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PART. A

MEDIUM TERM
FINANCIAL STRATEGY.
1983 PAPERS

1983

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NOTE OF A MEETING HELD IN THE CHANCELLOR'S ROOM, HM TREASURY ON TUESDAY 11 JANUARY 1983 AT 3PM

Those Present:

Chancellor of the Exchequer	Sir Campbell Fraser)
Chief Secretary	Sir Terence Beckett)
Financial Secretary	Mr R E Utiger)
Economic Secretary	Mr A Willingale)
Mr Burns	Mr J Pope) CBI
Mr Bailey	Sir Donald MacDougall)
Mr Kemp	Mr B Rigby)
Mr Moore	Mr J Caff)
Mr Ridley	Mr D McWilliams)
Mr Battishill - IR	

CBI BUDGET REPRESENTATIONS

Sir Campbell Fraser explained that the document which Sir Terence Beckett had sent the Chancellor with his letter of 7 January was a draft of the CBI Budget representations which had not yet been endorsed by the CBI Council. However, the recommendations it contained had secured universal acceptance in the CBI's individual committees so that no significant changes were likely to be made as a result of the Council meeting. He would, of course, inform the Chancellor of any amendments. The document would not be released to the press until 26 January and the CBI were not intending to give any publicity to their meeting with the Chancellor. Sir Campbell then invited Mr Utiger, as Chairman of the Economic and Financial Policy Committee, to summarise the CBI's representations.

2. Mr Utiger stressed the great uncertainty of the general economic prospect. It no longer appeared that a strong recovery in world trade would give a major boost to growth in 1983. The weakness of the international economy was having a substantial impact on much of UK industry.

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There was as yet little hard evidence about the shape and pace of the US recovery but such anecdotal evidence as existed gave the CBI no basis for expecting a substantial improvement in 1983. Again there was much anecdotal evidence to suggest that the depth of the recession and the levels of unemployment prevailing in Europe were leading firms to adopt very aggressive pricing policies simply to keep businesses in operation and to preserve employment. Against this background, the growth of UK consumer expenditure was one of the few bright spots on the world scene. However, Mr Utigar drew attention to the sharp imbalance between movements in the real post-tax incomes of businesses and persons, illustrated in chart III.1. Company profitability was likely to come under very heavy pressure over the next year and for this reason the CBI felt that the 1983 Budget must give priority to measures which would reduce business costs. In this way, competitiveness would be improved, profitability increased, jobs preserved and employment opportunities increased.

3. Mr Utiger acknowledged that the Government had already done much to help industry and that the recent fall in sterling would certainly benefit some sectors but it would be wrong to conclude from this that any relief in the 1983 Budget should be slanted towards individuals. The CBI were in favour of indexation of the personal tax thresholds in the next Budget but would not look for any further personal tax reliefs unless the Chancellor could meet the priorities the CBI had identified for reduction of business costs with room to spare. Even when account was taken of the latest fall in sterling and the improvements achieved in productivity, the UK was still 20 per cent less competitive than it had been in 1975 and international competition was likely to become even more severe in the future. He drew the Chancellor's attention to chart II.2 which demonstrated how the loss of export market share and the rise in imports, both directly related to our poor competitive performance, had reduced the potential growth of GDP.

4. The Chancellor commented that the CBI's analysis of the current situation had much in common with that of the Government. He stressed the need to keep down the level of pay settlements. Mr Rigby agreed but noted that pay was not the only area in which action needed to be taken if the UK's competitive performance was improved sufficiently. Sir Terence Beckett referred to the reduction in settlement levels which had already been achieved. The CBI would continue to keep up the pressure but it would be difficult to achieve a much faster fall.

5. Mr Utiger then turned to the size of the Budget. The CBI appreciated that in taking decisions on the size of the PSBR for 1983-84, the Chancellor was having to take a judgement about the difference between two very large aggregates. However, in the present very uncertain world situation, it was their belief that the risk of giving too small a stimulus in the Budget was greater than the risk of doing too much. He noted that at the time of the last Budget, the Government had set a target for the PSBR of 2¾ per cent of GDP in 1983-84 but he pointed out that economic activity was considerably lower than had then been expected. As a result, the CBI would advocate a PSBR of around £9 billion, representing 3 per cent of GDP. As charts II.3 and II.4 illustrated, such a figure would still be comparatively low in historical terms and by comparison with the budget deficits of other countries and the scale of the recession. On unchanged policies, the CBI would expect a PSBR of £6 billion, so that their proposals amounted to a package of around £2½-3 billion.

6. Speaking for small firms, Mr Pope emphasised that he and his colleagues were grateful for the measures that the Government had already introduced to meet their specific problems. He noted that it was the unanimous view of the Smaller Firms Council that the 1983 Budget should be directed towards achieving improvements in the basic structure of UK industry and in its competitive performance rather than

measures designed to improve their own particular position. Thus they too would support action designed to reduce business costs in preference to personal tax reliefs.

7. Mr Utiger then listed the CBI's principal recommendations for the 1983 Budget. He proposed first the abolition of the NIS. All were agreed on the undesirability of the tax and there was concrete evidence from the Employment Policy Committee that previous cuts in the NIS had not been given away in higher wage settlements; indeed, the issue had not even been raised in negotiations. The CBI were also recommending lower business rates. They appreciated the practical difficulties involved but suggested a 15 per cent derating of business premises; a cut on business rates increases; the abolition of empty property rating, at a cost of around £35 million, which would provide direct help to those most in need; and "mothball" relief for rates on those parts of properties which were temporarily unused, although they appreciated that it might take longer to work up a scheme of this kind. The CBI also saw a case for additional capital expenditure. The construction industry was particularly depressed and in need of Government help, while the import content of construction activity was very low. There were plenty of useful infrastructure projects which could be undertaken once funds were made available. Additional expenditure in this area could be financed partly by further cuts in current spending. Mr Utiger stressed the importance of pursuing a consistent policy towards public sector investment, given the long timescales involved. Finally, he referred to the very specific representations which the CBI were making to the Secretary of State for Energy on fuel and energy costs. A number of UK industries faced a serious risk of being driven out of business over the next few years as they could no longer compete with their continental rivals unless energy costs were significantly lower.

8. The Chancellor commented on the marked consistency which the CBI had displayed in their Budget representations over the years. No forecast of the scope for fiscal adjustment in 1983-84 was yet available

but he noted that the Government's record in meeting the CBI's requests in the past had been a good one. He also recalled that the CBI had earlier pressed for a 4 per cent annual reduction in the exchange rate over the next 3 years. The recent fall in sterling must therefore have been welcome to some of their members. Sir Terence Beckett stressed that the UK was still 20 per cent less competitive than it had been in 1975.

9. Turning to the CBI's detailed proposals, the Chancellor expressed sympathy with their desire to reduce the level of business rates. However, he pointed out that rates would already have been struck by the time he announced his Budget. Mr Utiger suggested that it would still be possible to provide industry with a rebate but the Chief Secretary noted that this would require legislation. The Chancellor also expressed some surprise that the CBI had not recommended revalorisation of the specific duties. Mr Utiger explained that the CBI believed revalorisation would have a disproportionate impact on the RPI and they had some doubts about how tax effective any increase would be. Sir Campbell Fraser also pointed out that the effect of revalorisation would fall particularly heavily on a small number of industries. The Chief Secretary suggested that by advocating a standstill on the specific duties, the CBI were by implication proposing some tax relief for the personal sector. Mr Pope agreed. Given that on the basis of the CBI's recommendations there was likely to be little or no room in the Budget for income tax reductions, it seemed sensible to give some incentive to those at lower income levels through a decision not to increase indirect taxes.

10. The Economic Secretary enquired whether there was an inconsistency in the CBI's identification of the growth of consumer expenditure as a major expansionary factor for the UK and their recommendation of a relaxation in the fiscal stance. Mr Utiger pointed out that much dependend on the kind of relaxation which was proposed. Given the strength of consumer expenditure, the CBI were not recommending relief for individuals but for industry. The Economic Secretary then wondered

whether the CBI were contemplating any amendment to their proposals as a result of the fall in the exchange rate. Sir Terence Beckett said this would not be necessary. The recommendations were directed towards improving the UK's poor competitive performance in a shrinking world market. The latest fall in the exchange rate would not remove this problem. However, the Chancellor pointed out that the fall in sterling must have an effect on the total fiscal and monetary balance.

11. The Chancellor noted that the CBI had proposed reductions in the Contingency Reserve for 1983-84 and 1984-85. He pointed out that the Government had already reduced the figure for 1983-84 to £1,500 million and had been criticised by the TCSC for doing so. However, the CBI's suggestion for a reduction in the 1984-85 Reserve was well taken. Sir Donald MacDougall commented that the real problem lay with excessive local authority spending. The Chancellor said it would be helpful if the CBI's members could continue to put pressure on the local authorities and the NHS. The Chief Secretary pointed out that central government had been reducing manpower twice as fast as local government but Sir Terence Beckett commented that the staff reductions in the public sector were still small compared with those of the private sector.

12. Sir Terence Beckett drew attention to the surprising degree of unanimity displayed by the CBI's members urging the Government to cut business costs in the Budget rather than to reduce personal taxation. He suggested that the latter would involve a greater risk to the balance of trade and to the exchange rate. The Chancellor thought that the distinction drawn between the impact of measures to help industry and the impact of measures to help individuals could be overstated. Mr Burns agreed: in terms of import penetration, there was not a great deal to choose between them. Sir Donald MacDougall suggested that they could be distinguished in relation to their impact on competitiveness. Reductions in business costs would certainly make UK industry more

competitive. If cuts in personal taxation were reflected in greater pay restraint, they too could have an impact on competitiveness but the links here were much less certain. The Chancellor thought that taxation did nevertheless have an impact on pay bargaining. During the NHS dispute, for instance, attention had been focused on the low levels of take-home pay for health workers. He pointed out that the employee's NIC would be raised in April so that even if personal tax allowances and bands were indexed, take-home pay would still fall.

13. The Chancellor then asked the CBI what recommendations they had to make on the tax structure. Mr Pope replied that the CBI's views on capital taxation were well known to the Chancellor. He would therefore concentrate on their proposals to increase the amount of equity investment in smaller companies. They remained concerned that imaginative initiatives for broadening the equity base of small companies should be fostered. They were less interested in proposals to establish Small Firms Investment Companies but they were quite prepared to contemplate other proposals which would achieve the same objectives. They believed that if the existing incentives for investment in start-up companies could be extended to established smaller companies, more jobs would be created. They wanted to encourage the large financial institutions to invest in smaller companies and to improve the marketability of investment in such companies by making it easier for individuals and institutions to realise their investment at an appropriate time. Finally, they wanted to match willing investors with those companies in need of finance. The Financial Secretary said he was examining the SIFCs proposal. The Government's objectives were three-fold: to encourage more equity investment; to persuade companies to borrow longer and to encourage more direct investment by individuals and companies rather than by institutional investors. The SIFC proposal would not achieve the third of these. He also saw a potential conflict between promoting the marketability of investment in smaller companies and encouraging individuals and companies to invest

on a more permanent basis.

14. The Chancellor noted that the CBI were advocating the reintroduction of the 1972 "top hat" share option schemes. He suggested that there was a widespread feeling that it was not worth taking action in this area since any schemes which were set up would be likely to be abolished if the Labour Party won the next election. Mr Willingale saw this as one method of encouraging the movement of top management. The CBI would not press specifically for the reintroduction of the 1972 schemes but any action which the Government could take in this area would be welcome. He also drew the Chancellor's attention to the recommendations which the CBI had made on ACT. The Chancellor noted the proposal for extending allowances to commercial buildings but drew attention to the huge cost involved and suggested that this was not an area where the need for investment was perceived to be greatest. More generally, he suggested there was a certain peversity in the way in which successive governments had consistently subsidised investment but taxed labour. Mr Chandler had drawn attention to this in his recent NEDC paper and he wondered whether it might be worth examining the whole issue at some future Council.

15. Finally, Sir Terence Beckett pointed out that the CBI's representations made no reference to the investment income surcharge, although some members felt strongly on the subject, especially the small firms. Mr Pope acknowledged that businessmen had the opportunity to take out self-employed annuities to provide them with a pension on retirement but many preferred, for good reasons, to keep funds in their own firms during their working lives. The IIS penalised these individuals and thus encouraged them to continue working beyond the point when they should have retired from the business. The Chancellor acknowledged that the IIS was a clear surcharge on a risk-taking and suggested that the argument Mr Pope had put forward was a useful one to be deployed, even if it did not form part of the CBI's formal Budget representation.

Sir Campbell Fraser thanked the Chancellor for meeting the CBI and the meeting closed at 4.30pm.

MOM

MISS M O'MARA

Circulation:

Ministers and Officials present
Minister of State (C)
Minister of State (R)
Sir Douglas Wass
Sir Anthony Rawlinson
Mr Middleton
Mr Cassell
Mr Mountfield
Mr Hall
Mr Norgrove
Mr Ridley
Mr French
Mr Harris

CONFIDENTIAL

FROM: N MONCK
DATE: 26 January 1983

1. MR MIDDLETON
2. CHANCELLOR

Chief Secretary
Financial Secretary
Economic Secretary
Sir D Wass
Mr Burns
Mr Littler
Mr Cassell
Mr Evans
Mr Odling-Smee
Mr Kemp
Mr Lavelle
Mrs Lomax
Mr Riley
Mr Sedgwick
Mr Turnbull
Mr Hall
Mr Pickford
Mr Bennet
Mr Willetts
Mr Ridley

MONETARY TARGETS IN 1983/84: M1

I attach a paper about what should be said about M1 in 1983/84. Unlike last year, the forecast is that M1 will ~~grow faster than the~~ target range of 7-11% which has been provisionally confirmed for broad money in 1983/84. The main question is whether we rely on what has already been said in the 1982 MTFS and the Autumn Statement or say something clearer - that faster growth of M1 is expected and acceptable up to some point which might be defined in words or numbers.

