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Commentary on the economic situation

Budgetary and tax influences on Europe's currency tensions

German approach to monetary management, like Britain's in the early 1980s, dominated by analysis of the credit counterparts

The Bundesbank's approach to monetary management is similar to that practised in Britain in the late 1970s and early 1980s, with careful monitoring of the credit counterparts to broad money expansion. In this context its last two *Monthly Reports* make painful reading for anyone who favours an early reduction in interest rates elsewhere in Europe, particularly in Britain. So far in 1992 monetary growth has run at an annualised rate of about 9%, compared with a target range of 3 1/2% - 5 1/2%. As an article in the June *Monthly Report* comments, "The main factor behind the sharp monetary growth is still the marked expansion of credit. The banks' lending to the private sector again rose sharply, at an annual rate of 11 1/2% between January and April." The statistical section at the back of the *Report* gives information on prospective lending growth, with mortgage commitments separately identified. The signs are that lending will remain strong for a few quarters yet. In March and April new commitments to lend were much higher than a year earlier.

Lending growth is being stimulated by tax subsidies

The question arises, "why is German credit demand so buoyant, after a year in which deutschemark interest rates have been at their highest since the new currency was introduced in 1949?". Reunification is obviously much of the answer. The inflow of new workers from East Germany and other former communist countries has put pressure on housing accommodation in West Germany, raising rents and house values, and stimulating new borrowing. But there is another important aspect. The Bundesbank's June *Report* highlights "the frequently subsidised demand for credit in eastern Germany" as "probably" a key reason for the persistent strength in the demand for long-term bank finance. The Federal Government has apparently been concerned to mitigate the impact of large increases in rents which are seen as "prerequisite for the renewal of existing dwellings" in the new *Länder*. In the Bundesbank's words, "Social hardship is being absorbed by generous housing allowances."

High real interest rates throughout Europe due to German fiscal policies

All this is understandable enough, but it has had a ruinous effect on European monetary cooperation. Instead of providing a stable currency anchor for the rest of the ERM, Germany has presented its neighbours with an awkward problem. By offering tax-subsidised credit to a significant group of people, its government has simultaneously increased the budget deficit and enhanced borrowers' tolerance of high real interest rates. The implied increase in DM real interest rates will last for some years and is a structural change in the economic relationship between Germany and the rest of Europe. A sensible response to a structural change of this kind is a realignment of exchange rates. As the months of intensifying deflationary agony in Britain roll on, it has become clear that the decision to put the pound into the ERM at 2.95 DM in October 1990 was a mistake.

Professor Tim Congdon 10th July 1992

Summary of paper on

'The case for price stability'

Purpose of the paper A pseudo-debate has developed in the last few months about the definition of price stability, with some people claiming that inflation of 2% or 3% a year is "price stability". The purpose of this paper is to argue that price stability has only one interesting meaning - namely, the absence of change in the general price level - and that price stability in this sense is preferable to continuing inflation at 2% or 3% a year.

Main points

* **Price stability is best understood as the absence of change in the general price level, accompanied by an expectation that this will continue in all relevant time-horizons (i.e., at least a lifetime). Historically, price stability in this sense has been the norm in Britain.**
* **The most general argument for a stable price level starts from the obvious point that resources are required to set prices. Prices signal the relative scarcity of products and inputs, and price changes benefit society if they improve production and distribution. But they are wasteful if they are motivated merely by a wish to correct for changes in the value of money.**
* **Because any inflation rate requires economic agents to change prices to offset the fall in the value of money and is therefore wasteful, an inflation rate of 2% or 3% a year is inferior to full price stability.**
* **In the labour market price stability would enable companies and their workers to dispense with annual pay rounds, and to return to the simple but excellent principle that "you are paid more if you produce more".**
* **In financial markets one of the key prices is the rate of interest, since this is crucial to the valuation of capital assets. If prices are stable, nominal and real interest rates are the same, which simplifies asset valuation. In an inflationary economy, nominal and real interest rates are different by an unpredictable amount, which makes asset valuation complex. The uncertainties of asset valuation are very damaging to the banking system, which takes property, shares and other capital assets as collateral for loans. This is true even with inflation as low as 2% or 3%.**

This paper was written by Professor Tim Congdon. A slightly different version will appear shortly in a book of essays on contemporary conservatism, published by the Institute for European Defence and Strategic Studies, and edited by Gerald Frost and Digby Anderson.

