

# GERRARD & NATIONAL

## Monthly Economic Review

No. 76, October 1995

Contents	Page No.
Commentary on the economic situation	1
Research paper - Topic: What is the right monetary framework?	3
Statistics this month - Calendar of UK and US release dates	<i>Outside back cover</i>

The *Gerrard & National Monthly Economic Review* is intended to encourage better understanding of economic policy and financial markets. It does not constitute a solicitation for the purchase or sale of any commodities, securities or investments. Although the information compiled herein is considered reliable, its accuracy is not guaranteed. Any person using this *Review* does so solely at his own risk and Gerrard & National shall be under no liability whatsoever in respect thereof.

---

## Gerrard & National Holdings PLC

Gerrard & National Limited

Lombard Street Research Ltd.

33 Lombard Street, London, EC3V 9BQ Tel: 0171-623 9981 Tlx: 883589 Fax: 0171-623 6173

### **GNI Limited**

4th Floor, Atrium Building,  
Cannon Bridge,  
25 Dowgate Hill,  
London EC4R 2GN  
Tel: 0171-337 3500  
Tlx: 884862  
Fax: 0171-337 3501

### **Gerrard Vivian Gray Limited**

Burne House,  
88 High Holborn,  
London WC1V 6LS  
Tel: 0171-831 8883  
Tlx: 887080  
Fax: 0171-831 9938  
Stx: 74377

### **LM (Moneybrokers) Limited**

4th Floor,  
25 Cannon Bridge,  
25 Dowgate Hill,  
London, EC4R 2GN  
Tel: 0171-337 6500  
Tlx: 8811553  
Fax: 0171-621 1652

## Excellent inflation news ahead

### Headline retail inflation could drop to almost zero in spring 1996

#### **Inflation under 1%?**

Could the inflation rate in 1996 drop beneath 1%? Indeed, is it possible that the headline rate (i.e., excluding mortgage interest payments) could briefly dip to zero next spring?

Most forecasters and all measures of inflation expectations are giving a clear "no" to these questions. The latest Barclays survey of inflation expectations, carried out in June, found that the general public's mean one-year and two-year inflation forecasts (i.e., for June 1996 and June 1997) were 4.2% and 4.7% respectively. Investment analysts were more optimistic, at 3.5% and 4.0%, but they evidently remained sceptical that the Government would meet its 1% to 4% inflation target. Financial markets reflect analysts' scepticism, with the differential between the yields on conventional and index-linked gilts implying an expected inflation rate of over 4% at most future dates. But expectations are not always a good guide to outcomes. In fact, so far in the 1990s expected and actual inflation have been very different. Since early 1991 inflation has typically been 1% to 2 1/2% a year lower than expected in the Barclays surveys.

#### **As usual in the 1990s, inflation expectations are too high and wrong**

A strong case can be made that today, once again, inflation expectations - and the forecasting consensus which they reflect - are wrong. Inflation will benefit in early 1996 from a bunching of favourable influences, both special and underlying. Among the special influences the recent drop in the mortgage rate, a further drop if interest rates are reduced in the Budget and the probable £50 electricity rebate need to be highlighted. Roughly speaking, 1% off the mortgage rate is 0.35% - 0.4% off the headline RPI and that seems a reasonable estimate of the combined effect of September's fall in the mortgage rate and the Budget, if Mr. Clarke does in fact go ahead with lower interest rates. The £50 electricity rebate will be given to customers only if the planned flotation of the National Grid proceeds in December. In that event both the headline and underlying annual rates of retail price inflation will dip by 1 1/2%. (See Robert Chote's story in the *Financial Times* for 28th September for more details.) When allowance is made for a number of one-off adverse effects disappearing from the annual comparison (notably the mortgage rate and indirect tax increases between September 1994 and April 1995), the total benefit from all the identifiable special factors is about 3%. So, if the strength of the basic inflationary pressures in the economy were to remain unchanged, the headline rate of retail inflation would fall from its current 3.6% to about 1/2%. But, over and above that, basic inflationary pressures appear to be weakening. The slowdown is forcing companies to shake out excess stocks in particularly vulnerable sectors, such as building materials and household goods. This year's Budget will be a difficult one for Mr. Clarke politically, but it will be set against the best inflation background since 1959.

