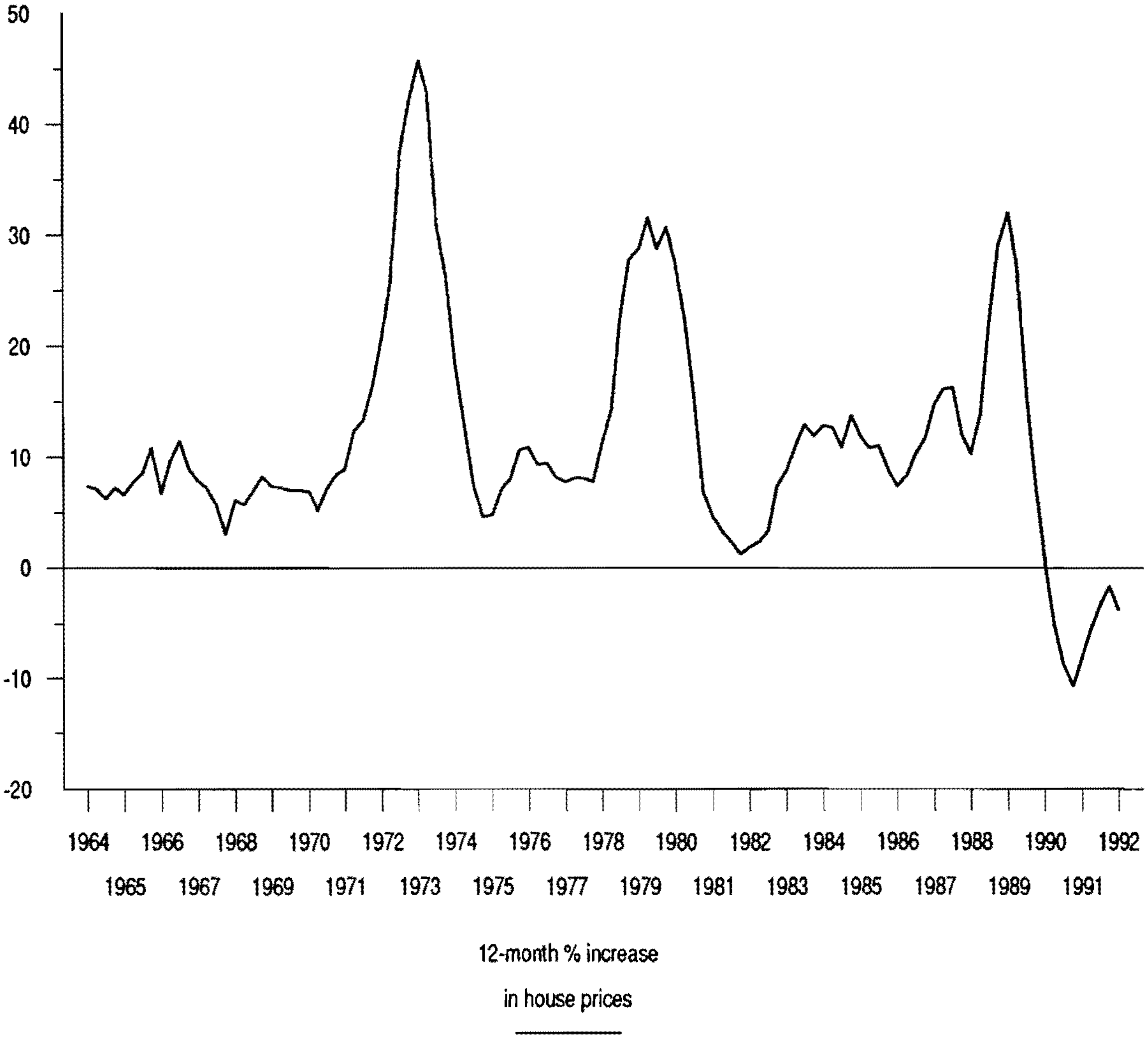


Comment:

Rapid money growth feeds through to inflation via over-expansion of nominal demand. Buoyant demand puts pressure on existing capacity, boosting profit margins and bidding up the prices of production inputs. The chart shows two measures of capacity utilisation. The "output gap" is the percentage deviation of GDP from its "trend" level, where trend is defined here as a five-year centred moving average. (A five-year average is chosen because this is close to the average length of recent business cycles. The trend is extrapolated over the final two and a half years using the slope from a regression run over the last five years.) Also shown is the percentage of CBI firms working at or above a satisfactory rate of operation. Both measures indicate that the degree of spare capacity in the economy is now on a par with the last two recessions.

House price inflation

Nationwide Anglia index, linked to BSA figures before 1973



Comment:

The three house price booms of the last thirty years have preceded upsurges in general inflation. Several reasons can be suggested for this relationship. One is the "wealth effect" of higher house prices, leading home-owners to withdraw equity and spend more on goods and services. In addition, rapid house price rises encourage property firms to build more houses, which increases demand for labour and raw materials. There is also a link with credit and monetary growth. If house prices are expected to grow faster than the rate of interest, there is an obvious incentive to borrow to buy residential property. Of course, all these mechanisms operate in reverse too. Recent house price falls have been unprecedented in the post-war period. This supports the view that disinflationary pressure now is greater than after the last two recessions.