The case for price stability

No inflation is better than inflation of 2%-3%

Genuine price stability much criticised in public debate

The only worthwhile definition of price stability is simple: it is a condition in which the general price level does not change and is expected to remain the same indefinitely into the future. Supporters of price stability in this sense have had a difficult time in public debate. Their main problem, after a generation in which inflation rates of 5 per cent or more have been almost continuous, is that people cannot make the effort of imagination required to think themselves back into a world of stable prices. Everyone has taken a decision where an inflation expectation is in-built. The British middle class regards rising house prices with considerable affection, while corporate treasurers have taken out fixed-interest-rate debt whose real value is assumed to decline as inflation continues. Many people have defended inflation at about 2 or 3 per cent a year as somehow more appropriate than zero inflation. Mr. Anatole Kaletsky in an article in *The Times* of 1st June described price stability as "a ludicrous notion", with more basis in the fairy tales of Hans Christian Andersen than in the recognised classics of economic theory.

Price stability the historical norm in Britain

Mr. Kaletsky's remark is historically inept. Between the middle of the 17th century and 1931, when Britain left the gold standard, the price level changed relatively little. There were phases of rising prices, but they were offset by other phases of falling prices, and over periods of 50 or 75 years the price level had no systematic tendency in any direction. It is only in the last 25 years that an inflation rate of 5 per cent has come to be regarded as "moderate" and "normal" by respectable newspaper columnists. The contrast between today's permissiveness on inflation and Britain's traditional commitment to price stability is extreme. Historically, British people were right to believe that the price level would be roughly the same when they died as when they were born. Nowadays, a reader of *The Times*, who took note of prevailing financial trends and acted on them, would be sensible to expect 5 per cent inflation to reduce the value of the pound by over 97 per cent in a lifetime of 75 years.

The purpose of this paper is to argue that Britain can and should restore price stability. Price stability is to be understood here in the proper sense of an unchanging price level, not as a state of affairs in which prices rise by 2 per cent or 3 per cent a year. In view of the cynicism of contemporary attitudes towards money and finance, the advocacy of full price stability may seem to be act of considerable intellectual daring. But, as we shall see, a number of the most damaging economic developments of the last 20 years find their explanation in high and volatile inflation. A return to stable prices is to be defended not as an attempt to retrieve a glorious but distant past, but as a vital contribution to the efficiency and prosperity of the British economy in the 1990s and beyond.