2. The paper is a Treasury one but it reflects comments from Mr George who favours relying on what has already been said in the context of minimal change in the MTFS generally. HF and FEU favour going at least as far as saying that M1 growth is likely to be "a few points higher" than the target range.

3. You will want to discuss the treatment ofM1 with the Governor at some stage. But the disagreement between Treasury and Bank is on a relatively narrow point and you may prefer to wait till you can do so in the context of MTFS as a whole, including the path for the later years.

pp S. LeComber
N MONCK
26 January 1983

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MONETARY TARGETS FOR 1983/84

Ministers have decided provisionally that the range of 7-11% shown in the 1982 MTFS for monetary growth in 1983/84 should now become the target for that year at least for £M3 and presumably also for PSL2, the other measure of broad money.

2. This paper discusses whether there should be a separate numerical target range for M1 or only a form of words which might or might not be explicit about the prospect and acceptability of M1 growing at a rate above the target range for broad money during 1983/84. The question is a fairly narrow one which involves balancing different risks. Treasu and Bank officials have reached different judgements on this.

3. The question is considered in the light of the internal role of monetary targets in guiding policy, their external presentation and impact, and the forecast. When a decision has been taken on the path for money, inflation and output in the later years of the 1983 MTFS, it may be relevant to the questions about M1 next year. It is assumed that even if the picture of the future changes somewhat the general policy stance will stay as close as possible to last year's MTFS.

The Role of Targets

4. Internally monetary targets express the objectives of policy at the start of the financial year and act as a guideline for decisions during the year. If actual monetary growth diverges from the target there is no automatic response, but the arguments for and against action are considered in the light of a range of evidence wider than the monetary aggregates (notably the exchange rate, real interest rates, and progres in reducing inflation). This broader approach reflects the many uncertainties involved in setting targets, interpreting monetary conditions, taking action to restrain monetary growth and estimating the benefits in terms of subsequent inflation.

5. The acceptance of substantial over-runs and base drift in the first 2 years of the original MTFS period and the justification of the measures taken and of the higher targets have naturally had an external impact. The TCSC, for example, has argued that monetary targets now ha

less impact on expectations generally and that the Government itself attaches less important to them. Even financial markets have sometimes accepted rapid monetary growth or higher targets relatively calmly. Credibility has been maintained by the broad consistency of policy as a whole and by the rapid reduction of inflation. The current prospect that with the possible exception of M1, the growth of all 3 monetary aggregates in 1982/83 seem likely to be within the target range also helps.

6. Overall there has probably been some loss of clarity and precision in the presentation of monetary policy but some gain in flexibility of its conduct. There is still a tension between the benefits and risks of having a separate numerical target range for M1, but they are probably smaller than they would have been earlier.

The 1982 MTFS

7. Last year's MTFS set a target range for 1982/83 of 8-12% compared with the illustrative range of 5-9% given in the 1980 MTFS for that year The target range applied to:

"both broad and narrow measures of money: £M3 (and PSL2), and M1".

PSL2 was effectively seen as a cross check on £M3 rather than a major aggregate in its own right*.

8. These changes followed 2 years of substantial base drift and overruns. Apart from these specific changes the 1982 MTFS was generally phrased cautiously. It was made clear that the whole strategy was subject to revision in the light of domestic productivity growth, changes

* Mr Turnbull's submissions to the Economic Secretary of 20 January dealt with the possibility of redefining PSL2, recommending against; another will cover the presentation of the decision, already approved in principle, to take public sector deposits out of £M3 and the PSBR from the start of the new target period, which on the precedent of the last 2 years would start at the end of banking February.

in the world economy etc. On the monetary side although there had been a "reasonably stable relationship" between the aggregates and money GDP and prices, the relationship between any one measure of money and money incomes could be changed by:

> "many factors including the behaviour of the exchange rate, the level and structure of interest rates, changes in savings behaviour, the balance between interest rates and fiscal policy and institutional changes".

Most of these factors were said to have been at work recently and to be likely to continue. The targets for 1983/84 would be reconsidered in the light of structural and institutional changes which may affect the economic significance of the different aggregates.

9. At the time of the last budget all three aggregates were forecast to be within the range of 8-12% in 1982/83. In other words a cross-over point was foreseen with the growth of £M3 slowing down and that of M1 rising. That has in fact happened and the prospect is that over the first 12 banking months of the 1982/83 target period all 3 aggregates may well be within the target range though there is a greater risk that M1 may be a little over the top.

10. But the Red Book allowed for an M1 over-run sometime in the MTFS period:

> "During the last 3 years, the relatively slow growth in the narrow aggregates has largely been a consequence of high nominal interest rates. Sustained progress in reducing inflation and interest rates may lead to some shift back into non-interest bearing forms of money. In such circumstances a more rapid growth in M1 than indicated by the ranges shown above might, for a time, be acceptable."

The Autumn Statement implied that this passage would be relevant to 1983/84:

> "Broad monetary aggregates, including £M3, are assumed to increase within the MTFS range in 1983/84. Recent months have seen a relatively more rapid growth in M1 (75 per cent of which does not bear interest) as a result of the decline in interest rates since last autumn. The lower level of interest rates will continue to add to the growth of M1 which may exceed the top end of the range."

The Forecast for 1983/84

11. The report on the forecast of January 1983 shows output rising at 2-2½% in 1983 and 1984. Inflation as measured by the 12 months RPI falls to about 5% in the first half of 1983 and then rising to 6½% by the end of the year and over 7% in 1984. The rise in the more widely based TFE deflator is smoothing increases, averaging about 6½%.

12. The forecast of monetary aggregates is:

	Q1 1984 on Q1 1983
£M3	9½%
PSL2	9%
M1	13½%

13. The associated assumptions on short-term interest rates are:

		3 month inter-bank	base rates
1983	Q1	11¼	11
	Q2	10¾	10½
	Q3	10½	10½
	Q4	10	10
1984	Q1	9½	9½

14. The forecast for the aggregates has a different pattern from the forecast at the time of last year's Budget, when M1 and £M3 grew at similar rates and were both within the target range. This time M1 rises over 3% faster than £M3 and is outside the target range. If interest rates were to fall faster, the disparity and the over-run compared with the target range for broad money would be bigger.

15. Such forecasts are of course notoriously uncertain. Over recent years, as the Annex shows, the gap between the published forecasts (which were not always the best judgements of the economists) and outturn with <u>no</u> adjustment for policy changes has been large. Although the performance has probably been good for 1982/83, there was an average under-estimate for £M3 over the period from 1978-1982 of about 4%. For M1 the errors were larger but the sign varied. The average absolute error was about 7% and was due in large part to errors about interest rates.

Options for M1 in 1983/84

16. For internal purposes it seems reasonable to HF and FEU, whatever is said externally, to take the forecast as a guideline, with adjustment for different levels of interest rates if necessary. The current estimate is that 1% fall in short-term interest rates adds about 1½-2% to M1 growth over 12 months and about 1% over 6 months. Although the growth of M1 is uncertain and only one input into a discretionary judgement of many indicators, it seems useful to start with a specific figure in mind.

17. Bank officials think that the use of a fragile forecast in this way might give an impression of spurious precision without adding anything compared with simply looking at the size of any M1 over-run, if there is one, compared with the 7-11% target range.

18. For external purposes the main options are:

a. a general verbal formula very much like last year's or the Autumn Statement (see paragraph 9 above) saying that faster growth of M1 might occur and could be acceptable;

b. a verbal formula that says explicitly that growth of M1 above the target range for 1983/84 is likely and appropriate. It might say, after referring back to or repeating the text of the 1982 MTFS or the Autumn Statement (see paragraph 9 above):

"In these circumstances growth of M1 a few points over the target range shown above would be appropriate."

c. as b. but giving a number in the text, say "about 3% above the target range" for broad money.

19. Bank officials favour option a. On the assumption that the general stance of MTFS including the role of different indicators is changed as little as possible, a change in what is said about M1 would in their view be conspicuous and might undo the helpful effect of the current performance of the monetary aggregates. If, in fact, M1 exceeds the

target range of 7-11%, the Bank considers that the words already used will have prepared the ground adequately. Some of the difficulties in option a. which are mentioned below have already arisen and proved manageable.

20. Treasury officials, however, consider that option a. has not been tested in the circumstances expected in 1983/84. If M1 does rise at more than 11% (compared with an annual rate of 15% over the latest 6 banking months), option a. would not allow us to claim during the year that all the aggregates are within the target range, which we have found invaluable to do recently. Also at the start of the year we could not either honestly or convincingly answer questions about how a single target range for 3 aggregates can make sense by saying, as we could and did last year, that we expected similar rates of growth again. There would be no public basis for answering questions eg from the TCSC after the Budget about inflationary prospects. In fact, it would not be easy to explain in what way M1 still had the target status it was given in the 1982 Budget.

21. A numerical target, as in option c. would involve some real difficulties, particularly of setting the number and presenting it. Some supporters of M1 might not accept the general proposition about the acceptability of faster growth of M1. Many others would be unpersuaded of the importance of M1. As paragraph 14 of the Annex demonstrates, the particular figure would be highly uncertain and their sensitivity to interest rates could produce perverse pressures for action. The published number might be exceeded if everything was going well and interest rates fell faster than forecast. It would be of uncertain presentational value and, like all these targets, might act as a constraint in an unwelcome way.

22. The arguments in favour of c. are that it would explicitly prepare the ground for what we expect and that it would maintain and perhaps en enhance the status given to M1 last year. It might be argued that by making explicit the higher growth rate for M1 in a separate target range the Government was relaxing policy and that this would be unnecessarily risky after recent experience with sterling. The answer would be that the more rapid growth in M1 was fully consistent withthe inflation and money GDP projections, and reflected to a significant extent the lagged

effects of the fall in interest rates in 1982. We would be putting numbers on the general proposition in the 1982 MTFS, not relaxing but clarifying policy.

23. If M1 were within its range it might make it easier to allow some over-run in £M3 and to reduce or avoid "over-funding" and the interest costs, uncertain economic benefits and potential embarrassment associate with it. (Satisfactory growth of M1 ie low growth was used as one reason for accepting the £M3 over-runs in November 1980 and in the 1981 and 1982 budgets.) If on the other hand it was over-running its target range, the rise in short-term interest rates called for might be what was required to keep monetary conditions right for reducing inflation. But whatever the merits, maintaining the status of M1 might in certain circumstances give the Authorities a choice between raising short-term interests to control M1 and doing more funding to control £M3.

24. Option b. is intermediate. It would prepare the ground for M1 growth faster than the target range more explicitly than option a. It would avoid some of the risks of numbers - the choice between loss of credibility and some painful corrective action - and would to that extent be a little more flexible. It might well prompt questions about the meaning of "few", but these could be evaded by saying that if we had meant a number we would have given one. We did not do so partly because its level would depend on a forecast of interest rates which we do not publish.

Conclusion

25. Unlike last year M1 is expected to grow significantly faster than £M3 and above the target range.

26. Bank officials judge that there is no case for treating the M1 forecast as a guideline internally or, externally, for moving beyond what we have already said about M1 in the 1982 MTFS and the Autumn Statement (option a. in paragraph 18).

27. HF and FEU favour treating the forecast of M1, conditional on interest rates, as an internal guideline.

28. There are conflicting arguments about the 3 broad options for what is said externally. HF and FEU judge that there is a good case for moving beyond last year's formula at least as far as option b.

HF
26 January 1983

THE ACCURACY OF MONETARY FORECASTS

Note by EA

This note analyses the accuracy of Treasury (quarterly) forecast of £M3 and of associated variables. Post mortems on past forecasts are the principal way of providing quantitative margins of error for use in assessing current forecasts. The limitations ofthe present exercise are considerable:

i. the analysis is confined to the Industry Act forecasts published since early 1978;

ii. it has not been possible to correct for the effects of subsequent changes in policy.

2. The table below shows target growth ranges, and average forecast errors for money supply and interest rates. The judgements made in published forecasts did not always represent the central view of the forecasters themselves.

3. The forecasts of the growth of £M3 were always too low, until the Autumn 1981 forecast when the predicted growth rate proved to be comparatively accurate, but if anything, too high. The forecasts for M1 growth, which tends rather to over-predict the outcome, suffered the largest mean absolute errors of the monetary aggregates, but there is some evidence that the errors are correlated within the errors in short-term interest rate predictions. Five times out of seven these errors are inversely related, suggesting that more accurate interest rate predictions would have also improved the record with M1. The absolute error in M1 forecasts has also tended to improve over time reflecting the increasing attention that has been paid to this aggregate.

4. The authorities' policy responses to above target growth of £M3 has generally been to raise interest rates, particularly during the earlier part of the period. This is reflected in short-term interest rate predictions which are consistent under-estimates until the Autumn 1980 forecast, which over-predicted. Thereafter there has been

no systematic tendency to either over or under predict, although the mean absolute errors were improved only slightly. The forecasts of long-term interest rates, by contrast, have been more accurate, and there is no desirable pattern in the errors.

5. Finally, projections of nominal GDP will reflect judgements about both the rate of inflation and real output. The positive errors early in the period reflect the unexpectedly rapid inflation of 1979 and 1980. However, on average the errors have been close to zero.

