

FROM: [REDACTED]  
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CHANCELLOR

THE GOVERNMENT'S INFLATION OBJECTIVE

The fall in the exchange rate has altered the immediate inflation prospect. EA's preliminary assessment was set out in [REDACTED] minute of 21 September, and the September forecast will provide a more considered assessment. But whatever the immediate prospect, you will need to consider how, if at all, to revise the Government's objective for inflation. This is an immediate issue, not only because it is a crucial input into interest rate decisions, but also because we need inflation assumption for use in the Public Expenditure Survey.

The Longer Term

2. This year's MTFS declared that the Government's longer term objective was "the defeat of inflation on a lasting basis". What exactly this means in practice was not spelt out: we have variously referred to "price stability", an inflation rate which matches the best of our competitors, and a permanently low rate of inflation on a par with the best in Europe. In the MTFS we assumed that inflation as measured by the GDP deflator would come down to 2 per cent by 1996-97, in line with the Bundesbank's medium term objective for German inflation.

3. Nothing that has happened in the last week should cause us to change the longer term objective. There is no reason for any reassessment of the benefits of low inflation, or the desirability of matching inflation performance among our competitors. But it does seem inevitable that the transition to this ultimate objective will now be different, and there are good reasons for arguing that some upward revision to the inflation path over the next few years would be perfectly acceptable.

The June Forecast

4. The June forecast painted a weaker picture for economic activity than we put forward in the MTF5, and partly as a consequence inflation was projected to undershoot the MTF5 path. This is shown in Table 1. In one sense, therefore, we were over-achieving on inflation before the recent reduction in the exchange rate; we were achieving convergence within the ERM more rapidly than envisaged at the time of the Budget.

Table 1: Inflation Paths (GDP deflator)

	<u>1992-93</u>	<u>1993-94</u>	<u>1994-95</u>	<u>1995-96</u>	<u>1996-97</u>
MTFS	4½	3½	3	2½	2
June Forecast	4.2	2.9	2.1	2.2	1.6

5. At the time our view of the prospect was if anything at the optimistic end of the spectrum. The consensus of outside forecasts was that inflation would fall less rapidly and the recovery in output would be more gradual. Indicators becoming available since June - before the fall in the exchange rate - tended to confirm the greater weakness of output which outside forecasters expected, while pointing to even lower inflation.

Implications of the fall in the exchange rate

6. The fall in the exchange rate, and the recent reduction in interest rates, alters both the immediate inflation outlook and the prospect for recovery. As set out in [redacted] note, the inflation path is likely to be higher in the absence of any further policy adjustments. And output is likely to be more buoyant because of the boost to our net exports from the (at least

temporary) improvement in competitiveness. The lower exchange rate gives a direct boost to inflation, and higher activity will further reduce domestic disinflationary pressures.

7. The inflation prospect will also depend on what happens to the exchange rate from now on. Of course this is highly uncertain. But any beneficial effect which might be expected when German interest rates fall back may well be offset by some recovery in the dollar. In any event, we cannot count on an appreciation, and it would be wise to work on the basis that sterling will remain at broadly at its present level in the medium term.

#### The real exchange rate

8. The June forecast showed a comparatively muted recovery in activity, with GDP remaining well below trend even in 1996-97. And we were heading for a situation in which our inflation was tending to undershoot inflation in competitor countries. The implication appeared to be that a period of undershooting was necessary in order to permit a return to trend output. The forecast suggested that we could not rely on buoyant domestic demand to bring about recovery in the medium term, because the private sector will inevitably behave cautiously after the excesses of the 1980s and the Government is committed to balancing the budget. We needed to rely on an increase in ~~net~~ exports.

9. It thus provided some support for the argument which many commentators have advanced - that the real sterling exchange rate needed to come down. Put another way, we needed to gain competitiveness, and the forecast showed that the process was getting under way - see Table 2. Furthermore, it gave no grounds for thinking that the process had gone far enough by 1996-97; further gains in competitiveness would have been required to bring output back to trend.

Table 2: Competitiveness in the June Forecast\*

	<u>Changes in relative labour costs</u>	<u>Relative consumer price inflation:</u>	
		<u>G6</u>	<u>Germany</u>
1992	-1.0	+2½	+1
1993	+0.9	-½	-1
1994	-1.1	-1½	-¾
1995	-3.1	-2	-¾
1996	-2.7		

\*Fourth quarter on a year earlier.