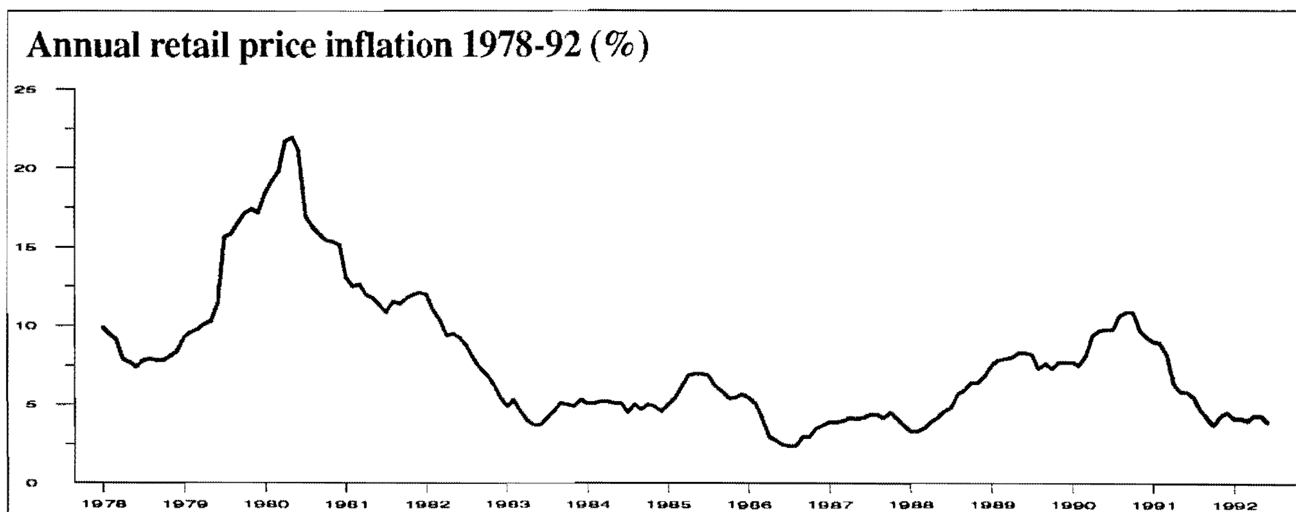
Our argument for price stability will have three parts

The argument will have three main parts. First, Friedman's well- known claim that there is no long-run trade-off between unemployment and the rate of inflation will be recalled. The most significant implication is that monetary policy should be focussed on monetary matters, such as the inflation rate, and should not try to promote employment or output. Secondly, the case will be presented for favouring full price stability over an inflation rate of 2 or 3 per cent a year. Finally, it will be argued that price stability is not only desirable, but also feasible. If the argument is right, the authorities responsible for managing our currency - namely, the Government and the Bank of England - should state clearly that genuine price stability is their goal. The credibility of this announcement would be increased if it were accompanied by a decision to give the Bank of England operational independence from the Government.

I. There is no long-run trade-off between unemployment and inflation, **a view proposed by Friedman**

Friedman's contention that there is no long-run trade-off between inflation and employment was made in his presidential address to the American Economic Association in 1967. The consensus of economic opinion in the mid-1960s was that inflation was inversely related to unemployment and that any given unemployment rate would be associated with a particular stable inflation rate. (Thus, if unemployment were x per cent, inflation would be a per cent now and in future years.) Friedman denied this. He proposed that there was only one unemployment rate, called the "natural rate", at which supply and demand in the labour market were in balance. If the unemployment rate were at x per cent, beneath the natural rate of $(x + n)$ per cent, excess demand in the labour market would increase wage settlements in real terms. These higher settlements would stimulate inflation and the higher inflation rate would become an influence on the labour market in future. Specifically, if unemployment remained at x per cent for another year, the persistence of excess demand would cause the same level of wage settlements in real terms to be reached. But, since inflation had risen, the same level of wage settlements in real terms would result in yet higher settlements in money terms. Inflation would again be stimulated. Because higher wage settlements feed higher inflation expectations and higher inflation

Annual retail price inflation 1978-92 (%)



expectations lead to higher wage settlements, the process of degeneration would prove unstable. Unemployment at x per cent would be associated not with a stable inflation rate (of a per cent), but with ever-accelerating inflation (i.e., a per cent in year one, $(a + y)$ per cent in year two, $(a + z)$ per cent in year three, where $z>y$, and so on.) The final outcome might be hyperinflation and social collapse.