MONETARY FORECASTS AND OUTTURNS 1978-82

Forecast made in	Year to	£M3	M1	3 month* inter-bank rate	20 year* Gilt rate	Nominal* GDP at market prices
Budget 1978	1979 Q1	1.4	-	3.0	0.8	0.5
Autumn 1978	1979 Q3	4.7	11.5	2.7	0	6.1
Budget 1979	1980 Q1	3.0	-0.7	2.7	0.2	2.6
Autumn 1979	1980 Q3	6.4	-8.8	1.5	-0.1	3.1
Budget 1980	1981 Q1	5.1	-11.8	1.8	0.9	-4.0
Autumn 1980	1981 Q3	5.1	7.0	-1.5	1.4	0.7
Budget 1981	1982 Q1	5.7	-7.0	2.0	1.6	-1.2
Autumn 1981	1982 Q3	-1.2	-3.8	-1.1	-0.8	-2.8
	Average	3.8	-1.9	1.4	0.5	0.6
	Mean absolute error	4.1	7.2	2.0	0.7	2.6

* Errors are here averages over the twelve month period.

CABINET OFFICE
Central Policy Review Staff
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EXCHEQUER
26 JAN 1983
Mr Kemp
CST, FST, EST,
MST C, MST R,
Sir D Wass,
[illegible],
Mr Burns,
Mr Bailey,
Mr Middleton,
Mr Moore,
Mr Monger,
PS/IR,
Mr Traynor

From: [illegible] Sparrow

Qa 06231

2[illegible] January 1983

The Rt Hon Sir Geoffrey Howe QC MP
HM Treasury
SW1

Dear Geoffrey,

1983 BUDGET

I may be helpful if I mention now three major points which emerged in our study of unemployment, and which are very relevant to your decisions on the Budget.

Our present tax system subsidises capital and taxes labour in a way which is difficult to defend in present circumstances. I therefore very much agree with Patrick Jenkin that abolition or at least further reduction of NIS should have the first call on whatever headroom you have.

If you also have scope for lower direct taxes, it would be desirable to use it to ease the problems of the unemployment trap. This means, in the first instance, that raising tax thresholds is preferable to cuts in tax rates. But an across the board increase in tax thresholds is a blunt instrument for tackling the unemployment trap. The great majority of families affected by the trap are single-earner couples, mostly with children, yet only a small part of the benefit of raising tax thresholds across the board would go to such families. Pending reform of taxation of husband and wife (which cannot under any circumstances happen for some time) one of the most effective ways of concentrating tax help on these families would be to create a new allowance for people with at least one child under 5. If it would be administratively impractical to introduce a new tax allowance for the coming Budget, a useful second-best would be to use the child benefit system to achieve a similar result.

I would also urge that, as in previous Budgets, some part of any fiscal headroom should be used for public works which meet important social and economic needs and which are also labour intensive. Such programmes have a low import content and will promote employment. They can be targetted to geographical areas of maximum difficulty. Projects which increase the supply of jobs circulating in the normal labour market are likely to have a greater effect on confidence and morale than schemes designed to occupy the unemployed. Moreover they help sustain the private construction industry.

Yours sincerely,

John.

John Sparrow

CABINET OFFICE

Central Policy Review Staff

70 Whitehall, London SW1A 2AS Telephone 01-233 7765

From John Sparrow

Qa 06251

26 January 1983

EXCHEQUER
26 JAN 1983
Mr Kemp
CST, FST, EST, MST^C, MST^R, Sir D Wass, ... Ryrie, Mr Burns, Mr Bailey, Mr Middleton, Mr Moore, Mr Monger, PS/IR, Mr Traynor

The Rt Hon Sir Geoffrey Howe QC MP
HM Treasury
SW1

Dear Geoffrey,

1983 BUDGET

I may be helpful if I mention now three major points which emerged in our study of unemployment, and which are very relevant to your decisions on the Budget.

Our present tax system subsidises capital and taxes labour in a way which is difficult to defend in present circumstances. I therefore very much agree with Patrick Jenkin that abolition or at least further reduction of NIS should have the first call on whatever headroom you have.

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CONFIDENTIAL

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Yours sincerely,

John.

John Sparrow

CONFIDENTIAL

A35

FROM: ECONOMIC SECRETARY
DATE: 27 JANUARY 1983

CHANCELLOR

cc Chief Secretary
Financial Secretary
Sir D Wass
Mr Burns
Mr Littler
Mr Middleton
Mr Cassell
Mr Evans
Mr Odling-Smee
Mr Kemp
Mr Lavelle Mr Monck
Mrs Lomax
Mr Riley
Mr Sedgwick
Mr Turnbull
Mr Hall
Mr Pickford
Mr Bennett
Mr Willetts
Mr Ridley

MONETARY TARGETS IN 1983-84 : M1

I have read the paper attached to Mr Monck's submission of 26 January.

2. The moral of this story, taken in conjunction with the PSL2 dilemma, is that we would have been far wiser to stick with the devil we knew last year. But we did not, and there is no going back.

3. I find some aspects of this submission disturbing. In particular, I shy at paragraph 23, where it seems to be suggested that if we take a high range for M1 and it sticks with it, then we could laugh our way round a parallel £M3 overshoot; in other words that M1 at 13½% and £M3 at 12% would be nothing to lose any sleep over.

4. But the nub of the matter remains this: do we devise a separate range, or a form of words, for M1? For the life of me I cannot grasp the logic of a target which, from the word go, it is our considered judgment we are not going to hit. I would have thought the markets were far more likely to be scared by the sight of M1 soaring steadily over the top of the range, urged on by

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cheerful cries of 'we said it would be appropriate', than they would by the presentation of what we believe to be a likely range - 11-15, or whatever, with a coherent explanation of why this should be, and why we believed it consistent with falling interest rates and abating inflation (provided we did not then try to pretend that observance by M1 of its flight path allowed us to ignore the performance of £M3). So on balance I would go for option c - but expressed as a secondary range.

5. Failing that I would go for option a, which at least has the virtue of vagueness and tradition. Option b, it seems to me, would give us the worst of every world. It would be tantamount to saying 'we have got to have a target for old time's sake. But it doesn't amount to a row of beans and we know we have no mind to hit it.'

CW Harrison
pp JOCK BRUCE-GARDYNE

FROM: T BURNS
DATE: 28 January 1983

A35

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State (R)
Minister of State (C)
PCC
Mr Cassell
Mr Evans ← Mr Odling-Smee
Mr Sedgwick
Mr Shields
Mr Riley
Mr Ridley
Mr French
Mr Harris

ECONOMIC PROSPECTS - JANUARY 1983 REPORT

You have seen the January forecast. This shows little change from the forecast circulated for Chevening and in broad terms follows the same pattern as the forecast published in the Autumn Statement. It already allows for a fall in the dollar oil price of between two and three dollars and implies an even bigger fall in real terms over the next eighteen months. The problems of OPEC this week have therefore not come as a total surprise and do not require a major re-think of the forecast although the downside risk for oil prices is now rather greater.

2. The main changes since the autumn statement forecast are

(i) a substantially lower exchange rate reflecting the recent fall;

(ii) some improvement in the growth of output this year;

(iii) a higher inflation rate by the end of this year;

(iv) some improvement in the prospects for the current account.

3. In the autumn forecasting round we highlighted

(i) the strong recent growth of domestic demand which we expected to continue;

(ii) the recent and prospective weak performance of world demand;

(iii) some concern about the share of both domestic and world demand that was being achieved by UK producers.

4. The information that has become available since then confirms our general view about demand behaviour but slightly changes the interpretation of UK performance

(i) the growth of final domestic demand has continued to be buoyant much as expected; consumer spending has been strong and total investment shows some increase in the second half of last year;

(ii) world demand has continued to be weak with a further fall in world industrial production in the final quarter of 1982;

(iii) the UK has done rather better than expected in terms of its share of ~~domestic and~~ world demand. Exports have performed well; in 1982 we maintained our share of world trade but

(iv) a significant part of the demand has been met from reduced stocks rather than from higher output (as foreshadowed in the Summer CBI Economic Trends Survey). Although this has meant a disappointing output performance in the latter part of 1982 it means that the stock/output ratio is probably no longer excessive which points to better prospects for a recovery of output this year.

World Outlook

5. I would argue that the UK and the rest of the world are now and are projected to be in better financial balance than for some while. Important characteristics that are common to both UK and the world are:

(i) inflation has come down rapidly;

(ii) so have nominal (although not real) interest rates;

(iii) real money balances have begun to recover;

(iv) there has been substantial de-stocking in industrial countries.

6. In addition at the world level it is now clear that the LDC countries have gone a long way towards reducing their imports and current account deficit. // These adjustments are in large part the result of the recent output fall but are consistent with some significant recovery of real demand over the next 12 months.

7. On balance we expect the fall in oil prices to help the adjustment of the world economy although it is unlikely to be as helpful as previous increases in oil prices were damaging. This is because a number of countries (the most common examples are Nigeria and Mexico) have already adjusted to higher oil prices and will find the reversal of this process painful. The banking system has also partially adjusted its lending behaviour to high real oil prices and will find the unwinding of this difficult.

8. The continuing high real interest rates and the downward pressure upon spending from a reduced supply of credit to high risk borrowers remain the most significant risks to growth. Recent UK experience suggests that as inflation and nominal interest rates are reduced domestic demand increases as the worst of the de-stocking comes to an end and consumer spending expands. We remain vulnerable to a reversal of world interest rates. As we have seen in the UK a reduction of

interest and inflation rates can lead to a faster growth of narrow money aggregates. This should not be resisted if we are to avoid a rebound of interest rates during this phase of adjustment.

Adjustment in the UK

9. The UK has made further progress towards adjusting to lower inflation and the forecast implies further correction over the course of the next year. In addition to the factors mentioned in paragraph 5 it is significant that

(i) the ratio of company to personal sector disposable income is expected to move back to virtually 1979 levels during the course of this year;

(ii) relative export prices are now much closer to their historical levels. Although they remain high by reference to the latter part of the 1970's they are within the range experienced over the past twenty years which is a marked contrast to the pattern over the past two years.

10. There are still some important problems:

(i) real interest rates remain very high;

(ii) relative wage costs are still high by past standards. Although there has been some improvement with the fall in the exchange rate and a slower growth of UK unit labour costs they are still outside the range of the 1960-1979 experience.

11. Even so the conditions are now emerging where we would expect to see a clear resumption of growth. This is what the forecast suggests. A large part of the adjustment to higher oil prices and lower inflation is now complete. This should ease the strains upon financial policy. Of course we now have the possible required adjustment towards lower oil prices. That could pose some problems for UK fiscal policy but it should not be anything like as difficult as simultaneously adjusting to higher oil prices and lower inflation.

Inflation

12. I discussed the inflation prospect at length in the Chevening paper. Some pick-up of inflation in the latter part of this year seems to be very likely. The recent figures probably overstate the progress towards lower inflation as we have been significantly helped by what are likely to be temporary factors.

13. The difficult issue is to judge the impact of the recent fall in the exchange rate upon inflation. Clearly there are some dangers.

14. Import prices are likely to rise more rapidly. Over the past 18 months import prices have risen very slowly as initially profit margins on imports into the UK ~~have been~~ were high relative to imports into other countries leaving some scope for reducing margins. The depreciation in 1981 did not lead to the increase in import prices that might have been expected on a mechanical application of past behaviour, and as a result margins were reduced. Even so at the beginning of the current bout of depreciation margins were probably still higher than elsewhere. This view emerges both from a comparison of aggregate price indices and specific products such as cars. However on the basis of the aggregate data that margin has probably now been substantially lost and any further depreciation is more likely to show up in higher import prices.

15. The problems this creates for inflation do not only reflect the share of imports in expenditure. A higher level of import prices enables domestic producers to raise their prices and their margins. At the same time exporters will be able to raise their prices in overseas markets. Recently these have been held down as UK exporters have attempted to compete with other countries by squeezing their margins and maintaining overseas prices at competitive levels. The depreciation removes some of this discipline and export prices can be expected to rise a bit faster.

16. The combined effect is to ease the financial position on companies partly at the expense of the personal sector; particularly those who have been in the front line in the move towards lower inflation. Undoubtedly some easing of financial pressure on companies is required

if output is to recover but judging the appropriate pressure that permits this would creating excessive scope for increased prices is very difficult. And there is still considerable downward pressure on wage costs. But it is to be regretted that much of the move towards better competitiveness and an easing of pressure on companies has been brought about by tax relief by government and exchange rate depreciation rather than by an adjustment of relative unit labour costs.

17 There is little scope for further adjustment by this route without significant pressure on inflation emerging. As it is the forecast shows a slight upward drift of inflation over the next three years. This will pose presentational problems in the MTFS. In general terms I agree that we are unlikely to see much further progress over the next three years towards lower inflation as we move into the phase when cyclical factors point the other way. It is still possible that we will see a slow downward drift of inflation after the inevitable hiccup later this year but probably only if there is no further significant depreciation.

PSBR

18. For the second year running we look like undershooting the Budget PSBR figure - and this year after a considerable Autumn effort at infilling. The forecast notes that historically there has been some tendency for the errors in the PSBR forecast to be related to the progress of the cycle. The PSBR tends to turn out higher than expected in those years when the financial pressure is at its greatest and output falls. The errors go the other way as the financial pressure eases and output increases. Clearly the forecasters have tried to take this into account in presenting their forecast. The forecast document also points out that recent PSBR forecasts have been more than usually accurate; the errors have been smaller than might have been expected on the basis of the historical forecasting record. This needs stressing if only to remind ourselves of the large potential error in this difficult area.

