Ryan Bourne: The speech that the Chancellor should have given last week

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On 26 May, Rishi Sunak opened his cost of living statement with:

"Madam Deputy Speaker, The high inflation we are experiencing now is causing acute distress for the people of this country. I know they are worried, I know people are struggling. I want to explain what is happening, why it is happening, and what we propose to do about it…"

A free-market economist version of Sunak continued:

"Sound macroeconomic management is foundational for prosperity. The pandemic, energy price shocks, and fallout from the Ukraine war have damaged our economy's productive capacity, generating higher prices and making us poorer. We are largely powerless to the direct effects of these forces.

Looking at monetary indicators before these events and nominal GDP since, however, it's obvious that it wasn't just supply-shocks driving up inflation, which at 9 percent and rising is now the highest it's been for 40 years.

Macroeconomic policy – both fiscal and monetary – has been too expansive, worsening inflation by raising aggregate demand faster than its trend growth, adding stimulus to an already supply-constrained economy. We must admit this macroeconomic failure and confront it.

Monetary policy is ultimately responsible for calibrating aggregate demand to aggregate supply, to control inflation. Our independent Bank of England has the tools to deal with inflation, through affecting aggregate demand.

The situation has been difficult for that reason. The Governor is correct that the Bank can't repair supply chains or control oil prices. Squeezing demand to keep inflation right at 2 percent target to counteract these would have damaged output and employment. But policy should have prevented the excess-demand inflation that monetary indicators warned was coming.

To reaffirm our commitment to low, anchored inflation, I'm therefore taking two steps to understand what went wrong and what might be done better in future.

First, I've written to the Bank Governor today requesting a public report on the economic models and leading indicators used by the Bank to forecast inflation. This experience suggests they are inadequate and should be exposed to outside scrutiny.

Second, given the Bank can only affect aggregate demand, and (in my mind, correctly) suspended strict inflation targeting in the face of major supply shocks, public credibility behooves us to consider a new target that reflects this reality.

I am therefore reviewing whether the Bank of England should shift from its inflation target to a nominal GDP level target equivalent to it growing by 4 percent per year. It is my belief we would have avoided a substantial proportion of our coming inflation had this target been operational.

Economic models and reviews might help for the future but will be of little comfort to families suffering today. What matters to them is easing pressure on their living costs. There are three potential tools here: monetary policy and fiscal policy, as well as supply-side policies to raise output and lower prices in particular important markets.

I've already touched on monetary errors. But I want to reaffirm the independence of the Bank of England in navigating how to meet its target. As the next few months' inflation figures are released, it is important for those in politics to remember that monetary policy affects the economy with 'long and variable lags.'

Policy has already been tightened. A lot of the one-time supply shocks will not affect the price level again. So, it's important to avoid a drumbeat for overly constrictive policy that chokes off more than the excess demand-driven inflation, in turn damaging output and employment.

Second, when it comes to fiscal policy, I've been inundated with requests for large fiscal transfers to make households whole. It would be a mistake, however, to add to inflationary pressures by sending large cash sums to all households, particularly because, in the face of excess saving during the pandemic, this would risk boosting aggregate demand again, necessitating the Bank of England to tighten policy more, raising interest rates further, putting pressure on mortgage costs, and worsening the debt dynamics of the public finances.

That is not to say I will ignore the pain families are suffering entirely. Given the explosion of energy and now food prices, poor households' budgets are strained disproportionately. I am therefore announcing additional strictly targeted, temporary cash grants to households in receipt of means-tested benefits and for pensioners to assist with their bills this year.

To avoid inflationary impacts, this will be ***fully funded*** *by a permanent cut to public expenditure, starting this year, of an equivalent sum. Our tax burden – at its highest since the late 1940s – stifles the productive private sector we all desire. I will not countenance raising it continually to finance new government spending programs whenever problems arise. Let this quid pro quo of temporary relief for permanent spending cuts indicate my intention instead to constrain the growth of government in the coming years en route to reducing tax rates again.*

Finally, that leaves supply-side policies, which cannot quell inflation, but can lower prices and raise output in certain sectors over the long run. Over recent decades governments have engaged in 'cost disease socialism' – of throwing demand subsidies at industries suffering rising costs to help households afford the products or services, rather than examining how existing government policies drive up the costs of supply. This inflationary period reminds us of the pernicious consequences of these permanent de facto taxes on basic staples.

My new Contract with British Households published today will map out the steps we will take to liberate markets to ease essential living costs and grow the economy in the coming years. We *will revive fundamental planning reform to make more land available for housing and commercial development in places people want it. Home and commercial building prices are forward-looking asset prices: the expectation of upcoming meaningful supply growth will reduce prices sooner.*

We will immediately eliminate all tariffs on products not supplied by any British producers, on the march to eliminating all tariffs within 3 years. People claim that shedding tariffs removes 'bargaining chips' for free trade agreement negotiations. Our experience has been that this argument covers the interest of protectionists, who demand tariffs are maintained for decades in trade deals anyway! This is unacceptable for consumers and neuters the pressure for productivity enhancements that openness to foreign competition provides to our industries.

We will release childcare from government's cost-raising grasp, first by eliminating mandated staff-child ratios and then removing requirements on childminders through the Early Years Foundation Stage. Parents, not politicians, should decide who cares for their kids and how. We will also green-light shale gas exploration, phase-out agricultural subsidies, and revive efforts to improve public sector productivity, particularly in healthcare.

I cannot pretend this three-point plan will avoid all near-term pain from inflation. But with the Bank of England touching the monetary brakes, targeted relief to support the poorest, and our plan to liberate important product markets, this government is intent on easing living costs for households sustainably in the years to come, while furthering our ambitions for a faster growing economy that uplifts all."

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