## Summary of paper on

### 'What is the right monetary framework?'

**Purpose of the paper**

A new framework of monetary control was introduced after sterling's departure from the European exchange rate mechanism on 16th September 1992. Now, more than three years later, the time has come for an initial appraisal of this framework, particularly for the inflation target.

#### Main points

- \* *The inflation target should be replaced by a target for the price level.*
- \* *The main point of replacing the inflation target by a price level target would be to break inflation expectations. Although the inflation target has been met consistently since 1993, inflation expectations are still higher than the official target band.*
- \* *The ultimate goal should be full price stability, in which the price level does not change over indefinitely long periods of time. Definitional problems arise, nevertheless, because the price level could be defined in terms of goods alone or goods and services, and it is affected by quality changes and new products.*
- \* *Full price stability reduces the number and costs of price changes, and so improves the efficiency of the price mechanism in allocating resources. This is helpful in the labour market, where the costs of collective bargaining and the incidence of strikes are likely to be lower, the closer the approximation to price stability.*
- \* *But full price stability would be of most benefit to long-term financial contracts, where it would eliminate the difficult task of assessing (or guessing) the long-term inflation rate, and so make real and nominal interest rates the same. Full price stability would encourage banks and investors to become much more long-term in their forward planning.*

This paper was written by Professor Tim Congdon. It forms part of his latest *Submission* to the Treasury Panel.

## What is the right monetary framework?

### The target should be a stable *price level*, not an *inflation rate*

#### Important changes to monetary framework after September 1992 ERM *débâcle*

Sterling's humiliating exit from the European exchange rate mechanism on 16th September 1992 prompted a major reformulation of monetary policy, in terms of both objectives and implementation. On objectives the previous 20 years had seen a sequence of policy shifts, reflecting changes in fashion among economists. Policy-makers had consistently seen lower inflation as their prime ultimate goal, but had fluctuated in their preferences for incomes policies, money supply control and exchange-rate fixing as intermediate targets to achieve it. After the *débâcle* of September 1992 the Government abandoned the notion that any intermediate target was wholly satisfactory and instead expressed policy intentions in terms of the ultimate objective. Underlying retail inflation was to be reduced to, and kept at, between 1% and 4% at an annual rate, and would ideally be in the lower half of the band by the end of the Parliament (i.e., late 1996 and early 1997). The changes to policy implementation were also quite radical, as the Treasury undoubtedly saw itself as responding to criticism of its poor (or allegedly poor) policy advice. First, the monthly meetings were the Chancellor of the Exchequer and the Governor of the Bank of England were formalised and the minutes of the meetings published. Secondly, the Treasury Panel of Independent Forecasters (the so-called "wise men") was created to act as a corrective to the Treasury's own forecasts.

#### and now timely for them to be reviewed

These arrangements have now been in place for three years and the time has come for an initial appraisal. In line with an agenda given to Panel members by Mr. Alan Budd, the Treasury's Chief Economic Adviser, the paper will consider the following topics in turn, with a particular emphasis on the first topic:

- the inflation target
- the medium-term monitoring ranges for M0 and M4
- the Bank's independent *Inflation Report*
- the publication of the Chancellor/Governor minutes
- the explicit listing in the 1995/6 Medium Term Financial Strategy of some of the indicators used in the assessment of inflation pressures.

### I. The inflation target

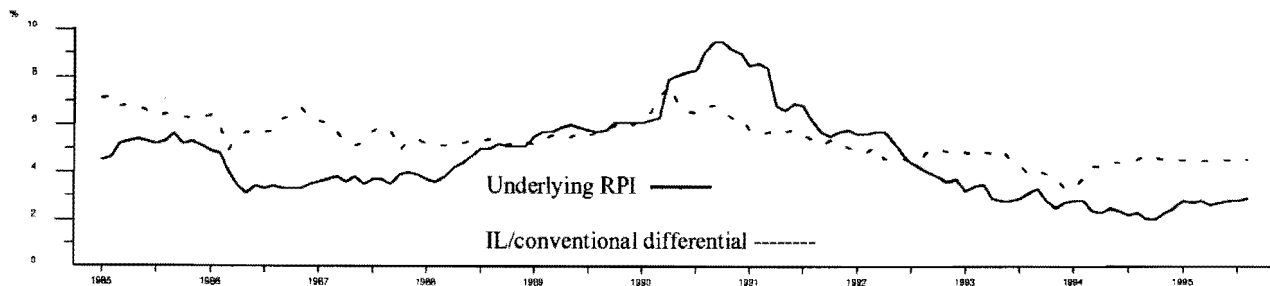
#### It has "worked"

