Opinion

Wolsey wanted his name for a college. Look what happened

Melanie McDonagh, page 28

Keep smiling – it's not as bad as the 1960s

We have dealt with inflation before, and if we learn the right lessons we can do so again

Anatole Kaletsky

To the naked eye, there is no perceptible difference between a 3.3 per cent and a 3 per cent rate of inflation. Why, then, all the fuss about a "cost of living spiral", as the latest mini-crisis to hit the Brown Government was described yesterday on the front page of *The Times*?

This question invites three right answers and one wrong one. The wrong answer is the one most widely heard among saloon-bar cognoscenti: that Britain is finally paying the price for a decade of living beyond its means, of excessive borrowing and spending by consumers, homeowners and government.

Comparisons are suddenly being drawn with the late 1960s and 1970s, when economic growth stagnated while inflation climbed inexorably higher. It has even been claimed that inflation today is exactly the same as it was in 1965, when Iain Macleod coined the word "stagflation" to describe the miserable combination of stagnation and accelerating prices.

But comparisons with the stagflation of the 1960s and 1970s are wrong because the main causes of that period's economic crises are not present today. There is no overweening trade union movement, no national obsession with protecting inefficient and dying industries against international competition and no totemic faith in fixed exchange rates between the pound and the dollar or the German mark.

The most important difference, however, is in the attitude to inflation among economic policymakers and politicians.

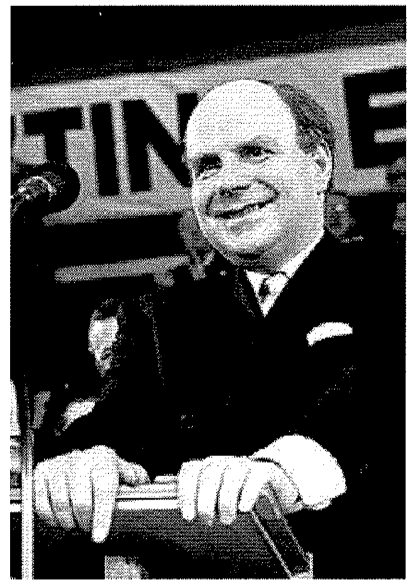
After the 20 years of almost uninterrupted economic crises that began in the late 1960s, there is a universal recognition that inflation is extremely damaging not only to financial stability but also to growth and employment and that it is very costly to reverse once it gets out of hand. There is also an understanding that inflation is primarily a monetary phenomenon that needs to be tackled through interest rate decisions by the Bank of England that affect the entire economy, rather than the panoply of meddlesome micro-level initiatives — price controls, wage controls, import controls, credit controls and exchange controls — that turned out to be not just futile but counterproductive in the 1960s and 1970s, adding to rather than overcoming inflationary pressures.

This greater awareness and understanding of inflation leads, of course, to the justifiable reasons for people to be concerned, though not alarmed or panicked, about the recent inflation figures. The first is that the new monetary regime created by Gordon Brown in 1997 is now facing its most serious test to date — and should this test end in failure, we really will have to dust off our history books of the stagflation period.

The key features of this new regime was the Bank of England's independent authority to set monetary policy so as to keep inflation as close as possible to a 2 per cent target. Nobody expected this target to be hit all the time, but the Governor was required to write a letter of explanation whenever inflation deviated from the target by more than one percentage point — which happened on Tuesday for only the second time since 1997. With the Governor now predicting that inflation will stay well above 3 per cent for most of the rest of the year, the burden of proof is now on the Bank to persuade the public, the media and the financial markets that monetary policy really is appropriate today to ensure that inflation returns to the 2 per cent target by next year. With inflation likely to keep rising for the next few months because of soaring oil prices, the Bank will have a hard task persuading people that it has the situation under control.

The Bank believes that a 5 per cent interest rate is already high enough to return inflation to its target — and I believe this too. But this judgment could turn out to be wrong — and if so the Bank will have to be step firmly on the economic brakes, regardless of the pain this may inflict on the economy and a housing market already in trouble. Such a tightening of the monetary tourniquet is not, in my view, very likely — but it is a possibility in the months ahead and Britain should be braced for this risk.

The second genuine reason to worry about the inflation figures is the challenge they pose to the Government. Will Gordon Brown withstand demands for public sector pay increases to compensate for the rising cost of living? If he gave in to such demands, the result really could be a 1970s-style wage-price spiral. Alternatively — and more probably — the Bank of England would respond to spiralling wages by sharply increasing interest rates. That, in turn, would trigger a deep recession and mass unemployment more reminiscent of the Thatcherite 1980s and 1990s than the 1960s and 1970s.



Comparisons with the era of Iain Macleod's "stagflation" are wrong

From this standpoint, probably the biggest worry has been Mr Brown's surprising combination of weakness and short-termism since he became Prime Minister. If he responds to minor hiccups such as the 10p tax row by giving away £2.7 billion, one wonders how he would react to a genuine challenge to his authority on the scale of the Winter of Discontent?

The season of escalating pay demands now likely to hit the Government brings us to the third genuine reason for worrying about the latest inflation figures: the accelerating increase in prices does represent a genuine reduction in all our living standards. That this burst of inflation has been caused mainly by rising oil and commodity bills should make it clear that a transfer of wealth is happening on a global scale. Commodity consuming countries such as Britain have enjoyed enormous gains in their living standards over the past 20 years, partly as a result of falling prices for oil, food and other commodities which we import. Now some of those gains are being recouped by commodity-producing countries.

Britain should, of course, try as hard as possible to reverse some of the recent increase in commodity prices, especially by taking tougher measures to reduce oil demand.

Beyond that, however, the best thing for Britain to do is to grin and bear it, accepting a small sacrifice in the standard of living. The decline in Britain's living standards caused by this shift in relative prices is likely to be a very small one compared with the big gains achieved since the early 1990s.

This, remember, is a period in which Britain overtook first Italy, then France and finally Germany and Japan in terms of national income per head. None of these relative gains will be lost if Britain's living standards decline slightly as a result of rising commodity prices, since other advanced economies are hit just as hard. If we lose control of inflation, by contrast, all Britain's economic achievements of the past two decades will turn to dust.