Competitiveness

19. Over the last two or three years we have put considerable stress on the loss of cost competitiveness. But recently exports have been substantially higher than would have been projected by the relationships in the Treasury model. There are a number of possible explanations for this. On balance my own view remains that over a 3-4 year period the model overstates the effect of a loss of cost competitiveness on exports and output. Of course if the loss of competitiveness was to last for a long time this could not be sustained and companies would withdraw from markets. But companies have reason to believe on the basis of past experience that some correction will take place either through a better cost performance generally or eventually by a lower nominal exchange rate. In this case they are encouraged to hang on. If this interpretation is correct it implies that as the exchange rate falls and output begins to recover we will not see all the beneficial effects upon exports from the lower exchange rate that many people might have expected. On this interpretation all that is happening now is that the patience and tenacity of exporters in hanging on to their markets has finally been rewarded in terms of better margins.

20. It has also been difficult to interpret the recent behaviour of imports. Our normal measure of cost competitiveness shows domestic producers to be at a clear disadvantage and final domestic demand (particularly consumption) has been rising rapidly. On the other hand the level of imports has been relatively stable. The only explanation seems to be that imports have been dominated by substantial de-stocking in the final months of 1982. As this unwinds the possibility of a furthe sharp surge in imports (as in 1981), is highly likely.

21. This implies that we are likely to see a substantial reduction in the current account surpluses in the next few months, as we did in the second half ~~latter part~~ of 1981.

T BURNS

M35

FROM: M A HALL
28 January 1983

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Sir Douglas Wass
Mr Burns
Mr Littler
Mr Middleton
Mr Cassell
Mr H P Evans
Mr Odling-Smee
Mr Kemp
Mr Lavelle
Mr Monck
Mrs Lomax
Mr Riley
Mr Sedgwick
Mr Turnbull
Mr Pickford
Mr [illegible]t
Mr [illegible]
Mr [illegible]y

MONETARY TARGETS IN 1983/84 : M1

I refer to the paper attached to Mr Monck's submission of 26 January. The Economic Secretary's of 27 January also refers.

2. There is no doubt that the increase in the number of monetary aggregates for which a range is announced, and the shift of emphasis to the whole range of factors affecting monetary conditions has made it more difficult to present monetary policy coherently. This is not necessarily a bad thing. The less simple and straightforward the message, the harder it is to get across.

3. The most damaging argument, and the one which is most difficult to dispel, is that the pursuit of targets for the monetary aggregates has in some way been demoted as a policy instrument, and that monetary policy is generally more lax as a result. You will have detected this as a theme in some of the interviews you have given to journalists in recent months. I think nevertheless that this is an area where we have been reasonably successful in presenting the policy both to the press and to the markets - to the extent that an overshoot of the

664

target range for M1, and perhaps £M3 as well, has been expected for a while, and not regarded as a serious potential setback.

4. Turning to Mr Monck's paragraph 18, there would be presentational advantages to option (c), if - but only if - we could be reasonably confident of what figure to use. Would there be any sense in a variant of (c), using a range, say 3-5 percent or "upto 5 per cent" instead of "about 3 per cent", by which M1 could be expected to rise above the target range. This would simply translate "a few points" into numbers. This is obviously not of critical importance in presenting monetary policy, but the suggestion of concreteness usually helps.

M A HALL

A35

FROM: M A HALL
28 January 1983

CHANCELLOR

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Chief Secretary
Financial Secretary
Economic Secretary
Sir Douglas Wass
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Mr Sedgwick
Mr Turnbull
Mr Pickford
Mr [illegible]t
Mr [illegible]s
Mr [illegible]ley

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M A HALL

PA

A35

CONFIDENTIAL

FROM: T BURNS
DATE: 3 FEBRUARY 1983

CHANCELLOR

cc. Chief Secretary
Financial Secretary
Economic Secretary
Minister of State (R)
Minister of State (C)
PCC
Mr Cassell
Mrs Lomax
Mr Odling-Smee
Mr Monck
Mr Evans
Mr Sedgwick
Mr Shields
Mr Riley
Mr Ridley
Mr French
Mr Harris

THE MEDIUM TERM FINANCIAL STRATEGY

1. I attach a paper by MP reviewing the main issues involved in updating the MTFS.

2. The first question is whether the Government will want to re-affirm its commitment to reducing inflation, given the low level from which we start and the generally flat or slightly rising profile for inflation shown in the latest internal forecast. We assume that the answer to this is yes; and that the text and figures in the MTFS will need to be broadly consistent with this aim. We also assume that you will want, as last year, to show a growth in output at least in line with productive potential.

3. Given this objective we need to have decisions on the choice of monetary guidelines, PSBR ratios and the illustrative assumptions for inflation and output. Work on the MTFS projections can then get under way.

Monetary Guidelines

4. On monetary guidelines my inclination is to go for the higher of the two runs of figures shown in the paper (table 2). These are the same as published in the last MTFS with the extra year added showing a further one point deceleration. I am eager to avoid being seen to accommodate monetary policy to a lower inflation rate. The maintenance of a given nominal framework as inflation falls is the most persuasive argument for why recovery will emerge. The higher range also enables us to say that we are expecting M1 to grow at or above the top of the range while £M3 is expected to be in the lower part of the range.

PSBR

5. I would prefer to stay with variant A for the PSBR path (table 5 of the paper). This shows a PSBR of 2¾% of GDP for 1983-84 falling to 2% of GDP by 1985-86. In the Chevening paper I argued in favour of publishing a PSBR of £8 billion for 1983-84; a downward revision would not be easy to justify given that output is now a little lower than expected at the time of the last Budget. Such a profile will also give an extra bit of flexibility for 1984-85 and 1985-86.

6. If you choose £7½ billion for the 1983-84 PSBR then we have little option other than to choose variant B for the later years.

Economic Assumptions

7. For the economic assumptions I see little difficulty in projecting a growth rate of 2½% per annum.

8. The profile for inflation is more difficult. Undoubtedly there is a very large margin of error surrounding the assumption for 1985-86, but it is unwise to push optimism too far, given:

i. the most recent forecast

ii. the extent to which the recent inflation decline has a number of temporary factors associated with it

iii. the prospects for world prices as world output recovers

iv. the various external forecasts.

I am inclined to opt for the alternative assumption A in table 9. It does not show much further progress on inflation but it does show a continuation of low inflation whilst pointing in the right direction.

9. In broad terms there will be two conflicting influences on inflation over the next two-three years both in the UK and the world as a whole:

i. a low level of output; continuing excess capacity, will exercise downward pressure on inflation

ii. an improved growth of output; putting some upward pressure on inflation if the very low real level of commodity prices recovers (and maybe also profit margins).

It is difficult to judge the balance of these factors. Most commentators are putting a lot of weight on (ii). This may be pessimistic but there are risks of credibility in departing too far from the consensus.

Other Aspects

10. Whichever option is chosen, we need to look again at what is said (or implied) about:

i. the exchange rate

ii. M1 and, more generally, the status of the different aggregates.

Ministers have already seen a paper by M1 by Mr Monck, and that discussion is not repeated in this paper. Discussions about the monetary ranges could have implications for the status of the different aggregates. On the exchange rate, we suggest sticking as closely as possible to the formula used last year.

Next Steps

11. We hope to discuss this paper with you next week and in the meantime hold separate discussions with the Bank and Alan Walters.

TB

~~T~~ BURNS

MEDIUM TERM FINANCIAL STRATEGY

1. This note raises the main issues involved in presenting the MTFS and extending the monetary guidelines and fiscal projections to 1985-86. They relate to:

(1) what is said about the broad objectives of policy;

(2) the financial framework: the monetary targets for 1983-84 and the guidelines for the later years; what is said about other financial indicators, including the exchange rate; and the PSBR assumption for the later years;

(3) the assumptions needed to construct the economic projections underlying the revenue and expenditure tables.

The monetary guidelines will need to be discussed in more detail with the Bank. But it is useful to take a preliminary look at all the main issues at the same time, to ensure broad consistency between different elements of the MTFS. The final section of the paper outlines two main options.

Objectives

2. The MTFS has always opened with a general statement of the Government's medium term objectives. In 1980-81 and 1981-82 this read:

"The Government's objectives for the medium term are to bring down the rate of inflation and to create conditions for a sustainable growth of output and employment."

Last year was a bit more explicit (as some commentators noted):

"The Government's objective is to continue reducing the rate of inflation, thereby promoting a sustainable growth of output and employment."

going on to add:

"The Government's policies are directed at achieving a rate of inflation that is well into single figures."

This objective has never been qualified though we have increasingly acknowledged that the financial policies needed to achieve it are, to some extent, contingent on world events and UK productivity performance. Nor has it been quantified, though last year we published illustrative assumptions about the inflation rate, as background to the fiscal projections.

3. The rise in the GDP deflator in 1981-82 was over 11%; in 1982-83 it is likely to be around 7% (slightly lower than the 7½% forecast this time last year). We think that present policies are unlikely to be consistent with a further significant or lasting reduction in the inflation rate, at least over the period covered by the MTFS; our best guess (inevitably uncertain) is that it will be broadly flat, possibly showing some tendency to rise as the economy recovers.

4. The Chevening discussions implied that Ministers are ultimately aiming for a further reduction in the inflation rate (a view reflected in some recent Ministerial speeches), but felt that a fuller discussion of the medium term strategy needed to achieve this should wait until after the election. This could create problems. Given the low level from which we start, a clear statement that the Government is aiming for a further reduction in inflation may look (and be) inconsistent with monetary guidelines and other assumptions similar to those we used last year.

5. It is, of course, helpful to emphasise the progress that has already been made. But we assume that Ministers will want to reaffirm the commitment to reducing inflation and to support this by signalling some further movement in this direction over the period of the MTFS. If this is correct, the opening sentences might be redrafted on the following lines:

"Government policies have achieved a rate of inflation that is well into single figures. The objective for the medium term is to continue reducing inflation, and to promote a sustainable growth in output and employment."

The rest of this paper considers how we could make the text and figures in the MTFS consistent with a modest further fall in the inflation rate over the next three years.

The 1982 MTFS

6. The monetary ranges for broad and narrow money, the PSBR assumptions, and the illustrative figures for inflation and real and money GDP shown in last year's MTFS are summarised in Table 1; the estimated outturn for 1982-83 is in brackets.

TABLE 1. Guidelines and Economic Assumptions 1982 FSBR

% change on a year earlier	1982-83		1983-84	1984-85
Money	8-12		7-11	6-10
M1		(12½)		
£M3		(11¼)		
PSL2		(9¼)		
PSBR £bn	9½	(7.9)	8½	6½
as % GDP	3½	(2.9)	2¾	2
Prices (GDP deflator)	7½	(7)	7	6½
Real GDP	1¾	(¾)	← 2½ →	
Money GDP	9.8	(8)	9.6	9.4

7. With monetary growth at the centre of the range, these figures implied little change in velocity over the period, and a significant growth in real money balances, consistent with the expected recovery in output. The FSBR also said that the ranges had been constructed on the assumption of "no major changes in the exchange rate from year to year". The exchange rate is now over 10% lower than it was in the first quarter of 1982. However, the outturn for 1982-83 may not be too different from that envisaged in last year's MTFS (though the time path has, not surprisingly, been more uneven) : an estimated outturn for the effective rate of 88, compared with a forecast of 87½.

Monetary Guidelines

8. Money GDP may have grown by 1½-2 per cent less than we expected last year. But this has not been reflected in the monetary figures. With the growth in both M1 and £M3 probably at the top of the target range, there has been a fall in velocity on both measures of money. Relative to consumer prices, at least, the growth in real money balances has also been stronger than we expected last year.

9. If we want to show a declining path for inflation, and we stick to the same monetary ranges as suggested last year, we shall need to explain the significance of these developments and explain why unchanged money figures are now thought to be consistent with a lower rate of inflation in the medium term. Some commentators will argue that the failure to reduce monetary growth in the face of unexpectedly low inflation and output has had the effect of automatically easing monetary pressures. In time this will lead to a faster growth in output and a rebound in inflation. Without a change in monetary growth in nominal terms, there is no reason to look for a lower rate of inflation in the medium term. The more we imply that we are looking for a better outcome on inflation, consistent with the same recovery in real output, the more difficult it will be to rebut these arguments.

10. One approach is to argue that we have changed out view about the impact of structural changes on velocity, and now think that last year's monetary ranges may be consistent with a better medium term outcome on inflation. We have good reason for expecting a fall in M1 velocity as interest rates and inflation come down. This was foreshadowed in last year's MTFS and underlined in the Autumn Statement. We admitted that the scale and timing of this shift was uncertain. Mr Monck's paper on "Monetary Targets in 1983-84 : M1" discusses various ways in which we might seek to get this message across - either by repeating last year's form of words, adding to them, or adopting a (more or less formal) separate range for narrow money.

11. It may be more difficult to sustain the argument that the velocity of £M3 is likely to remain lower than we were expecting last year, and could even fall further without lasting damage to inflation. As

Mr Burns' paper for Chevening noted, some of our explanations for the fall in £M3 velocity in recent years imply some move in the opposite direction in the future, for example as real interest rates fall. The timing and scale are, of course, very difficult to judge. But there are problems in pleading too much ignorance. The more often we point to unpredictable structural shifts in velocity, the more we risk discrediting the whole MTFS approach with its emphasis on a stable financial framework centred on monetary targets.

12. It is worth considering the case for moving down the monetary ranges, at least as they apply to broad money. This would be a way of reinforcing expectations of a lasting move to lower inflation. We do not need to imply that we think there is a very close relationship between monetary growth over the next few years and the rate of inflation over the same period. But if we take the view that inflation is likely to stabilise, or even fall further - in reponse to past policy, or world events - the stance of policy may look excessively easy if we do stick to last year's guidelines - with possible implications for the rate of inflation in the longer term.