In a most important sense the inflation target has been a great success. As the target has been met, it has "worked". The backward-looking twelve-month increase in the underlying retail price index (i.e., excluding mortgage interest costs) dropped beneath 4% in October 1992 and has stayed there. Indeed, it was under 2 1/2% from March to December 1994, and may return to the lower half of the 1% to 4% band in early 1996, just as originally planned back in 1992. In comparison with the various frustrations, bunglings and blowings-off-course that have characterised British economic policy since the ill-fated National Plan of 1965, the definite attainment of a very clearly-stated official target represents a spectacular advance.

## Continuous mistakes in inflation expectations

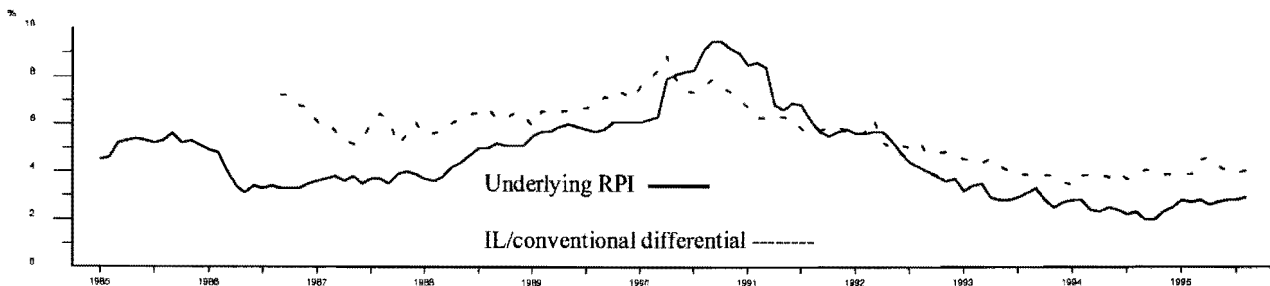
### - Long-term inflation expectations have been too high

The differential between the yield on IL 2 1/2% 2016 and Tr. 7 3/4% 2012-15 is a measure of long-term inflation expectations. It has been above actual inflation for most of the last decade.



### - Shorter-term inflation expectations have also been too high

The differential between the yield on IL 2% 1996 and TR. 8 3/4% 1997 is a measure of shorter-term inflation expectations. It also has been above actual inflation over the last eight years. (The IL's under-performance over the ten years to 1996, relative to the conventional Treasury 8 3/4% 1997, is over 1% a year.)



**But "only" 2% inflation is not price stability**

But policy-makers must not become complacent. In particular, they must not be misled by the widespread indifference among economists to an inflation rate of "only" 2% into thinking that their task is complete. Britain used to be a country where most people did not know the meaning of the word "inflation". They did not know its meaning because, except in wartime, they had never experienced a persistent and systematic upward movement in the price level. In a normal, peaceful world, they therefore had no "inflation expectations" whatsoever. (Even in the general elections of 1959 and 1964 the complaint was not about "inflation", but about "the cost of living". A high proportion of the electorate must have thought that there was a more or less unique "cost of living" and that, aberrantly and temporarily, prices were too high relative to it.)

**Aim should be the complete elimination of inflation expectations**

The campaign against inflation will not be complete until the traditional state of affairs - a complete absence of inflation expectations - is restored. There is obviously some way to go. Inflation expectations can be measured either by means of surveys (such as that conducted by Barclays Bank) or from financial behaviour, notably by comparing the yield on conventional and index-linked gilts. As shown by the charts above, the prevalent expectation is that the RPI

will rise by 4% a year or more over all relevant time-horizons. Despite a number of conceptual difficulties in its definition, it would be sheer eccentricity to regard a 4%-a-year rise in the RPI as "price stability".