Friedman's theory very influential in the mid-1970s

Friedman's theory was political dynamite. Until then governments followed the policy prescription in Keynes' *General Theory of Employment, Interest and Money* (published in 1936), which urged an active use of fiscal policy to maintain full employment. By claiming that an unemployment rate held beneath the natural rate would lead to hyperinflation, Friedman questioned the validity of all policies of demand management intended to influence employment and output. In the Britain of the mid-1970s, when inflation exceeded 20 per cent and serious commentators worried about the durability of Britain's democratic institutions, his ideas had an obvious relevance. They gained numerous converts in the public debate, including such influential figures as Mr. Samuel Brittan on the *Financial Times* and Mr. Peter Jay on *The Times*. The intellectual groundwork had been laid for the Thatcher Government's absolute priority to the defeat of inflation in the early 1980s, regardless of the effects on unemployment.

Since the absence of a long-run trade-off between inflation and unemployment has been an underlying assumption of policy-making for over a decade, there may seem little point in reiterating it now. But politicians and leader-writers often claim that a drive for price stability would have an intolerable cost in terms of lost output and employment. Undoubtedly there is a short-term cost in aiming for stable prices rather than inflation of, say, 3 or 4 per cent. A disagreeable message of Friedman's theory is that inflation can be reduced only if unemployment is held above the natural rate for a certain period. Further, the more ambitious is the inflation objective, the longer is the required period of above-normal unemployment. But it is important to keep a sense of perspective.

Britain has already suffered the costs of reducing inflation

In the last 20 years Britain has suffered from inflation of over 20 per cent for extended periods of many months and from inflation of over 10 per cent for several years in a row. Efforts to reduce inflation to more moderate figures have already been extremely costly to our economy. Many members of the political establishment tolerate and indeed defend the massive social pain inflicted by reducing inflation from 25 per cent to 3 per cent. Why then do they object to the extra inconvenience which might result from lowering it from 3 per cent to nothing? Moreover, if Friedman's theory is correct, the current decline in inflation implies that unemployment is above the natural rate. Friedman's apocalyptic verdict that inflation accelerates upwards without limit when unemployment is beneath the natural rate has a happy but often forgotten corollary, that it declines indefinitely when unemployment is above the natural

rate. As inflation is falling at present, a fair deduction is that the rate of unemployment compatible with long-run price stability is lower than today's level.

The frequent assertions in public debate that zero inflation would have a heavy social cost are misguided. They are motivated by the common but tiresome wish to display a social conscience, and to appear kinder and more compassionate than advocates of sound money. They are thoroughly wrong-headed. They stem from the old and discredited view that any given inflation rate is associated with a particular rate of unemployment now and forever into the future. If this were right, price stability would be accompanied by permanently higher unemployment than 5 per cent inflation, 5 per cent inflation by permanently higher unemployment than 10 per cent inflation, 10 per cent inflation by permanently higher unemployment than 20 per cent inflation, and so on.

As in Germany, monetary policy shuld focus on inflation

Presumably the blessings of zero unemployment could be enjoyed if prices were rising by several thousand per cent a month. That is obvious nonsense. To repeat the central theme of Friedman's 1967 lecture, there is no long-run trade-off between inflation and unemployment. A mass of evidence from a large number of countries and over many periods confirms the validity of Friedman's insight. Indeed, in the 1970s and 1980s such havens of low inflation as Germany and Switzerland almost always had less unemployment than high-inflation delinquents like Britain and Italy. Monetary policy in Britain - as in Germany and Switzerland - should concentrate on reducing inflation, not on trying to minimize unemployment.

II. Inflation of 2% or 3% still wastes scarce resources in unnecesary price calculations

But the claim that the elimination of inflation would not in the long run have greater social costs than reducing inflation to a low level does not complete the case for price stability. It is still necessary to explain why full price stability would be better than low and stable inflation rate of 2 or 3 per cent. The most general argument for price stability relies on the well-recognised efficiency and success of the market system, in which the forces of supply and demand are given free play. Supply and demand are not abstract concepts invented for the purpose of philosophical discourse, but instead real-world relationships between quantity and price.