13. There are, however, a number of arguments against such a move, at this time :-

(i) it might be interpreted as a deliberate attempt to tighten policy - in effect, to chase the rate of inflation down - which would put the recovery in jeopardy;

(ii) it might involve tacitly conceding a degree of primacy for £M3. The arguments for looking for lower monetary growth apply mainly to the broad aggregates. Last year the monetary ranges applied equally to both broad and narrow measures of money;

(iii) by drawing attention to the money figures, the change might be taken as a move away from the more flexible approach to policy developed over the past year.

Any change would, in logic, have to apply to 1983-84. It would be difficult to justify simply changing 1984-85, particularly as we have always argued that the ranges for the later years are purely illustrative, not targets.

14. Table 2 shows two possible sets of figures. Variant A repeats last year's guidelines for 1983-84 and 1984-85 and allows a further 1% deceleration in the range for 1985-86. Variant B shows ranges which are 1% points lower in each year. One way of reinforcing the credibility of variant A would be to stress that the ranges apply equally to both broad and narrow measures of money, and say that there are reasons for looking for a growth in £M3 towards the bottom of the range, just as there are reasons for expecting M1 to grow at or above the top, at least for a time. In describing variant B, we would need to say that we are expecting M1 to grow above the range. The choice between these variants would not necessarily amount to much in practice; a 1% difference is small in relation to the width of the range, and the precision with which we can control these aggregates. But the mere act of moving down the ranges could be presentationally significant.

Table 2: Alternative Monetary Ranges for 1983-84 to 1985-86

	1983-84	1984-85	1985-86
Variant A[1]	7-11	6-10	5-9
Variant B[2]	6-10	5-9	4-8

[1] Broad and narrow money

[2] Mainly broad (at least by implication)

The Exchange Rate

15. In principle, there could be a case for revising down the monetary ranges in response to the fall in the exchange rate. If the forecast is broadly right, however, it may not be very strong, particularly for the later years. In practice, last year's assumption of "no major fall" encompassed exchange rate levels not all that different from those shown in the latest forecasts:

Table 3 : Exchange Rate Forecasts

	1982 MTFS	Winter 1983
1982-83	87.4	88.1
1983-84	83.7	80.0
1984-85	81.8	79.7

16. We shall need to say something about the role of the exchange rate. Commentators will read significance into any departure from last year's formula, and that may be a good reason for adhering to it fairly closely (though in fewer words). Last year we said:

> "The behaviour of the exchange rate can help in the interpretation of monetary conditions, particularly when the different aggregates are known to be distorted. The exchange rate is a route through which changes in the money supply affect inflation. It can also be an important influence on financial conditions. External or domestic developments that change the relationship between the domestic money supply and the exchange rate may therefore disturb the link between money and prices, at least for a time. Such changes cannot be readily taken into account in setting monetary targets But they are a reason why the Government considers it appropriate to look at the exchange rate in monitoring conditions and in taking decisions about policy." Para 2.8.

17. The statement that the monetary ranges "have been constructed on the assumption that there are no major changes in the exchange rate from year to year" (para.2.16) is likely to be as true this year as last - though given recent experience commentators may find that difficult to accept. We have, however, admitted to the Select Committee that "no major change" can cover movements of **up to** 10%, and we can emphasise the difference between year to year changes and shorter term volatility.

The PSBR Assumption

18. The PSBR for 1983-84 has provisionally been set at £8 billion, equal to 2¾% of GDP, the ratio suggested in last year's MTFS and the Autumn Statement. Last year we showed a further decline to 2% in 1984-85. The forecast assumes that this ratio is held in 1985-86. Given the forecast for money GDP,this implies the following, rather uneven, path for the nominal PSBR:

Table 4: The PSBR Path: Winter 1983 forecast

	1981-82	1982-83	1983-84	1984-85	1985-86
PSBR £bn	8.7	7.9	8.0	6.5	7.1
as % GDP	3.4	2.9	2.7	2.0	2.0

19. The MTFS has always emphasised the importance of consistent fiscal and monetary policies; we have argued that a progressive deceleration in monetary growth requires a trend decline in the PSBR ratio, to avoid undue pressure on real interest rates. Despite considerable success on the fiscal front in the last couple of years, real interest rates **have not fallen,** and, in the forecasters judgment, are likely to remain near present levels over the next few years. If reducing real interest rates is a priority, there may be a case for looking for a sharper decline in the PSBR ratio over the MTFS period than the latest forecasts assume. This case would be all the stronger if we go for a faster deceleration in monetary growth, consistent with some further decline in inflation.

20. On the other hand, if we stick to 2% for 1984-85 (and, a fortiori if we take a lower figure) there may be no room for a positive fiscal adjustment next year, once account is taken of this year's fiscal changes (**assuming that this year's PSBR is set at 2¾%**). An increase in the PSBR ratio to **2½%** (equivalent to **about £8 billion**) would give us an extra £1½ billion to play with on the fiscal adjustment. It may be difficult to find convincing excuses for this change. But, given that it is small, and that most outside commentators now regard fiscal policy as excessively tight, there should be no great presentational problem. If we then chose a ratio of 2% in 1985-86 we would be showing a gradual decline in the PSBR both in nominal terms and relative to GDP over the whole MTFS period (though the **precise numbers for the** nominal PSBR will depend on the assumed path for money GDP, which could be significantly different from the present forecast).

21. Alternatively, we could reconcile a 2% PSBR ratio for 1984-85 with a small positive fiscal adjustment in that year, if we aimed a little lower in 1983-84, for example, by setting the PSBR ratio at 2½ per cent (about £7½ billion) rather than the 2¾ per cent (£8 bn) now in mind. This would have the effect of sharing the fiscal adjustment between the two years. We can also help to create more room for tax cuts in 1984-85 by avoiding measures in the 1983 Budget which have a sharply increasing effect on revenue over time (eg some of the company tax options fall into this category).

22. The long term objective for the PSBR has a bearing on the choice of figures for 1985-86. What this objective should be depends both on the underlying growth in the economy and the objective for inflation. Even if we are aiming for stable prices, it is not clear that we should be looking for a balanced budget in the long term. The PSBR ratio averaged around 2½-2¾ per cent during the 1950's and 1960's. A rather lower PSBR ratio would probably be consistent with the same average rate of inflation now, to allow for a lower ratio of debt to GDP and a slightly slower underlying rate of growth in real output. Rough calculations on the lines suggested in Mr Burns' paper suggest a longer term objective for the PSBR ratio of between 1½-2 per cent - and less than this if we want to improve on the 50's/60's inflation performance.

23. Table 5 suggests two possible paths for the PSBR, both consistent with a fairly smooth decline relative to GDP (and no actual rise in the nominal PSBR). The figures for the later years are purely illustrative; we can and have revised them significantly when we come to take decisions about fiscal policy. But they play an important part in shaping expectations. While the lower path would no doubt be attacked by some as excessively deflationary, it is little more than a straight line extrapolation of last year's MTFS. We could not justify an expectation of lower inflation over the next few years by pointing to a tighter fiscal policy. But the lower figures might look more consistent with lower monetary figures, and continued optimism about the prospects for reducing real interest rates.

Table 5: Alternative PSBR Paths

	1983-84	1984-85	1985-86
Variant A:			
£ bn	8	8	7
as % GDP	2¼	2½	2
Variant B:			
£ bn	7½	6½	5
as % GDP	2½	2	1½

The Economic Assumptions

24. Last year we published assumptions (shown in table 1) for:

(1) the general rate of inflation (GDP market price deflator) in each year;

(2) the average rate of growth of output over 1983-84 and 1984-85;

(3) Money GDP, in each year.

The text also described, in vague terms, the oil price assumption underlying the projection of North Sea oil tax revenues. We normally face close questioning from the Select Committee on such things as unemployment, productive potential and the pattern of growth (though we avoid giving figures, especially for unemployment).

25. We shall have to provide at least as much information this year. The published FSBR forecasts will include the first half of 1984, updating and extending those already shown in the Autumn Statement. Taking this as our starting point, we shall need to revise the assumptions for 1984-85, and choose numbers for 1985-86. (The question of what to say about oil prices will need careful consideration nearer the time).

26. In choosing assumptions in the past we have always been rather more optimistic than internal forecasts while aiming to produce a defensible, realistic and internally consistent picture. This has sometimes, in some respects, produced better medium-term forecasts. On output, the only assumption we have volunteered from the outset, we have been somewhat too optimistic in the MTFS, while the internal forecasts have been somewhat too pessimistic. On inflation (and on money GDP) the MTFS projections of 1980 and 1981 were more accurate than internal forecasts (though this would not of course be apparent to an outsider). In some other areas - such as unemployment - the MTFS has been rather less accurate than the internal forecasts.

27. As well as the internal forecasts, we have usually given some weight to:

(1) what outside forecasters are saying;

(2) economic assumptions published by the Government in other contexts, eg public expenditure;

(3) the need to present a picture broadly consistent with the Government's general medium term objectives, and, in particular, the monetary guidelines.

The Internal Forecast

28. Table 6 compares the latest internal pre-Budget forecast with the figures for GDP and inflation underlying the 1982 MTFS:

Table 6 : Treasury Forecasts

	1982-83	1983-84	1984-85	1985-86
Output				
1982 MTFS	1.7	2.6	2.6	n.a.
1983 Pre-Budget	0.8	2.8	2.2	1.7
Inflation (GDP deflator)				
1982 MTFS	7.8	6.9 (7)*	6.7 (6½)*	n.a.
1983 Pre-Budget	7.1	5.6	6.9	7.1
Money GDP (at market prices)				
1982 MTFS £ bn	280	307	336	n.a.
% change	9.8	9.6	9.4	n.a.
1983 Pre-Budget £bn	274	298	326	355
% change	7.9	8.7	9.3	8.9

* figures in brackets show rounding used for publication

29. In the terms used in the MTFS these forecasts suggest:

(i) an average rate of growth of real GDP in the last two years of 2%;

(ii) an inflation rate of 7% in both 1984-85 and 1985-86 (1½% points above the forecast for 1983-84, though this may be revised before publication in the FSBR);

(iii) growth in money GDP close to 9% in each of the last two years (growth in 1984-85 similar to that shown last year, though the level is 3% lower).

All these figures are subject to revision between now and March, to take account of new information and Budget decisions. If the PSBR is held to the £8 bn assumed in the forecast, however, these revisions may be relatively minor. This general profile of inflation and output has been a feature of all recent forecasts.

Outside Forecasts

30. Table 7 summarises six of the outside forecasts completed within the last three months. Only Phillips and Drew take account of last month's fall in the exchange rate, and all assume a significantly higher rate than the latest internal forecasts. The interpretation of unchanged policies varies - the National Institute allow no fiscal adjustment, while the EIU assume a significant relaxation in fiscal and monetary policies relative to the MTFS.

Table 7: Outside Forecasts

Calendar years % change	LBS	EIU	P&D	CE	NI	BANK	Average	HMT
Output								
1983	2.0	2.0	1.8	1.8	1.0	1.4	1.7	2.1
1984	2.0	3.4	2.9*	1.9	1.0	0.8	2.0	2.4
1985	1.7	2.2	n.a.	2.0	1.5	1.2	1.7	1.9
Inflation (consumer expenditure deflator)								
1983	6.7	6.3	6.7	6.3	5.1	7.3	6.4	6.8
1984	9.2	6.3	7.0*	8.0	5.6	7.4	7.2	7.2
1985	9.3	8.3	n.a.	9.4	[5.2ø]	7.4	7.9	7.4

* 1st half only

ø RPI

31. On output, the Treasury forecast is above the average of outside forecasts, and only the EIU is as buoyant overall - no doubt partly a reflection of the lower exchange rate we are assuming. On inflation, almost all the forecasters are expecting somefurther deceleration in inflation in 1983, followed by a modest upturn in 1984 and 1985. (The National Institute - with a very tight fiscal policy, and the exchange rate constant at 92 - is a possible exception, though fully comparable figures are not available for 1985). The Treasury inflation forecast - despite a lower exchange rate - is close to the average of the outside forecasts, and more optimistic than most for 1985.

Public Expenditure

32. In contrast to last year, when there were published cash factors, the Public Expenditure Survey is not based on explicit assumptions about inflation. The published MTFS assumptions about the GDP deflator will, however, enable commentators to convert the cash figures in the White Paper into cost terms and to draw conclusions about the growth of public expenditure in "real" terms. In choosing inflation assumptions therefore we have to keep an eye on what they imply for the real growth in public expenditure. The lower the inflation assumption, the higher the implied figures for public expenditure in cost terms, and vice versa.

33. The new public expenditure White Paper contains cost terms figures for 1983-84, using the forecast for the GDP price deflator published in the Autumn Statement (5%). This implies a real growth in public expenditure between 1982-83 and 1983-84 of ¼%. We will probably volunteer a new cost terms table, covering the later years of the survey, after the Budget. That would also reflect any revisions to our inflation forecast for 1983-84.

34. Table 8 compares the implied movement in public expenditure in cost terms using the White Paper cash totals and the latest internal forecasts for the GDP price deflator with the cost terms figures as they appeared last year. The new White Paper cost figures for 1983-84 are also shown.

