

COUNTERING INFLATION

Paper by the Secretary

1. This note discusses in very summary form
- (a) the four main problems to which some kind of solution has to be found if we are to master inflation;
 - (b) our progress to date in developing a set of policies to deal with those problems in the longer term;
 - (c) the specific issue of what our position should be in 1977/8;
 - (d) issues which merit particular attention or stress in public presentation.

The need for brevity means that it is very much an aide-memoire.

THE MAIN PROBLEMS

2. Adapting very slightly the analysis set out in Professor Ball's paper for the SMI's Economic and Social Affairs Committee, we have to fight inflation on four separate fronts:

- (a) the pressure of demand must not be excessive;
- (b) we must minimise the impact of external shocks to the price level, such as the rise in the cost of imported commodities currently stemming from the fall in value of sterling;
- (c) expectations of future wage and price increases must be held as far as possible to what is feasible and desirable;
- (d) defects in the labour market which tend to favour inflation must be remedied as far as possible, particularly those which affect the maximum level of employment which can be safely sustained and the generation of unstable or inflation reinforcing expectations.

3. It becomes clearer and clearer that in this context the argument for or against "incomes policy" is not easy to reconcile with the resolution of the four problems set out above. On some occasions we seem to be referring specifically to the question of the use of statutory powers and an apparatus of Boards and Commissions in the traditional manner. The argument for or against such an approach is a relatively narrow one and tends to be solely concerned with means. The danger, however, arises that in discussing this particular means we fail to recognise the wider purposes which this form of counter-inflationary policy must, like any other, satisfy; the calming of expectations and minimisation of defects in the labour market. To conclude that

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one is against a statutory or highly institutional policy is not to imply that the objectives which it is designed to meet are irrelevant and can be left to solve themselves. There is a strong case for abandoning any use of the term "incomes policy", just as strong a one for stopping talking about "reflation" or "deflation".

Part II

PROGRESS WITH A LONG-TERM POLICY

Pressure of Demand and level of unemployment

4. The discussions we have had about fine-tuning and the rest combined with the likelihood of a prolonged period of high unemployment mean that there is no great risk of our erring on the wrong side in our attitude to unemployment. There are some secondary technical questions of great complexity that have to be answered if it should be felt necessary to attempt a redefinition of what is the highest sustainable level of unemployment. There are policy issues of considerable importance when we come to ask ourselves what obstacles there are to increasing the maximum sustainable level of unemployment. But these are not of central importance at the moment.

5. Although we have committed ourselves clearly to a policy of monetary targets and although such a policy has now been welcomed across a very broad front, there remain a number of difficult questions whose implications we need to explore even if no attempt is made to find definite answers. How swiftly is it sensible to attempt to reduce the rate of inflation? By how much should the monetary target "bear down" on the inflationary momentum existing in the economy at any point in time? To what extent should we follow the example of other countries and ensure our targets are to some extent adaptable to unanticipated and unavoidable differences between the actual growth of prices and what had previously been anticipated. What must be done to improve the data base related to the money supply? To what extent should we allow ourselves to be guided by the concept of the full employment deficit - and can it be reconciled with some of the systems of monetary targets that have been discussed?

Expectations

6. The problem of inflationary expectations decomposes into several elements. The first is simply the rate at which people expect prices to grow in the future. The second is the rate at which they seek to increase their own spending and real wages. The third is the influence of the system or systems by which wages are negotiated and determined. We have already developed policies to tackle most of these complex issues. A target, however rough, for the reduction in the rate of inflation will be an increasingly important element in effecting expectations as people adjust to it. The reduction of public expenditure and the transfer of resources from public into private consumption will make it easier to sustain an acceptable rate of growth of real private income and consumption. Furthermore, our proposals for reshaping the tax system may help considerably in as much as we can raise the tax threshold and lower tax rates for higher incomes. However, we have not got very far yet in developing a position on three important matters which greatly affect expectations and the level of wage settlements:

- (1) How are we to tackle the excessive growth of wages and salaries in central government? Can a way be found quickly? What do we do about pay research? Can we remove some of the absurdities of the determination of public sector pensions without provoking a revolution? How will cash limits be determined in relation to central government pay negotiation?
- (2) Are we satisfied with the determination of pay in local authorities? The current system of national negotiation has the effect of generalising Metropolitan salary levels (less London weighting) swiftly round the country regardless of the state of labour markets locally. On the other hand were we to move towards local negotiations there would then be the risk that the big unions would pick off key authorities one by one.
- (3) We have not asked ourselves whether we should consider any change in the determination of pay in the nationalised industries. Nor has the policy group which is concerned with the Government's relations with these industries.

It is not clear that a policy of cash limits and target rates or return will be sufficient to give management the defences behind which to defend the Government of the day from highly politicised dispute about wages.