**Full price stability has at least three advantages over low inflation, 1. Lower costs of using the price mechanism**

Sceptics might wonder whether a condition of price stability has any significant advantages over a condition of low inflation. Three arguments will be developed here for the superiority of genuine price stability over a "low" inflation rate. (The following discussion borrows from T. G. Congdon *For a Stable Pound*, published in London by the Centre for Policy Studies, 1991.) The first is quite general. The price mechanism is the hallmark of the free market economy with extensive private property. As there is ample evidence that this type of economy is more efficient than a command economy with predominantly state ownership, the virtues of the price mechanism in expressing consumer preferences and allocating resources cannot be in doubt. But the price mechanism is costly to use. Someone has to interpret market signals, decide on where and when price changes are necessary, and make sure that the market is informed. Management time and resources are involved.

**In an economy with full price stability, only change in products' relative scarcity lead to price changes**

In an inflationary environment, where the overall price level is continuously moving upwards, every individual price change has two components, the first an adjustment of the individual price to keep pace with the overall price level ("the inflation adjustment") and the second an adjustment to reflect the changing scarcity of the product in question (the "relative scarcity adjustment"). Changing scarcity reflects underlying shifts in the supply and demand schedules, and price changes motivated by them would occur even in a barter economy. There are costs in making both kinds of adjustment. However, where the overall price level is stable, no costs have to be incurred in making the inflation adjustment, because of course there is no ongoing inflation. The costs of using the price mechanism, the costs which are most distinctive of a free market economy, are therefore minimised. In a society enjoying full price stability the costs of using the price mechanism arise only because of relative scarcity adjustments, only - in other words - because the supply-and-demand conditions for different products and services have altered.

Inflation adjustment costs can be reduced, and arguably kept manageable, by the publication of a representative price index. However, that leaves another difficulty. When the rate of inflation goes up (or down), people cannot be certain whether the increase (or decrease) is transitory or permanent. Since the outcome of their behaviour depends on how permanent the change in inflation proves to be, they invest time and resources in analysing the inflation outlook. This investment of time and resources would be unnecessary if people had a credible guarantee that the price level would never change from its present level. (Cukierman's 1984 book on *Inflation, stagflation, relative prices, and imperfect information* gave a technical analysis of these problems, which he terms "the aggregate-relative confusion" and "the permanent-transitory confusion".)

**2. In the labour market, only changes in productivity justify wage increases, if full price stability prevails**

The two further arguments for price stability are applications of this general idea. First, when the overall price level is stable, wages do not have to be increased frequently in order to compensate for inflation. Wages may rise over the years, but the justification can only be increased productivity or (for particular industries) a favourable shift in sectoral demand. In a country with a roughly 2%-a-year or 2 1/2%-a-year productivity increase, annual wage bargains - with all the trouble they involve for management, employees and trade unions, including the occasional strike - could be replaced by two-year or even three-year deals. Historically, when productivity growth was typically lower than nowadays, many occupations had fixed wage scales which varied little over periods of a few decades. One reason that strikes have been more infrequent in the last few years than in the mid-1970s is that, with inflation so much lower, managements and unions have had less need to meet - and to squabble - about pay increases. Low inflation has been beneficial compared with the wild inflation of the mid-1970s, but full price stability would be even better.

**3. In financial markets, full price stability makes real and nominal interest rates equivalent**

Full price stability would clearly be advantageous to the labour market, but it might be of even greater help to financial markets. In an inflationary world, all interest-rate terms in financial contracts have to make an allowance for the fall in the value of money. The real interest rate is always different from the nominal interest rate. Both borrowers and lenders are fully aware that they are different, and devote time and effort to forecasting how different they might be. The problem is most severe for long-term contracts, because a 1%- or 2%-a-year divergence in real interest rates from the expected level matters far more over a 20- or 30-year time-horizon than over a time-horizon of a few months.

The most extreme example of these difficulties is the impact of inflation on the price of an undated bond with a fixed coupon, the sort of financial instrument which at one time dominated Britain's national debt. As the price of an undated bond is inversely related to the yield, and as the nominal yield has to adjust to the inflation rate, investment in such securities becomes - in an inflationary economy - largely an exercise in forecasting inflation. The complications are at their worst when long-dated assets are used as collateral for bank loans. The solvency of the banking system, and indeed the efficiency of the financial system as a whole, become heavily dependent on making the right inflation guess. In general, in an inflationary environment the financial system cannot be certain what real interest rate is implied by any particular nominal interest rate.