Table 8: Public Expenditure

	1982-83	1983-84	1984-85	1985-86
1982 White Paper/MTFS				
Cash totals £bn	114.7	120.7	127.6	n.a.
(% change)		(5.2)	(5.7)	
GDP price deflator 1981-82=100	107.8	115.3	123.0	n.a.
(% change)	(7.8)	(6.9)	(6.7)	
"Cost terms" £bn*	106.4	104.7	103.8	n.a.
(% change)	(1.3)	(-2.5)	(-0.8)	
1983/PEWP and 1983 forecast inflation				
Cash totals £bn	113	119.6	126.4	132.3
(% change)	(7.7)	(5.8)	(5.7)	(4.7)
GDP price deflator 1981-82=100	107.1	113.1	120.9	129.5
(% change)	(7.1)	(5.6)	(6.9)	(7.1)
"Cost terms" £bn*	105.5	105.7	104.5	102.2
(% change)	(0.8)	(0.2)	(-1.1)	(-2.2)
1983 PEWP (and A.S. inflation forecast)				
GDP price deflator	107.5	112.8		
(% change)	7½	5	n.a.	n.a.
Cost terms £bn	105.1	105.9	n.a.	n.a.
(% change)	(0.4)	(0.8)		

* i.e. cash totals adjusted for movements in GDP price deflator since 1981-82.

35. Since the White Paper figures do not embody a specifically quantified view of future inflation, it is difficult to say whether they are compatible with any particular profile of inflation that might underlie the expenditure totals in the MTFS. But the published inflation assumptions will affect the implied real content of the published cash totals and the implied ratio of public expenditure to GDP. An inflation assumption that was well below the levels in the forecast would make the present cash plans look more generous in terms of volume, and this could prompt the sort of criticism of lax control recently expressed by the

Select Committee. Similarly, because the lower inflation assumption would reduce the level of nominal GDP in future years, the published cash plans would represent a higher ratio of GDP than is implied in the forecast. These presentational problems could become problems of substance if an unrealistically low inflation assumption led departments to make their own dispositions on that assumption: the real content if their plans would be higher than could be sustained within the cash totals if inflation fell only as forecast and this would make the cash totals harder to hold in those later years. While these problems should be manageable provided the inflation assumptions are not too far below those in the latest forecast they clearly would become greater as the assumptions depart further from the forecast.

36. The MTFS inflation assumptions will directly influence the base line for 1986-87 in the new Survey. On past form, the baseline might be constructed by assuming some further deceleration in the general rate of inflation and possibly allowing for some additional squeeze in volumes. The figures currently in mind are 3 or 3½%. Either might look unduly severe if we adopted an inflation assumption of say 5 or 5½% for 1985-86; but would look reasonably consistent with 4 or 4½%.

37. There is no obvious tension between the PES assumptions about unemployment (which will be published in the White Paper) and the latest forecasts. Both show unemployment, on the new definition (GB, narrow) flat at around 3m. This is broadly consistent with the 2% average growth in output in the forecast over the last two years, and what we have previously said about productive potential (an underlying growth of around 2-2½% over the next few years).

Alternative Assumptions

38. There is some room for departing from the internal forecasts on both inflation and output; but, in the light of the outside forecasts, it might be difficult to defend both a signficantly more buoyant path for output and a much lower path for inflation. Very low inflation figures could have unwelcome implications for the real growth - and possibly the control - of public expenditure over the next few years,

and point to an unrealistically low baseline for 1986-87 in the new Survey. A low path for inflation may also look inconsistent with last year's monetary guidelines, at least insofar as they relate to broad money.

39. Table 9 compares the forecast with two alternative assumptions about inflation. Both alternatives are coupled with 2½% growth in real output - (slightly above the forecast).

Variant A shows a fairly flat path for inflation. The 1983-84 inflation rate is rounded up to 6%, and there is some token deceleration thereafter. Given the margins of error, this is a defensible, if rather favourable, interpretation of the current internal forecast. On this assumption about inflation, the cash totals in the White Paper would imply no growth in public expenditure in cost terms.

Variant B illustrates a more ambitious path for inflation. This would have obvious political advantages, but it would look distinctly optimistic in relation to 2½% growth and the outside forecasts. We can, in principle, reconcile low inflation and high output in a number of ways, for example by assuming a very slow growth in costs, reflecting some combination of low earnings or high productivity growth, but outsiders are unlikely to find the picture very convincing. This inflation assumption could cause practical and presentational problems on public expenditure; it implies continuing growth in cost terms, given the White Paper cash totals, and could point to an unrealistically low base line for 1985-86 in the new Survey.

Table 9: Alternative Economic Assumptions

	Internal Forecast	Alternative Assumptions A	Alternative Assumptions B
Inflation (GDP deflator)			
1983-84	5.6	6	5½
1984-85	6.9	5½	5
1985-86	7.1	5	4
Real output			
1983-84	2¾	2¾	2¾
1984-85 / 1985-86 average	2	2½	2½
Money GDP			
1983-84	8¾	9	8½
1984-85 / 1985-86 average	9	8	7
Public expenditure in 1981-82			
Cost terms £ bn (% change)			
1983-84	105.7 (0.2)	105.4(-)	105.8 (0.3)
1984-85	104.5(-1.1)	105.5(-)	106.6 (0.8)
1985-86	102.2(-2.2)	105.2(-0.3)	107.3 (0.7)

40. The choice of economic assumptions interacts with the decisions that are needed on the monetary guidelines and the PSBR path:

(i) retaining the same monetary ranges as in last year's MTFS (and allowing a further 1% reduction in 1985-86) would imply some shift in velocity, and a faster growth in real balances relative to last year, even on the higher of the two inflation assumptions (variant A). The combination of a still lower growth in money GDP with last year's guidelines would imply a continuing fall in velocity over the time period of the MTFS. It might be difficult to convince people that this was consistent with the assumed reduction in inflation, or with a continuation of the fall beyond the end of the MTFS period;

(ii) lower monetary ranges would help to get round some of the problems involved in choosing the lower inflation assumption (variant B). A change would be presented as being consistent with better inflation prospects than were envisaged last year. It might, however, be interpreted as a deliberate tightening in stance and, on this view, the assumption of 2½% real growth would look less credible. Since the lower ranges would be more relevant to broad money, they would also imply a degree of primacy for £M3;

(iii) the choice between the two PSBR variants is fairly fine. But the lower path (falling to 1½% in 1985-86) would look more consistent with a clearer signal on inflation, and lower monetary ranges.

41. We see no particular problems with the higher inflation assumption (variant A). It can be defended as a reasonable interpretation of what the present policy might deliver. It would be more difficult to present variant B in this light. Even if changes to the financial framework helped to make a better inflation outlook more credible, there could be awkward questions about the prospects for recovery.

MP1 Division
2 February 1983

CONFIDENTIAL

FROM: T BURNS
DATE: 3 FEBRUARY 1983

CHANCELLOR

cc. Chief Secretary
Financial Secretary
Economic Secretary
Minister of State (R)
Minister of State (C)
PCC
Mr Cassell
Mrs Lomax
Mr Odling-Smee
Mr Monck
Mr Evans
Mr Sedgwick
Mr Shields
Mr Riley
Mr Ridley
Mr French
Mr Harris

THE MEDIUM TERM FINANCIAL STRATEGY

1. I attach a paper by MP reviewing the main issues involved in updating the MTFS.

2. The first question is whether the Government will want to re-affirm its commitment to reducing inflation, given the low level from which we start and the generally flat or slightly rising profile for inflation shown in the latest internal forecast. We assume that the answer to this is yes; and that the text and figures in the MTFS will need to be broadly consistent with this aim. We also assume that you will want, as last year, to show a growth in output at least in line with productive potential.

3. Given this objective we need to have decisions on the choice of monetary guidelines, PSBR ratios and the illustrative assumptions for inflation and output. Work on the MTFS projections can then get under way.

Monetary Guidelines

4. On monetary guidelines my inclination is to go for the higher of the two runs of figures shown in the paper (table 2). These are the same as published in the last MTFS with the extra year added showing a further one point deceleration. I am eager to avoid being seen to accommodate monetary policy to a lower inflation rate. The maintenance of a given nominal framework as inflation falls is the most persuasive argument for why recovery will emerge. The higher range also enables us to say that we are expecting M1 to grow at or above the top of the range while £M3 is expected to be in the lower part of the range.

PSBR

5. I would prefer to stay with variant A for the PSBR path (table 5 of the paper). This shows a PSBR of 2¾% of GDP for 1983-84 falling to 2% of GDP by 1985-86. In the Chevening paper I argued in favour of publishing a PSBR of £8 billion for 1983-84; a downward revision would not be easy to justify given that output is now a little lower than expected at the time of the last Budget. Such a profile will also give an extra bit of flexibility for 1984-85 and 1985-86.

6. If you choose £7½ billion for the 1983-84 PSBR then we have little option other than to choose variant B for the later years.

Economic Assumptions

7. For the economic assumptions I see little difficulty in projecting a growth rate of 2½% per annum.

8. The profile for inflation is more difficult. Undoubtedly there is a very large margin of error surrounding the assumption for 1985-86, but it is unwise to push optimism too far, given:

i. the most recent forecast

ii. the extent to which the recent inflation decline has a number of temporary factors associated with it

iii. the prospects for world prices as world output recovers

iv. the various external forecasts.

I am inclined to opt for the alternative assumption A in table 9. It does not show much further progress on inflation but it does show a continuation of low inflation whilst pointing in the right direction.

9. In broad terms there will be two conflicting influences on inflation over the next two-three years both in the UK and the world as a whole:

i. a low level of output; continuing excess capacity, will exercise downward pressure on inflation

ii. an improved growth of output; putting some upward pressure on inflation if the very low real level of commodity prices recovers (and maybe also profit margins).

It is difficult to judge the balance of these factors. Most commentators are putting a lot of weight on (ii). This may be pessimistic but there are risks of credibility in departing too far from the consensus.

Other Aspects

10. Whichever option is chosen, we need to look again at what is said (or implied) about:

i. the exchange rate

ii. M1 and, more generally, the status of the different aggregates.

Ministers have already seen a paper by M1 by Mr Monck, and that discussion is not repeated in this paper. Discussions about the monetary ranges could have implications for the status of the different aggregates. On the exchange rate, we suggest sticking as closely as possible to the formula used last year.

Next Steps

11. We hope to discuss this paper with you next week and in the mean-time hold separate discussions with the Bank and Alan Walters.

~~T~~ BURNS

MEDIUM TERM FINANCIAL STRATEGY

1. This note raises the main issues involved in presenting the MTFS and extending the monetary guidelines and fiscal projections to 1985-86. They relate to:

(1) what is said about the broad objectives of policy;

(2) the financial framework: the monetary targets for 1983-84 and the guidelines for the later years; what is said about other financial indicators, including the exchange rate; and the PSBR assumption for the later years;

(3) the assumptions needed to construct the economic projections underlying the revenue and expenditure tables.

The monetary guidelines will need to be discussed in more detail with the Bank. But it is useful to take a preliminary look at all the main issues at the same time, to ensure broad consistency between different elements of the MTFS. The final section of the paper outlines two main options.

Objectives

2. The MTFS has always opened with a general statement of the Government's medium term objectives. In 1980-81 and 1981-82 this read:

"The Government's objectives for the medium term are to bring down the rate of inflation and to create conditions for a sustainable growth of output and employment."

Last year was a bit more explicit (as some commentators noted):

"The Government's objective is to continue reducing the rate of inflation, thereby promoting a sustainable growth of output and employment."

going on to add:

"The Government's policies are directed at achieving a rate of inflation that is well into single figures."

This objective has never been qualified though we have increasingly acknowledged that the financial policies needed to achieve it are, to some extent, contingent on world events and UK productivity performance. Nor has it been quantified, though last year we published illustrative assumptions about the inflation rate, as background to the fiscal projections.

3. The rise in the GDP deflator in 1981-82 was over 11%; in 1982-83 it is likely to be around 7% (slightly lower than the 7½% forecast this time last year). We think that present policies are unlikely to be consistent with a further significant or lasting reduction in the inflation rate, at least over the period covered by the MTFS; our best guess (inevitably uncertain) is that it will be broadly flat, possibly showing some tendency to rise as the economy recovers.

4. The Chevening discussions implied that Ministers are ultimately aiming for a further reduction in the inflation rate (a view reflected in some recent Ministerial speeches), but felt that a fuller discussion of the medium term strategy needed to achieve this should wait until after the election. This could create problems. Given the low level from which we start, a clear statement that the Government is aiming for a further reduction in inflation may look (and be) inconsistent with monetary guidelines and other assumptions similar to those we used last year.

5. It is, of course, helpful to emphasise the progress that has already been made. But we assume that Ministers will want to reaffirm the commitment to reducing inflation and to support this by signalling some further movement in this direction over the period of the MTFS. If this is correct, the opening sentences might be redrafted on the following lines:

"Government policies have achieved a rate of inflation that is well into single figures. The objective for the medium term is to continue reducing inflation, and to promote a sustainable growth in output and employment."

The rest of this paper considers how we could make the text and figures in the MTFS consistent with a modest further fall in the inflation rate over the next three years.

The 1982 MTFS

6. The monetary ranges for broad and narrow money, the PSBR assumptions, and the illustrative figures for inflation and real and money GDP shown in last year's MTFS are summarised in Table 1; the estimated outturn for 1982-83 is in brackets.