One of the chief methods we have advocated for affecting expectations and achieving the greatest possible understanding of the impossibility of living as a nation beyond our means for a sustained period of time is the institution of a concerted action body (CAB). The proposal for such a body in the Right Approach has been well received on the whole. The further work which is being undertaken to analyse what might be involved in it shows clearly that there are many important alternatives open to us. They will require a lot of careful consideration as soon as our proposals can be fully drafted (which should be in the early new year).

Imported Inflation

7. As Jim Ball makes clear, a proper fiscal and monetary policy should minimise the likelihood of our suffering from gyrations in the exchange rate as avoidable and damaging as those which the Labour Government have imposed on us in the last two or three years. If one assumes that there will be no great problem of overall exchange rate stability, we are left with the issue of our attitude towards certain specific commodities where import costs are of great importance. The chief ones are energy and food. We have not asked ourselves yet whether policies in either area need to be tailored to the requirements of a counter-inflationary policy. But the implications of our thinking about policy across a broad front is that we should almost always allow prices to rise to market levels and operate to offset any consequent hardship on the income side to the extent that this can be afforded.

The Labour Market

8. We have not given much thought for some time now to changes which might be desirable in the labour market and nor, it appears, have others. However, the CBI have launched a major study of the matter which is due to be finished by February and we will no doubt be able to draw on that. Several decisions will have to be made at some point about such matters

as the certification of unions, the role of ACAS, what can be done about synchro-pay (if anything) and whether we can ensure that collective agreements last for at least 12 months.

Part III

THE SHORT-TERM PROBLEM

9. The Government will shortly be considering how they can reconcile a further reduction in inflation with a tolerable level of employment, continuing growth and freer collective bargaining. We shall need to develop our own view, and it must carry real conviction at a period when an election is becoming more and more likely.
10. The following conflicting issues have to be reconciled:
 - (1) inflation has settled down at an annual rate of increase of 15% or so. There are still considerable fears that it will accelerate, if the opinion polls are to be trusted. Even on the Government's most optimistic forecasts the rate is not likely to decline very much till the middle of 1977. Given the normal time-lags, people will not perceive clearly any deceleration till quite some time after it has begun.
 - (2) The money supply target adopted and pursued by the Chancellor has become increasingly tight, even if one assumes that henceforward the wages policy "works" and other costs keep within the bounds expected today. If we have to keep to the targets now laid down but costs and prices increase in the event faster than currently expected, then the clash between the two will lead to yet another stagflationary liquidity and profit squeeze of the 1970-71 kind. The damage this would do to confidence and the prospects for investment and long-term recovery could well be without precedent.
 - (3) There is a lot of suppressed wage inflation working in the labour market. The consolidation of successive flat-rate pay supplements alone - which the unions will not be able to delay for long - is one reason. The correction

of differentials is a second. The re-establishment of traditional criteria for comparability is a third.

- (4) These pressures are reasonable and understandable. If they are suppressed still longer, the consequences for incentives, emigration, morale, industrial relations and production will be very serious and could well be catastrophic. The system must be allowed the latitude it needs if some of the grosser distortions are to be allowed to sort themselves out.
- (5) The Labour movement at shop-floor level must be facing increasing difficulties in sustaining a pay limit, and the union leadership must be losing patience with the suppression of their traditional bargaining role. It could be argued that an explicit attempt to achieve further restraint (particularly if dictated or dominated by the Government) would well provoke an even more extravagant and comprehensive breakdown of the current atmosphere of restraint than would take place if no replacement were sought for the current "phase II".
- (6) However, some optimists would say that the suppressed wage inflation in the system would not be able to work itself through much or, perhaps, at all in a period of such high unemployment as we have entered on.
- (7) If there is to be another period of restraint shaped by a Government-TUC deal on the lines of the last two, one also has to bear very much in mind the price of that deal, both in terms of new legislation and further distortions of economic policy. The wealth tax is the most obvious price some of us might have to pay.

11. In an uncertain world the best strategy may well be to choose that policy which minimises the "downside" risk. This is what Professor Ball recommends in advocating his transitional regime. Always assuming that one can be devised which is flexible enough, it is likely to be valuable if a strong resurgence of wage costs is otherwise inevitable and harmless if it is not. On the other hand a free-for-all could permit a very damaging and irreversible wage explosion, which would, on the criterion proposed, make it the less good strategy to follow.

Presentation

12. Finally we need to think a little about presentation. Mr Gilbert's note makes some important points about this. In brief it seems that

- (1) We probably should not "knock" the Social Contract too violently. It contains the seeds of its own decay.
- (2) While there are still serious differences of view about the relevance of a statutory, institutionalised "incomes policy" of the old kind, there is a clear, new synthesis of doctrines about the causes and remedies for inflation round which we can unite. To do the latter may require little more than semantic changes.
- (3) We must recognise and, probably, warn clearly of the difficulties next year will bring us. Furthermore we must prepare a clear view of our own on the matter of what should happen after Phase II ends.