**which is a great advantage for long-term financial contracts**

Because such uncertainty afflicts long-dated assets and lending more than short-dated, the time-horizon of decision-taking shortens. Long-dated assets are priced more cautiously than in a society with full price stability, and both the capital stock and the financial system are smaller in relation to national product. If the accusations of "short-termism" routinely thrown at the City have any substance at all, it surely lies here. Short-termism is found in societies with

high inflation and is at its most extreme in hyperinflations; long-termism is a characteristic of societies with price stability.

Ideally, price stability should be a lifetime expectation. In all key financial contracts - such as arranging a mortgage, purchasing accident and health insurance, allocating savings between different types of asset, making provision for old age and writing a will - an individual ought to be confident that every reference to a sum of money has the same meaning in nominal and real terms at all future dates. Britain used to be a society where people had this type of confidence. It stopped being such a society in the late 1950s and early 1960s, suffered a disintegration of confidence in economic policy-making in the late 1960s and early 1970s, and has been trying to recover since the mid-1970s. If its future inflation rate is on average 1/2%, 1% or 2 1/2% a year, the nominal and real value of the money amounts in long-term contracts will still diverge sharply. (The matrix below shows how different are the effects of these inflation rates on the value of money over periods of 30-, 50- and 75-years.) If the Government retains an inflation target which is no more precise than "2 1/2% a year or less", people will still have to make guesses about the correct interest-rate terms for these contracts.

### Effect of various "low" inflation rates on the value of money in the long term

Numbers in the matrix show the value of money after the three time-horizons for the given compound % p.a. inflation rates. For example, after fifty years of 1% p.a. inflation, money has 0.608 (or 60.8%) of its value at the start.

% p.a. inflation rate	Time-horizon	30 yrs	50 yrs	75 yrs
	1/2		0.861	0.779
1		0.742	0.608	0.474
2 1/2		0.477	0.291	0.157

**To restore the traditional meaning of price stability, the target should be expressed in terms of the price level, not the inflation rate**

If Britain is to restore the traditional understanding of its currency, the first step must be to end the practice of defining the target in terms of "an inflation rate". The target should instead be expressed in terms of "a price level". As the price level at a future date is merely the present price level plus (or minus) an accumulated inflation (or deflation) rate, the difference may appear to be one of form rather than substance. However, a price level objective stated over a fairly long time-horizon is much more precise than an inflation objective confined to the next two years. As the matrix demonstrates, a 1/2%- a-year increase in the price level over the next 75 years leaves the value of money



somewhat impaired at under 70% of its value today, but a 2 1/2%-a-year increase erodes it drastically to under a sixth of its present value. Both a 1/2% inflation rate and a 2 1/2% inflation rate are consistent with the target as it now stands. Evidently, were that target to hold indefinitely, anyone taking key lifetime financial decisions would be a fool to assume that the money and real terms in long-term contracts are the same.

A target of the kind, "the retail price index 10 years from now is to be no more than 15% higher, and no less than 10% higher, than it is today", would give a much better fix on long-term inflation expectations. It would appear to be much the same as a continuation of the "2 1/2% a year or less" formula (of which 1 1/4% a year, or 13.2% over ten years, is the middle), but it would in fact be tighter and more specific, and it would begin the shift towards thinking about price levels rather than inflation rates. Ultimately the price level objective would approximate to price stability and the intended target period would be extended to perhaps 15 or 20 years, and then simply stated as "to be continued indefinitely". If the target were set and achieved, Britain would have recovered the kind of currency that it had - for 250 years - until the Second World War.

**But two problems arise in defining "price stability",**

**1. is it the prices of goods, or of goods and services?**

Admittedly, that leaves unresolved two tricky issues in the definition of "price stability". The first is whether price stability should be defined in terms of *goods* or of *goods and services*. On the whole, the production of goods is less labour-intensive than the production of services. As wages rise with productivity, services tend to become more expensive relative to goods. In consequence, over periods of many years an index such as the RPI, which has a big services weighting, increases more than the producer price index, which is almost exclusively goods. This problem is serious in very dynamic economies where there is a wide differential between productivity growth in the manufacturing and services sectors. But in a mature economy like Britain's the secular divergence between retail and producer inflation is only about 1/2% a year. If the target were to keep the RPI ten years from now at a level between 5% and 10% of today's level, the price of goods would be more or less constant.