TABLE 1. Guidelines and Economic Assumptions 1982 FSBR

% change on a year earlier	1982-83		1983-84	1984-85
Money	8-12		7-11	6-10
M1		(12½)		
£M3		(11¼)		
PSL2		(9¼)		
PSBR £bn	9½	(7.9)	8½	6½
as % GDP	3½	(2.9)	2¾	2
Prices (GDP deflator)	7½	(7)	7	6½
Real GDP	1¾	(¾)	← 2½ →	
Money GDP	9.8	(8)	9.6	9.4

7. With monetary growth at the centre of the range, these figures implied little change in velocity over the period, and a significant growth in real money balances, consistent with the expected recovery in output. The FSBR also said that the ranges had been constructed on the assumption of "no major changes in the exchange rate from year to year". The exchange rate is now over 10% lower than it was in the first quarter of 1982. However, the outturn for 1982-83 may not be too different from that envisaged in last year's MTFS (though the time path has, not surprisingly, been more uneven) : an estimated outturn for the effective rate of 88, compared with a forecast of 87½.

Monetary Guidelines

8. Money GDP may have grown by 1½-2 per cent less than we expected last year. But this has not been reflected in the monetary figures. With the growth in both M1 and £M3 probably at the top of the target range, there has been a fall in velocity on both measures of money. Relative to consumer prices, at least, the growth in real money balances has also been stronger than we expected last year.

9. If we want to show a declining path for inflation, and we stick to the same monetary ranges as suggested last year, we shall need to explain the significance of these developments and explain why unchanged money figures are now thought to be consistent with a lower rate of inflation in the medium term. Some commentators will argue that the failure to reduce monetary growth in the face of unexpectedly low inflation and output has had the effect of automatically easing monetary pressures. In time this will lead to a faster growth in output and a rebound in inflation. Without a change in monetary growth in nominal terms, there is no reason to look for a lower rate of inflation in the medium term. The more we imply that we are looking for a better outcome on inflation, consistent with the same recovery in real output, the more difficult it will be to rebut these arguments.

10. One approach is to argue that we have changed out view about the impact of structural changes on velocity, and now think that last year's monetary ranges may be consistent with a better medium term outcome on inflation. We have good reason for expecting a fall in M1 velocity as interest rates and inflation come down. This was foreshadowed in last year's MTFS and underlined in the Autumn Statement. We admitted that the scale and timing of this shift was uncertain. Mr Monck's paper on "Monetary Targets in 1983-84 : M1" discusses various ways in which we might seek to get this message across - either by repeating last year's form of words, adding to them, or adopting a (more or less formal) separate range for narrow money.

11. It may be more difficult to sustain the argument that the velocity of £M3 is likely to remain lower than we were expecting last year, and could even fall further without lasting damage to inflation. As

Mr Burns' paper for Chevening noted, some of our explanations for the fall in £M3 velocity in recent years imply some move in the opposite direction in the future, for example as real interest rates fall. The timing and scale are, of course, very difficult to judge. But there are problems in pleading too much ignorance. The more often we point to unpredictable structural shifts in velocity, the more we risk discrediting the whole MTFS approach with its emphasis on a stable financial framework centred on monetary targets.

12. It is worth considering the case for moving down the monetary ranges, at least as they apply to broad money. This would be a way of reinforcing expectations of a lasting move to lower inflation. We do not need to imply that we think there is a very close relationship between monetary growth over the next few years and the rate of inflation over the same period. But if we take the view that inflation is likely to stabilise, or even fall further - in reponse to past policy, or world events - the stance of policy may look excessively easy if we do stick to last year's guidelines - with possible implications for the rate of inflation in the longer term.

13. There are, however, a number of arguments against such a move, at this time :-

(i) it might be interpreted as a deliberate attempt to tighten policy - in effect, to chase the rate of inflation down - which would put the recovery in jeopardy;

(ii) it might involve tacitly conceding a degree of primacy for £M3. The arguments for looking for lower monetary growth apply mainly to the broad aggregates. Last year the monetary ranges applied equally to both broad and narrow measures of money;

(iii) by drawing attention to the money figures, the change might be taken as a move away from the more flexible approach to policy developed over the past year.

Any change would, in logic, have to apply to 1983-84. It would be difficult to justify simply changing 1984-85, particularly as we have always argued that the ranges for the later years are purely illustrative, not targets.

14. Table 2 shows two possible sets of figures. Variant A repeats last year's guidelines for 1983-84 and 1984-85 and allows a further 1% deceleration in the range for 1985-86. Variant B shows ranges which are 1% points lower in each year. One way of reinforcing the credibility of variant A would be to stress that the ranges apply equally to both broad and narrow measures of money, and say that there are reasons for looking for a growth in £M3 towards the bottom of the range, just as there are reasons for expecting M1 to grow at or above the top, at least for a time. In describing variant B, we would need to say that we are expecting M1 to grow above the range. The choice between these variants would not necessarily amount to much in practice; a 1% difference is small in relation to the width of the range, and the precision with which we can control these aggregates. But the mere act of moving down the ranges could be presentationally significant.

Table 2: Alternative Monetary Ranges for 1983-84 to 1985-86

	1983-84	1984-85	1985-86
Variant A[1]	7-11	6-10	5-9
Variant B[2]	6-10	5-9	4-8

[1] Broad and narrow money

[2] Mainly broad (at least by implication)

The Exchange Rate

15. In principle, there could be a case for revising down the monetary ranges in response to the fall in the exchange rate. If the forecast is broadly right, however, it may not be very strong, particularly for the later years. In practice, last year's assumption of "no major fall" encompassed exchange rate levels not all that different from those shown in the latest forecasts:

Table 3 : Exchange Rate Forecasts

	1982 MTFS	Winter 1983
1982-83	87.4	88.1
1983-84	83.7	80.0
1984-85	81.8	79.7

16. We shall need to say something about the role of the exchange rate. Commentators will read significance into any departure from last year's formula, and **that** may be a good reason for adhering to it fairly closely (though in fewer words). Last year we said:

> "The behaviour of the exchange rate can help in the interpretation of monetary conditions, particularly when the different aggregates are known to be distorted. The exchange rate is a route through which changes in the money supply affect inflation. It can also be an important influence on financial conditions. External or domestic developments that change the relationship between the domestic money supply and the exchange rate may therefore disturb the link between money and prices, at least for a time. Such changes cannot be readily taken into account in setting monetary targets But they are a reason why the Government considers it appropriate to look at the exchange rate in monitoring conditions and in taking decisions about policy." Para 2.8.

17. The statement that the monetary ranges "have been constructed on the assumption that there are no major changes in the exchange rate from year to year" (para.2.16) is likely to be as true this year as last - though given recent experience commentators may find that difficult to accept. We have, however, admitted to the Select Committee that "no major change" can cover movements of **up to** 10%, and we can emphasise the difference between year to year changes and shorter term volatility.

The PSBR Assumption

18. The PSBR for 1983-84 has provisionally been set at £8 billion, equal to 2¾% of GDP, the ratio suggested in last year's MTFS and the Autumn Statement. Last year we showed a further decline to 2% in 1984-85. The forecast assumes that this ratio is held in 1985-86. Given the forecast for money GDP,this implies the following, rather uneven, path for the nominal PSBR:

Table 4: The PSBR Path: Winter 1983 forecast

	1981-82	1982-83	1983-84	1984-85	1985-86
PSBR £bn	8.7	7.9	8.0	6.5	7.1
as % GDP	3.4	2.9	2.7	2.0	2.0

19. The MTFS has always emphasised the importance of consistent fiscal and monetary policies; we have argued that a progressive deceleration in monetary growth requires a trend decline in the PSBR ratio, to avoid undue pressure on real interest rates. Despite considerable success on the fiscal front in the last couple of years, real interest rates **have not fallen,** and, in the forecasters judgment, are likely to remain near present levels over the next few years. If reducing real interest rates is a priority, there may be a case for looking for a sharper decline in the PSBR ratio over the MTFS period than the latest forecasts assume. This case would be all the stronger if we go for a faster deceleration in monetary growth, consistent with some further decline in inflation.

20. On the other hand, if we stick to 2% for 1984-85 (and, a fortiori if we take a lower figure) there may be no room for a positive fiscal adjustment next year, once account is taken of this year's fiscal changes (**assuming that this year's PSBR is set at 2¾%).**
An increase in the PSBR ratio to **2½%** (equivalent to **about £8 billion)** would give us an extra £1½ billion to play with on the fiscal adjustment. It may be difficult to find convincing excuses for this change. But, given that it is small, and that most outside commentators now regard fiscal policy as excessively tight, there should be no great presentational problem. If we then chose a ratio of 2% in 1985-86 we would be showing a gradual decline in the PSBR both in nominal terms and relative to GDP over the whole MTFS period (though the **precise numbers for the** nominal PSBR will depend on the assumed path for money GDP, which could be significantly different from the present forecast).

21. Alternatively, we could reconcile a 2% PSBR ratio for 1984-85 with a small positive fiscal adjustment in that year, if we aimed a little lower in 1983-84, for example, by setting the PSBR ratio at 2½ per cent (about £7½ billion) rather than the 2¾ per cent (£8 bn) now in mind. This would have the effect of sharing the fiscal adjustment between the two years. We can also help to create more room for tax cuts in 1984-85 by avoiding measures in the 1983 Budget which have a sharply increasing effect on revenue over time (eg some of the company tax options fall into this category).

22. The long term objective for the PSBR has a bearing on the choice of figures for 1985-86. What this objective should be depends both on the underlying growth in the economy and the objective for inflation. Even if we are aiming for stable prices, it is not clear that we should be looking for a balanced budget in the long term. The PSBR ratio averaged around 2½-2¾ per cent during the 1950's and 1960's. A rather lower PSBR ratio would probably be consistent with the same average rate of inflation now, to allow for a lower ratio of debt to GDP and a slightly slower underlying rate of growth in real output. Rough calculations on the lines suggested in Mr Burns' paper suggest a longer term objective for the PSBR ratio of between 1½-2 per cent - and less than this if we want to improve on the 50's/60's inflation performance.

23. Table 5 suggests two possible paths for the PSBR, both consistent with a fairly smooth decline relative to GDP (and no actual rise in the nominal PSBR). The figures for the later years are purely illustrative; we can and have revised them significantly when we come to take decisions about fiscal policy. But they play an important part in shaping expectations. While the lower path would no doubt be attacked by some as excessively deflationary, it is little more than a straight line extrapolation of last year's MTFS. We could not justify an expectation of lower inflation over the next few years by pointing to a tighter fiscal policy. But the lower figures might look more consistent with lower monetary figures, and continued optimism about the prospects for reducing real interest rates.

Table 5: Alternative PSBR Paths

	1983-84	1984-85	1985-86
Variant A:			
£ bn	8	8	7
as % GDP	$2\frac{3}{4}$	$2\frac{1}{2}$	2
Variant B:			
£ bn	$7\frac{1}{2}$	$6\frac{1}{2}$	5
as % GDP	$2\frac{1}{2}$	2	$1\frac{1}{2}$

The Economic Assumptions

24. Last year we published assumptions (shown in table 1) for:

(1) the general rate of inflation (GDP market price deflator) in each year;

(2) the average rate of growth of output over 1983-84 and 1984-85;

(3) Money GDP, in each year.

The text also described, in vague terms, the oil price assumption underlying the projection of North Sea oil tax revenues. We normally face close questioning from the Select Committee on such things as unemployment, productive potential and the pattern of growth (though we avoid giving figures, especially for unemployment).

25. We shall have to provide at least as much information this year. The published FSBR forecasts will include the first half of 1984, updating and extending those already shown in the Autumn Statement. Taking this as our starting point, we shall need to revise the assumptions for 1984-85, and choose numbers for 1985-86. (The question of what to say about oil prices will need careful consideration nearer the time).

26. In choosing assumptions in the past we have always been rather more optimistic than internal forecasts while aiming to produce a defensible, realistic and internally consistent picture. This has sometimes, in some respects, produced better medium-term forecasts. On output, the only assumption we have volunteered from the outset, we have been somewhat too optimistic in the MTFS, while the internal forecasts have been somewhat too pessimistic. On inflation (and on money GDP) the MTFS projections of 1980 and 1981 were more accurate than internal forecasts (though this would not of course be apparent to an outsider). In some other areas - such as unemployment - the MTFS has been rather less accurate than the internal forecasts.

27. As well as the internal forecasts, we have usually given some weight to:

(1) what outside forecasters are saying;

(2) economic assumptions published by the Government in other contexts, eg public expenditure;

(3) the need to present a picture broadly consistent with the Government's general medium term objectives, and, in particular, the monetary guidelines.

The Internal Forecast

28. Table 6 compares the latest internal pre-Budget forecast with the figures for GDP and inflation underlying the 1982 MTFS:

Table 6 : Treasury Forecasts

	1982-83	1983-84	1984-85	1985-86
Output				
1982 MTFS	1.7	2.6	2.6	n.a.
1983 Pre-Budget	0.8	2.8	2.2	1.7
Inflation (GDP deflator)				
1982 MTFS	7.8	6.9 (7)*	6.7 (6½)*	n.a.
1983 Pre-Budget	7.1	5.6	6.9	7.1
Money GDP (at market prices)				
1982 MTFS £ bn	280	307	336	n.a.
% change	9.8	9.6	9.4	n.a.
1983 Pre-Budget £bn	274	298	326	355
% change	7.9	8.7	9.3	8.9

* figures in brackets show rounding used for publication

29. In the terms used in the MTFS these forecasts suggest:

(i) an average rate of growth of real GDP in the last two years of 2%;

(ii) an inflation rate of 7% in both 1984-85 and 1985-86 (1½% points above the forecast for 1983-84, though this may be revised before publication in the FSBR);

(iii) growth in money GDP close to 9% in each of the last two years (growth in 1984-85 similar to that shown last year, though the level is 3% lower).