If a market system is about all about prices, people are needed to set them. Any market, from Petticoat Lane to the Stock Exchange, involves large numbers of people constantly trying to assess supply and demand. The market economy is best seen as a continuous attempt by many millions of people to set many millions more of prices. The resources of time, manpower and imagination devoted to setting the right prices are enormous. Despite the commitment of resources it requires, the price mechanism has delivered far better economic performance in the market economies of the West than has central planning in the command economies of the former Communist bloc. It is is because the

price mechanism works that people in Britain and other advanced economies enjoy such remarkably high living standards.

When prices are stable, any individual price change improves resource allocation and production decisions

However, it would be wrong to think that all price-setting activity is beneficial to society. The price mechanism is at its most useful when it gives signals about the relative scarcity of goods and services, since these signals guide production and distribution. But the existence of inflation forces economic agents to devote effort and resources to judging how much the price of goods should be adjusted for changes in the value of money. These judgements about the inflation rate add nothing to the sum of human happiness. Since they involve much guesswork about how financially responsible (or irresponsible) politicians will be in future, they do not help the truly worthwhile activities of producing and selling real things.

Resources used to adjust prices in order to reflect relative scarcity are socially advantageous; resources used to adjust prices for inflation are social waste. The higher is the inflation rate, the greater the waste and the poorer is society. Here is the core of the argument for price stability. Clearly, the loss to society from an inflation rate of 3 per cent is much less than that from an inflation rate of 30 per cent or even 10 per cent. But unnecessary damage to the economy is certainly still being imposed by 3 per cent inflation. Two kinds of social waste need to be given particular emphasis, waste in the labour market and waste in the financial system. They may be considered in turn.

Reduction in waste exemplified in,
i. The labour market

The British labour market, like that in other industrial countries, has become accustomed to the practice of an annual pay round. In most industries employers, trade unions and other representatives of the workforce come together every year at roughly the same date in order to reach agreement on wage payments and structures. This process often takes up significant management time and is by far the most important justification for the activities of trade unions, which have to levy members, pay officials and so on. If a deal cannot be struck, further procedures may be explored, with ballots of workforce opinion and resort to arbitration. In short, pay bargaining absorbs scarce resources (of management time and the costs of union activity) even if the parties involved consistently succeed in making agreements. Still worse, if they sometimes fail to reach agreement and a strike follows, there is a straightforward loss of output.

If prices were stable, an annual pay round would no longer be necessary

In an inflationary economy, an annual pay round is necessary and inevitable, because every group has to watch its position relative to other groups. The annual pay round would be habitual even with inflation as modest as 2 or 3 per cent. By contrast, in an economy enjoying full price stability, an annual pay round is not required. If genuine price stability had been established, there would be no need to review wages every year. The main reason for higher pay would no longer be the pressure for particular groups to match national inflation

and to preserve differentials, since there would no longer be any national inflation to match. Instead pay rises would have to be justified by higher productivity. More simply, you would be paid more if you produced more. This simple principle - which has an obvious appeal in common sense and morality - is undermined by any inflation rate, even one of only 2 or 3 per cent. It would be reasserted by a return to full price stability.