**and 2. how much adjustment should be made for quality change?**

The second issue is whether quality changes are fully captured by existing price indices and, if not, whether price indices over-state (or under-state) "true" inflation. The right approach is surely to require statisticians to make an allowance for quality change, acknowledging that this is often difficult, not least for new products. The RPI is in fact supposed to be adjusted for changes in quality, and it is difficult to believe that any resulting gap between measured and true inflation amounts to more than 1/4% or at the outside 1/2% a year. Again, a target that the increase in the RPI lie between 5% and 10% of today's level ten years from now would probably give sufficient allowance for quality changes.

In short, the aim of policy should be a target for the price level several years hence, not an annual inflation target applicable over the next two years. For most of the 18th, 19th and early 20th centuries this was the unspoken

**Price stability ought to be better-maintained with a scientifically managed paper money than in a commodity-money world**

assumption behind successive Bank Charter Acts. Parliament gave the Bank of England a charter to remain a profitable privately-owned bank, on condition that it kept the value of the pound stable in terms of gold and, by extension, with goods and services in general. The challenge today is to maintain a currency equally stable in value over the very long run but without the crutch of the outmoded gold link. Given the advances in economic theory and understanding over the last 100 years, the conduct of monetary management ought to be more rigorous, exact and responsible in a paper-money world than in the commodity-money world of the past.

**II. The M0 and M4 monitoring ranges**

The theory of the price level presented in Mill's *Principles of Political Economy* - that the value of money, like the value of other things, depends on its quantity relative to the demand for it - is basically correct. If too much money is created, the value of money will fall. However, the emergence of paper money and the banking system led to considerable ambiguity in the meaning of "money", and so to the debates between the Banking and Currency Schools about the right approach to monetary control. To simplify, the Banking School doubted that control over "currency" (i.e., the note liabilities of the Bank of England) was sensible as a means of ensuring control over the price level, because the behaviour of the banking system and all its liabilities was crucial, whereas the Currency School insisted that control over the Bank of England's note issue was sufficient for the purpose. These debates have re-surfaced in modern times between advocates of monetary targetting in terms of broad money (i.e., including all the banking system's liabilities) and narrow money (i.e., focussing on *either* only the central bank's liabilities, M0, also known as "monetary base control", *or* the central bank's liabilities plus the sight liabilities of the banks, M1).

**The debate about the right specification of the monetary target has historical roots in the 19th century**

Just as the Banking and Currency Schools never buried their swords, but co-existed in a state of armed neutrality for some decades after the passage of the Bank Charter Act of 1844, so the antagonists in the broad vs. narrow money controversy remain unreconciled. The Lawson boom was nevertheless a clear defeat for narrow money enthusiasts. M0 continued to behave well until long into 1988, but by then measures to correct the boom were far too late. By contrast, economists monitoring M3 and M4 gave accurate early warnings of future trouble in late 1985 and early 1986, only a few months after these broad money aggregates had started to accelerate. (See T. G. Congdon *Reflections on Monetarism*, published by Edward Elgar for the IEA in 1992, particularly pp. 117-66.)