10. The lower exchange rate we now have can be seen in some ways as a substitute for the process of undershooting world inflation which was starting in the June forecast. The need for very low inflation in order to reduce the real exchange rate - improve competitiveness - is now less pressing because the nominal exchange rate has fallen. So we can tolerate higher inflation than expected in June without jeopardising the prospect of improving competitiveness. Indeed, if we can only match world inflation over the next few years we would retain all of the gain in competitiveness which has just occurred.

11. But there is clearly a risk that any temporary gain in competitiveness from the lower exchange rate will be completely eroded by higher domestic inflation. This is a serious risk, as we have warned many times. The dangers are increased if we allow the reduction in the exchange rate to give a substantial boost to activity.

#### Medium term objectives

12. The crucial question we therefore have to answer before deciding what inflation path would be acceptable in the medium term is how far we are prepared to see the fall in the real exchange rate be eroded by higher domestic inflation. The June

forecast suggested that we should definitely not allow it to be eroded entirely, and ideally we should aim to pocket some of the gain in competitiveness if we can. One variant of this would be to aim to match from now on the inflation performance in our main competitors. Some options for inflation in the medium term are shown in Table 3.

Table 3: Alternative paths for UK inflation (GDP deflator)

	<u>1993-94</u>	<u>1994-95</u>	<u>1995-96</u>	<u>1996-97</u>
Match inflation in Germany	3.8	2.9	4.0	
Match inflation in the G6	2.6	2.8	2.9	
Retain about half the gain in labour cost competitiveness from the lower exchange rate	3½	4½	3½	3
[Assume the same output path as the June forecast	3½	4	4½	4]

Memo items:

[REDACTED]				
June forecast	3	2½	2½	1½
MTFS	3½	3	2½	2

13. The first two rows of the table show what we might have to achieve to match inflation in Germany and G6, according to [the latest WEP forecast]. It is very close to the path in the MTFS. It would imply a slightly higher UK inflation path than in the June forecast, but not as high as that in [REDACTED] note of 21 September. We would have to hold inflation in the range 3-4 per cent over the next two years, and not allow it to creep up any higher. In order to achieve this we may well require a significant tightening of policy, which could well mean output falling below the path in the June forecast [check]. By 1996-97, labour cost competitiveness would be about 7 per cent better than in the June forecast.

14. It is probably unrealistic to aim for such a favourable outcome. It would require very tough policies to hold inflation down to 3 per cent in 1993-94 and 1994-95, and would almost certainly imply a very weak and delayed recovery in output. We can in any event tolerate somewhat higher inflation whilst still retaining a good deal of the gain in competitiveness (relative to the June forecast) brought about by the lower exchange rate. The third line of the table illustrates a path which would involve retaining about half of the competitiveness gain. It would effectively accommodate the additional inflationary pressures in 1993-94 and 1994-95, before bringing inflation back to 3 per cent by the end of the period. But even this path would probably require [slower output growth in the last two years than in the June forecast].

What should our objective be?

15. Choice of a revised inflation path in the medium term will need to balance a number of considerations:

- recognising the inevitable increase in inflationary pressures in the short term due to the lower exchange rate;
- acknowledging the political pressures for a relaxation in the stance of policy in the short-term, so as to bring forward the recovery;
- the need to show inflation being brought under control in the medium term, and coming back close to our longer term objective.

16. More detailed assessment of alternative inflation objectives will have to await the outcome of the September forecast. That will give us a firmer view of what the present stance of policy is likely to deliver, and the output path which goes with it. It

will thus enable us to assess the achievability of alternative inflation objectives, and assess how they tie in with the longer term needs of the economy.

17. But in the meanwhile, we can probably draw the following conclusions:

- inflation will inevitably be higher in the next year or two, and it would not be feasible to bring it back to the path in the MTFS - still less the June forecast - without a sharp tightening of policy;
  - some increase in inflation can be tolerated in the short run without jeopardising the competitive position of British industry or throwing away all the gains from the lower exchange rate;
  - but we need to see inflation falling back again in the medium term in order to demonstrate our commitment to the longer term objective of defeating inflation.
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