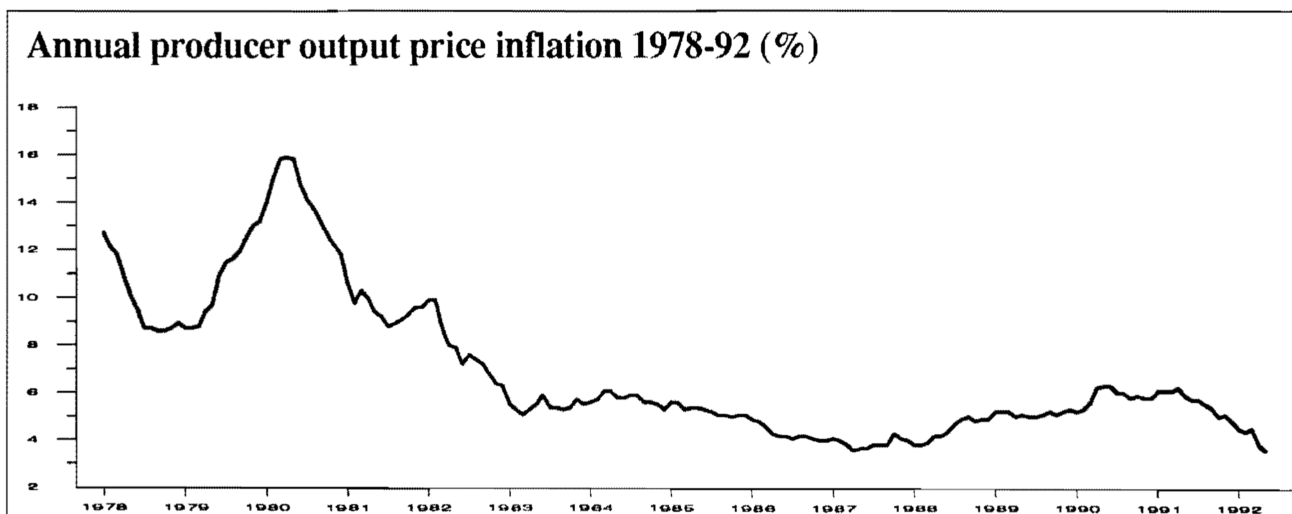
People in Britain have forgotten the time when a job had a fixed and known rate of pay. But in the 1930s, and even in the late 1940s and early 1950s, there were many walks of life where pay rates were regarded as stable points of reference for managements and employees. This had a healthy effect on attitudes towards work and effort. With pay rates fixed over many years, extra pay was recognised as the result of promotion and special merit. A "rise" was an exceptional and valued event in someone's life, an act of recognition which had special meaning for a worker and his boss. Nowadays, by contrast, pay rises are driven by guesses about future inflation and bargaining success depends on cleverness in interpreting the macroeconomic situation. The connection between effort and reward, between input and output, is less precise in an economy suffering from inflation than in one with absolute price stability.

ii. Financial markets

The obsolescence of the annual pay round in an economy with stable prices has clear advantages for society and is easy to understand. The benefits of price stability for financial markets are more complex, but perhaps even more important. Many financial markets appear to be the epitome of price flexibility, with share prices and exchange rates fluctuating widely from day and day. The relevance of, say, a stable retail price index to their efficiency may seem limited. But this is not so. Price stability is vital to the efficiency of financial markets.

Asset values depend on interest rates

The immense size of the capital stock and the longevity of many capital assets are some of the most remarkable features of modern industrial societies. Indeed, it is not an exaggeration to say that these features are fundamental to their high



Annual producer output price inflation 1978-92 (%)

productivity. Capital assets such as power stations, oil refineries, ships, airplanes, petrochemical plants, steel mills and multi-storey office buildings have made possible technical efficiencies and economies of scale which would be beyond the imagination of pre- industrial communities. Miscalculations in assessing the level of resources appropriate for such investments are very expensive to society. The value of any capital asset depends on two main considerations - the expected flow of future income and the interest rate at which this flow is discounted. The interest rate is crucial, because it signals the sacrifice involved in deferring the realisation of an investment. Further, the larger and more long-lived the capital asset, the more significant is the interest rate term. In the extreme case of an asset providing a constant income in perpetuity, its value is halved by a doubling of interest rates. Large changes in interest rates can cause violent swings in asset prices, particularly in the prices of long-lived assets, while big mistakes in asset pricing may lead to expensive misallocation of investment resources.

If prices were stable, nominal and real interest rates would be the same

It is here that we come to the great importance of price stability to the efficiency of savings and investment in capitalist economies. In an economy with stable prices nominal and real interest rates are identical. The interest rate known and well-publicised in financial markets is the interest rate appropriate for all asset valuations and relevant to all decisions to borrow, lend and invest. But that is not so in an economy suffering from inflation. Instead businessmen and individuals have to make an inflation adjustment to every interest rate they encounter and in every interest rate decision they take. Real interest rates are often more important to them than nominal rates, with the difference between them determined by inflation expectations. As a practical matter, inflation expectations differ from one economic agent to another and from one year to the next. Expected real interest rates therefore also differ between people and over time.