**Broad money gave better signals than narrow about the Lawson boom**

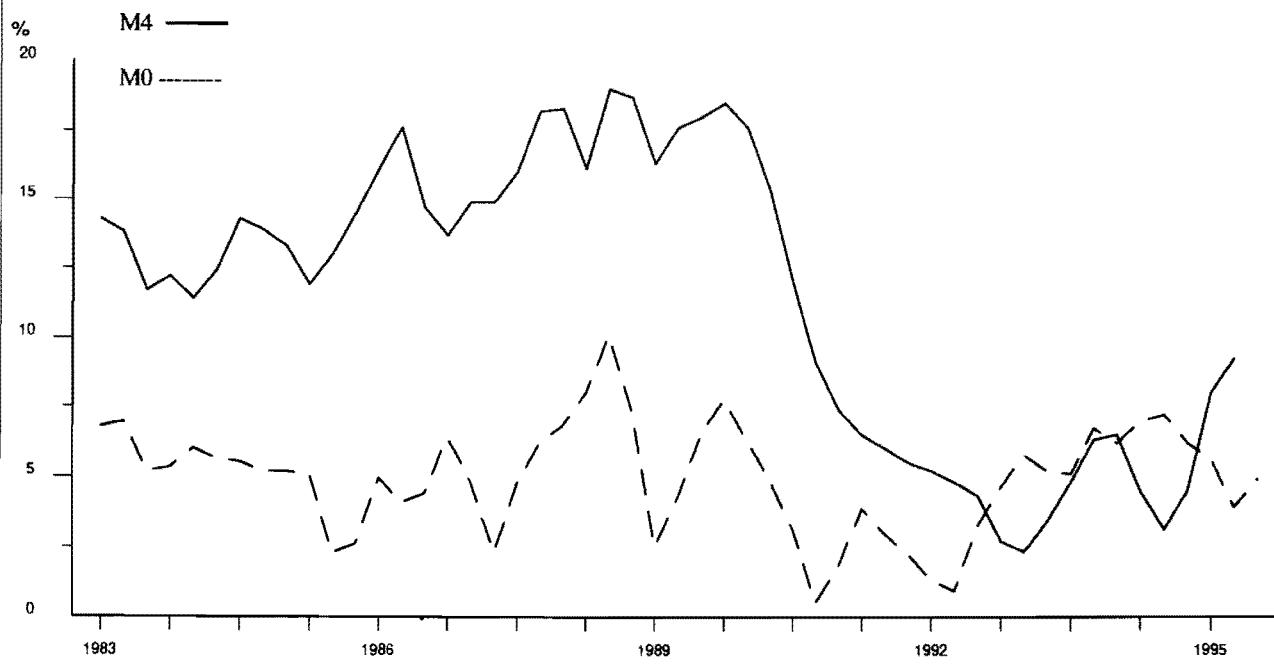
**More fundamentally, narrow money cannot play meaningful role in the "real balance effect"**

At a more theoretical level, narrow money cannot fit as a significant causal variable into any plausible account of the transmission mechanism of monetary policy. For well-known institutional reasons, the supply of M0 (and indeed of M1) is determined by agents' demand for narrow money balances. On the other hand, if agents' holdings of broad money differ from the demand to hold them, national income may have to adjust to bring the demand for and supply of money balances back into equilibrium. This process of equilibration - known

in the literature as "the real balance effect" and developed in detail by Patinkin in his classic *Money, Interest and Prices* - is the heart of the monetary transmission mechanism. The level of broad money and its recent rate of change therefore have a most important bearing on the macroeconomic outlook. In the short run discrepancies between the demand for and supply of real broad money balances motivate fluctuations in economic activity; in the long run real variables are determined only (or, at any rate, mostly) by real things, and an excess of the supply of nominal broad money balances over the demand to hold them results in a fall in the value of money (i.e., inflation).

### M0 and M4 growth since 1983

Chart shows six-month annualised growth of M0 and M4, using quarterly data. Clearly, the growth rates have often diverged sharply, with very different implications for monetary policy



**The M0 monitoring range can be misleading and ought to be scrapped**

The M0 monitoring range serves only a slight useful purpose, as a supplement to other more substantive information on the black economy and small-ticket retail sales. (Neither the black economy nor small-ticket retail spending plays a major role in the business cycle.) But in the conduct of monetary policy it can be positively misleading, as it encourages non-specialists to ascribe narrow money a causal role in the inflationary process. The M0 monitoring range ought therefore to be scrapped. By contrast, the M4 monitoring range not only feeds a steady flow of information to policy-makers, but also gives advance warning about future economic activity and inflation. In the absence of substantial short-run changes in the demand to hold broad money (which are relatively rare and usually obvious when they happen), a sharp change in broad money growth is always important. In general, an acceleration (deceleration) is followed by stronger (weaker) growth of (domestic) demand within less than a year and by

higher (lower) inflation within less than three years. The M4 monitoring range must be retained and, preferably, given a more prominent role in policy-making.