Ambiguity of interest rates in an inflationary economy complicates asset valuation

When inflation has become deeply entrenched, these uncertainties about inflation expectations and real interest rates greatly complicate asset valuation. Because privately-owned capital assets represent the greater part of the capital stock in a market economy, and the because the valuation of capital assets is fundamental to savings, investment and the distribution of wealth, the complexity of asset valuation matters vitally to almost everyone. A brief account of inflation and interest rate developments in the last 20 years illustrates the point.

In Britain and elsewhere nominal interest rates did not keep pace with rapid inflation in the 1970s. Interest rates were remarkably low in real terms, favouring borrowers and investors in hard assets (land, buildings, precious metals, certain types of commodity). This encouraged people to believe that low real interest rates had become a permanent feature of industrial economies. In the early and mid-1980s borrowers remained eager to invest in hard assets

and were able to persuade banks to lend to them. The late 1970s also saw a remarkable surge in so-called "sovereign lending" to Third World countries, many of which exported the commodities whose prices benefited from general inflation. The booms in both real estate lending (in the USA, Britain and other countries) and sovereign lending reflected a prevailing view that real interest rates would stay low in the mid and late 1980s, and beyond.

Sharp change in real interest rates between the 1970s and 1980s illustrates risks of misperceptions about inflation

However, the 1980s instead were a decade of high real interest rates in most countries. The peak levels of dollar real interest rates in the early 1980s coincided with the onset of the Third World debt crisis and brought misery to many of the world's poorest nations. In the USA itself high real interest rates brought financial hardship to large sectors of the economy (over-borrowed farmers, the oil-producing states) and culminated in the late 1980s in the crippling of the real-estate industry. Office developers had thought that real interest rates would continue at the levels of the 1970s, in which case they could have survived despite a chronic over-supply of space. Instead at the real interest rates which actually prevailed in the 1980s debts grew remorselessly faster than rents and bankruptcies were inevitable.

Even the British housing market has been plagued by uncertainties about real interest rates. In the housing boom between 1986 and 1989 home-owners took it for granted that, in the long run, increases in house prices would at least match the interest rate on mortgages. Since then they have had a rude financial awakening. House prices have fallen while mortgage rates remain in double digits. It is a simplification, but not a caricature, to say that the housing boom was motivated by an universal belief that the long- run real interest rate relevant to mortgage debt (i.e., the mortgage rate adjusted for the rate of house price increase) was nil or slightly negative. Between mid-1990 and mid-1992 this real interest rate was in fact positive at between 15 and 20 per cent. Hundreds of thousands of households now find that their mortgage is greater than the value of their homes.

Bad debts because of mistakes in assessing real interest rates damage the financial system, particularly the banks

Volatile real interest rates and consequent sharp fluctuations in asset values are traumatic for borrowers and lenders. But their impact on intermediaries, particularly banks and specialist mortgage lenders, is if anything even worse. It is here that we see most vividly the damage that inflation causes to the financial system. Few individuals can buy large, bulky and long- lived capital assets from income or even from accumulated wealth. Instead financial institutions have to be involved, often as lenders of many people's savings. Of course, banks know that the values of capital assets fluctuates and allow for this by restricting loans to proportions of valuation. The more uncertain are capital values, the lower are the proportions. But - not matter how cautious banks are - they suffer bad debts if asset values collapse. In the extreme, their own solvency may be threatened.

To summarize, the ability of banks to support the purchase of capital assets, and so to promote the efficiency of the real economy, depends on the ease and reliability with which the assets can be valued. The complexity of the interest rate term in any contract in an inflationary economy, and the unpredictability of real interest rates, gravely undermine the ability of banks and other lending intermediaries to perform their normal business role. This argument is basic to understanding the present plight of banking systems all over the world. At the start of the 1980s, after a decade of low or negative real interest rates and a moderate incidence of bad debts, large international banks had reduced their capital/asset ratios to the lowest levels ever and were still eager to expand. Today, after a decade of high real interest rates and ruinous bad debt experience in many countries, banks are struggling to boost capital/asset ratios and are withdrawing from unprofitable business areas. The swings in the banking system's behaviour, and the profound impact this has had and continues to have on many non-financial businesses, reflect changes in real interest rates and associated fluctuations in asset values. These fluctuations, in turn, have been caused by high and volatile inflation. In short, the sorry state of the world's banking systems in the early 1990s is the result of a generation in which 5 per cent a year or more has been almost continuous.

The ambiguity of real interest rates remains even with inflation as "low" as 2% or 3% a year

If inflation were reduced to a 2 or 3 per cent a year, banks and other intermediaries would of course be in a happier and more stable situation than they were in the 1970s and 1980s. But, even with inflation at those rates, nominal and real interest rates would be different. All the complexities and agonies of valuing large, long-lived assets, and of financing investments in them, would remain. The difficulties would no doubt be less than in the last 20 years, but it must not be forgotten that a doubling of the yield (from 2 per cent to 4 per cent, or from 3 per cent to 6 per cent) halves the value of a long-lived capital asset. In a world of 2 to 3 per cent inflation (which would no doubt in practice see inflation oscillating from nil to 5 per cent), changes in real interest rates and asset yields would remain a costly nuisance to savers and investors, and to companies and their banks. There is no advantage to society in having inflation at 2 or 3 per cent rather than zero. When the price level is stable and expected to remain so for many years, banks and the financial system can be certain about the real meaning of any nominal interest rate. A free market economy, with its massive stock of privately-owned capital assets, is therefore at its most efficient when the price level is absolutely stable.

III. Stable prices to be achieved by stabilizing the growth of the money supply (on broad

How, then, is a stable price level to be achieved? Despite all the intellectual turmoil about monetary policy in the last 20 years, the solution may be more obvious and easier to implement than many people in Britain think. The world now has ample experience of managing paper monies without a commodity backing. There is also little doubt about which country and which system has come closest to the ideal of price stability. As everyone knows, Germany has been more successful than any other leading nation in maintaining a good

***definitions) at a sufficiently low rate,* as has been attempted - with some success - in Germany in the last 15 years**

currency and its independent central bank, the Bundesbank, has become anexample to central banks all over Europe. Fortunately, the Bundesbank is not secretive about the reasons for its formidable achievement. The centrepiece of its effort to keep inflation down is control over the money supply, which in this context means the broad definition of money including bank deposits. The rate of broad money growth largely depends on the rate of growth of bank credit and this in turn is strongly influenced by interest rates.

The method of monetary control favoured by the Bundesbank today in Germany is similar to that implemented in Britain between the introduction of broad money targets in 1976 and their abandonment in 1985. In Britain also the system worked well, with the economy enjoying in the early 1980s a fair measure of economic stability combined with gradually falling inflation. By contrast, since 1985 the Government's fascination with the European exchange rate mechanism has been a disaster, with the irresponsible boom of mid-1986 to mid-1988 followed by the longest and deepest recession since the 1930s.

Stable money growth should have precedence over exchange rate stability

In the 1990s British economic policy should be focussed on the goal of price stability. That goal should be pursued by a Bank of England which is at least as independent of government as the Bundesbank. The best way for a newly-independent Bank of England to reconcile a stable economy and a sound financial system with continued progress against inflation is to give priority to the stable growth of credit and money. Exchange rate stability - such as that enforced by the European exchange rate mechanism - should always be secondary to the well-being and prosperity of the British people.