### **III. The Bank's Inflation Report**

A regular progress report is plainly essential if a price level or inflation target relates to a period of several years, as it ought to do, or even to a period of only two years, as is currently the case. So the Bank of England's new practice of publishing a quarterly *Inflation Report* is to be welcomed. As is now widely understood, there is a long and rather unpredictable lag between policy action and the inflation response. The forthright recognition of this lag, and various attendant uncertainties, in the Bank's *Report* is particularly encouraging. Nevertheless, if Britain were a society genuinely keen to establish price stability, the title of *Report* would be criticised as a misnomer. The title *Inflation Report* evidently assumes the continuation of inflation and so perpetuates inflation expectations, which is the opposite of what policy ought to be doing. The re-specification of policy towards a price level objective ought to be accompanied by a re-naming of the report to something more supportive of policy, such as the *Currency Report* or the *Price Level Report*.

### **IV. The minutes of the monthly monetary policy meetings**

The *Inflation Report* is one input to the monthly meetings between the Chancellor of the Exchequer and the Governor of the Bank of England. Officials have claimed that the *Inflation Report* and the meetings have given a better focus for the official policy discussion and the wider debate about economic policy. Both arrangements have the virtue that they have not required the formal creation of new institutions or contentious legislation. However, precisely because the arrangements are rather loose and informal, they are very frail and could easily be changed by any government. This may be one reason that their favourable impact on inflation expectations has been less than hoped. More fundamental institutional changes need to be considered.

### **Proposal for a new Bank Charter Act**

The New Zealand example - where a contract to deliver price stability is drawn up between the Governor of the Reserve Bank and the Minister of Finance - is interesting, but it has the drawback that finance ministers come and go every few years, or even every few months. By contrast, the task of combatting inflation - and, ultimately, maintaining full price stability - is protracted. Not only does it suffer from the long and unpredictable lags already mentioned, but it is in fact never-ending. The best institutional structure would recognise the long time-horizon of currency control and insulate it from the antics of particular governments and day-to-day politics. Parliament might pass an Act (perhaps called the Bank Charter Act) with three main elements,

- an objective for the price level ten years from now, which (on the first occasion) might be that the retail price index should be no more than 10% above and no less than 5% above its level at the date of the Act's passage into law,
- full operational independence for the Bank to achieve this objective over a period longer than the electoral cycle (say, ten years instead of five), and

- the Bank to give regular quarterly reports (the *Price Level Report*) to Parliament on progress, with the Governor and his colleagues to be questioned by a committee of both Houses.

The Bank of England would - very specifically - not have to collaborate with the Government of the day about its interest-rate decisions, but it would remain answerable to Parliament. This structure would be altogether consistent with ultimate democratic control over the Bank's conduct and performance.

### **V. The list of indicators to be monitored**

In view of the lags between policy action and inflation response, both policy-makers and anyone involved in monitoring policy (including the members of the suggested Parliamentary committee) need to know what variables have to be watched. The listing of indicators in the 1995/6 *Financial Statement and Budget Report* was on the same lines as a list given to the Treasury and Civil Service Committee in late 1992. Like that original list, it was rather miscellaneous. The weakness of this catholic "look at everything" approach is threefold. First, it is entirely atheoretical. Instead of policy-makers taking decisions according to a known theory of inflation, they give the impression of looking at a mail-order catalogue of all the items relevant to their work and trying to pick the best bargains. Secondly, because of its atheoretical nature, the list suppresses - or, at any rate, averts - discussion of the underlying causal processes at work. The identification of the origin of any inflationary trouble, and so of the right policy answer, is made more difficult. Thirdly, a simple listing leaves unclear the question of the relative importance of the different variables, with the result that policy can become unfocussed and disorganised.

### **Listing of indicators may weaken understanding of the monetary causes of inflation**

The list is harmless enough in itself, as long as it does not prevent policy-makers taking practical decisions inside a coherent and robust theoretical framework. Debates about what constitutes that "coherent and robust theoretical framework" remain vigorous and will no doubt continue for decades to come. However, surely enough has been learnt over the last 20 years for policy-makers to recognise the validity of the theory long regarded as standard by the leaders of economic thought. In that theory inflation is essentially a monetary phenomenon and, in the long run, the price level rises only because the quantity of money increases at a faster rate than the quantity of goods and services.