All these figures are subject to revision between now and March, to take account of new information and Budget decisions. If the PSBR is held to the £8 bn assumed in the forecast, however, these revisions may be relatively minor. This general profile of inflation and output has been a feature of all recent forecasts.

Outside Forecasts

30. Table 7 summarises six of the outside forecasts completed within the last three months. Only Phillips and Drew take account of last month's fall in the exchange rate, and all assume a significantly higher rate than the latest internal forecasts. The interpretation of unchanged policies varies - the National Institute allow no fiscal adjustment, while the EIU assume a significant relaxation in fiscal and monetary policies relative to the MTFS.

Table 7: Outside Forecasts

Calendar years % change	LBS	EIU	P&D	CE	NI	BANK	Average	HMT
Output								
1983	2.0	2.0	1.8	1.8	1.0	1.4	1.7	2.1
1984	2.0	3.4	2.9*	1.9	1.0	0.8	2.0	2.4
1985	1.7	2.2	n.a.	2.0	1.5	1.2	1.7	1.9
Inflation (consumer expenditure deflator)								
1983	6.7	6.3	6.7	6.3	5.1	7.3	6.4	6.8
1984	9.2	6.3	7.0*	8.0	5.6	7.4	7.2	7.2
1985	9.3	8.3	n.a.	9.4	[5.2ø]	7.4	7.9	7.4

* 1st half only

ø RPI

31. On <u>output</u>, the Treasury forecast is above the average of outside forecasts, and only the EIU is as buoyant overall - no doubt partly a reflection of the lower exchange rate we are assuming. On <u>inflation</u>, almost all the forecasters are expecting somefurther deceleration in inflation in 1983, followed by a modest upturn in 1984 and 1985. (The National Institute - with a very tight fiscal policy, and the exchange rate constant at 92 - is a possible exception, though fully comparable figures are not available for 1985). The Treasury inflation forecast - despite a lower exchange rate - is close to the average of the outside forecasts, and more optimistic than most **for** 1985.

Public Expenditure

32. In contrast to last year, when there were published cash factors, the Public Expenditure Survey is not based on explicit assumptions about inflation. The published MTFS assumptions about the GDP deflator will, however, enable commentators to convert the cash figures in the White Paper into cost terms and to draw conclusions about the growth of public expenditure in "real" terms. In choosing inflation assumptions therefore we have to keep an eye on what they imply for the real growth in public expenditure. **The lower the inflation assumption, the higher the implied figures for public expenditure in cost terms, and vice versa.**

33. The new public expenditure White Paper contains cost terms figures for 1983-84, using the forecast for the GDP price deflator published in the Autumn Statement (5%). This implies a real <u>growth</u> in public expenditure between 1982-83 and 1983-84 of ¾%. We will probably volunteer a new cost terms table, covering the later years of the survey, after the Budget. That would also reflect any revisions to our inflation forecast for 1983-84.

34. Table 8 compares the implied movement in public expenditure in cost terms using the White Paper cash totals and the latest <u>internal</u> forecasts for the GDP price deflator with the cost terms figures as they appeared last year. The new White Paper cost figures for 1983-84 are also shown.

Table 8: Public Expenditure

	1982-83	1983-84	1984-85	1985-86
1982 White Paper/MTFS				
Cash totals £bn	114.7	120.7	127.6	n.a.
(% change)		(5.2)	(5.7)	
GDP price deflator 1981-82=100	107.8	115.3	123.0	n.a.
(% change)	(7.8)	(6.9)	(6.7)	
"Cost terms" £bn*	106.4	104.7	103.8	n.a.
(% change)	(1.3)	(-2.5)	(-0.8)	
1983/PEWP and 1983 forecast inflation				
Cash totals £bn	113	119.6	126.4	132.3
(% change)	(7.7)	(5.8)	(5.7)	(4.7)
GDP price deflator 1981-82=100	107.1	113.1	120.9	129.5
(% change)	(7.1)	(5.6)	(6.9)	(7.1)
"Cost terms" £bn*	105.5	105.7	104.5	102.2
(% change)	(0.8)	(0.2)	(-1.1)	(-2.2)
1983 PEWP (and A.S. inflation forecast)				
GDP price deflator	107.5	112.8		
(% change)	7½	5	n.a.	n.a.
Cost terms £bn	105.1	105.9	n.a.	n.a.
(% change)	(0.4)	(0.8)		

* i.e. cash totals adjusted for movements in GDP price deflator since 1981-82.

35. Since the White Paper figures do not embody a specifically quantified view of future inflation, it is difficult to say whether they are compatible with any particular profile of inflation that might underlie the expenditure totals in the MTFS. But the published inflation assumptions will affect the implied real content of the published cash totals and the implied ratio of public expenditure to GDP. An inflation assumption that was well below the levels in the forecast would make the present cash plans look more generous in terms of volume, and this could prompt the sort of criticism of lax control recently expressed by the

Select Committee. Similarly, because the lower inflation assumption would reduce the level of nominal GDP in future years, the published cash plans would represent a higher ratio of GDP than is implied in the forecast. These presentational problems could become problems of substance if an unrealistically low inflation assumption led departments to make their own dispositions on that assumption: the real content if their plans would be higher than could be sustained within the cash totals if inflation fell only as forecast and this would make the cash totals harder to hold in those later years. While these problems should be manageable provided the inflation assumptions are not too far below those in the latest forecast they clearly would become greater as the assumptions depart further from the forecast.

36. The MTFS inflation assumptions will directly influence the base line for 1986-87 in the new Survey. On past form, the baseline might be constructed by assuming some further deceleration in the general rate of inflation and possibly allowing for some additional squeeze in volumes. The figures currently in mind are 3 or 3½%. Either might look unduly severe if we adopted an inflation assumption of say 5 or 5½% for 1985-86; but would look reasonably consistent with 4 or 4½%.

37. There is no obvious tension between the PES assumptions about unemployment (which will be published in the White Paper) and the latest forecasts. Both show unemployment, on the new definition (GB, narrow) flat at around 3m. This is broadly consistent with the 2% average growth in output in the forecast over the last two years, and what we have previously said about productive potential (an underlying growth of around 2-2½% over the next few years).

Alternative Assumptions

38. There is some room for departing from the internal forecasts on both inflation and output; but, in the light of the outside forecasts, it might be difficult to defend both a signficantly more buoyant path for output and a much lower path for inflation. Very low inflation figures could have unwelcome implications for the real growth - and possibly the control - of public expenditure over the next few years,

and point to an unrealistically low baseline for 1986-87 in the new Survey. A low path for inflation may also look inconsistent with last year's monetary guidelines, at least insofar as they relate to broad money.

39. Table 9 compares the forecast with two alternative assumptions about inflation. Both alternatives are coupled with 2½% growth in real output - (slightly above the forecast).

Variant A shows a fairly flat path for inflation. The 1983-84 inflation rate is rounded up to 6%, and there is some token deceleration thereafter. Given the margins of error, this is a defensible, if rather favourable, interpretation of the current internal forecast. On this assumption about inflation, the cash totals in the White Paper would imply no growth in public expenditure in cost terms.

Variant B illustrates a more ambitious path for inflation. This would have obvious political advantages, but it would look distinctly optimistic in relation to 2½% growth and the outside forecasts. We can, in principle, reconcile low inflation and high output in a number of ways, for example by assuming a very slow growth in costs, reflecting some combination of low earnings or high productivity growth, but outsiders are unlikely to find the picture very convincing. This inflation assumption could cause practical and presentational problems on public expenditure; it implies continuing growth in cost terms, given the White Paper cash totals, and could point to an unrealistically low base line for 1985-86 in the new Survey.

Table 9: Alternative Economic Assumptions

	Internal Forecast	Alternative Assumptions A	Alternative Assumptions B
Inflation (GDP deflator)			
1983-84	5.6	6	5½
1984-85	6.9	5½	5
1985-86	7.1	5	4
Real output			
1983-84	2¾	2¾	2¾
1984-85, 1985-86 average	2	2½	2½
Money GDP			
1983-84	8¾	9	8½
1984-85, 1985-86 average	9	8	7
Public expenditure in 1981-82			
Cost terms £ bn (% change)			
1983-84	105.7 (0.2)	105.4(-)	105.8 (0.3)
1984-85	104.5(-1.1)	105.5(-)	106.6 (0.8)
1985-86	102.2(-2.2)	105.2(-0.3)	107.3 (0.7)

40. The choice of economic assumptions interacts with the decisions that are needed on the monetary guidelines and the PSBR path:

(i) retaining the same monetary ranges as in last year's MTFS (and allowing a further 1% reduction in 1985-86) would imply some shift in velocity, and a faster growth in real balances relative to last year, even on the higher of the two inflation assumptions (variant A). The combination of a still lower growth in money GDP with last year's guidelines would imply a continuing fall in velocity over the time period of the MTFS. It might be difficult to convince people that this was consistent with the assumed reduction in inflation, or with a continuation of the fall beyond the end of the MTFS period;

(ii) lower monetary ranges would help to get round some of the problems involved in choosing the lower inflation assumption (variant B). A change would be presented as being consistent with better inflation prospects than were envisaged last year. It might, however, be interpreted as a deliberate tightening in stance and, on this view, the assumption of 2½% real growth would look less credible. Since the lower ranges would be more relevant to broad money, they would also imply a degree of primacy for £M3;

(iii) the choice between the two PSBR variants is fairly fine. But the lower path (falling to 1½% in 1985-86) would look more consistent with a clearer signal on inflation, and lower monetary ranges.

41. We see no particuar problems with the higher inflation assumption (variant A). It can be defended as a reasonable interpretation of what the present policy might deliver. It would be more difficult to present variant B in this light. Even if changes to the financial framework helped to make a better inflation outlook more credible, there could be awkward questions about the prospects for recovery.

MP1 Division
2 February 1983

lowest since ~~late~~ 1960s. at ~~3.6~~ 3.7 p.c. That's a combination no Government in Britain has been able to achieve in recent years, and few overseas.

Ultimately economic revival depends upon you in industry. The Government is doing its best to clear away the obstacles.

A35

RECORD OF A DISCUSSION ON THE MEDIUM TERM FINANCIAL STRATEGY AT 2.30 P.M. ON 17 FEBRUARY AT NO.11.

Present:- Chancellor of the Exchequer
Chief Secretary
Economic Secretary
Sir D Wass
Mr Burns
Mr Littler
Professor Walters
Mr Middleton
Mr Kemp
Mr Ridley
Mr Kerr
Mrs Lomax
Mr Shields

Mr Burns' minute of 15 February, covering the draft MTFS; and minutes of 16 February from the Chief Secretary and the Economic Secretary, were considered.

2. The Chancellor questioned whether the MTFS as drafted was sufficiently ambitious: some readers might find the rhetoric about sustained pressure to reduce inflation unmatched by the actual reductions in monetary growth which were suggested, and by the inflation prospect offered in paragraph 19. The draft did not satisfactorily resolve the difficulty presented by the short-term rise in forecast inflation: it offered not even the prospect of gold at the rainbow's end. By comparison with the original MTFS, the reductions in monetary growth seemed hardly rigorous; and the document would do little to encourage expectations of reduced inflation.

3. It was noted that the inflation forecast in paragraph 19 referred to the GDP deflator, which now stood at 7 per cent, rather than the RPI, which now stood at under 5 per cent: the forecast path was therefore one of reduction, though decelerating. It was also noted that this gradual decline should be seen against the likelihood of world economic recovery, and a rising world inflation trend. The importance of congruence with the internal forecasts, and with the industry act forecast, was also noted.

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4. Professor Walters suggested that the draft should explain that, whereas forecasts tracked the cycle, the MTFS cut through it. The text should also set its projections for the UK economy in the world context.

5. Mr Ridley suggested that expectations of lower inflation might best be reinforced by including, in words if not figures, some projections forward to 1986-87 and 1987-88. The Chief Secretary drew attention to the difficulty of showing any public expenditure figures for years beyond the Survey period; but it was suggested that there would be less difficulty about showing ranges for monetary growth, and figures for the PSBR as a proportion of GDP, for the two additional years.

6. The Chancellor asked that the draft should be revised before discussion with the Governor on 21 February. This revision could be fairly minimal, but should include the dropping of paragraph 14 and the second of the alternative formulations on inflation in paragraph 19. Further work should then be done, in slower time, to widen the draft's perspective; draw attention to the cyclical upturn, through which the MTFS should steer; explain the relationship between the GDP deflator and RPI; and reassert the prospect of further progress on inflation in subsequent years. Figures for revenue and expenditure beyond 1985-86 should not be shown, but consideration should be given to including figures for monetary growth and for inflation.

J O KERR

18 February 1983

DISTRIBUTION

Those Present
Financial Secretary
Minister of State (R)
Minister of State (C)
Sir A Rawlinson
Mr Byatt
Mr Cassell
Mr Odling-Smee
Mr Monck
Mr Evans

IMMEDIATE

CONFIDENTIAL

FROM: ECONOMIC SECRETARY
DATE: 7 FEBRUARY 1983

CHANCELLOR

cc Chief Secretary
Financial Secretary
Minister of State (R)
Minister of State (C)
PCC
Mr Burns
Mr Cassell
Mrs Lomax
Mr Odling-Smee
Mr Monck
Mr Evans
Mr Sedgwick
Mr Shields
Mr Riley
Mr French
Mr Harris

THE MEDIUM TERM FINANCIAL STRATEGY

After reading Mr Burns' submission of 3 February and the attached paper by MP, it seems to me that this has got to be split into what we want and what we say.

2. Firstly, what we want. I am inclined to take issue with the statement in paragraph 4 of the MP paper, which refers to 'the low level [of inflation] from which we start'. All things are relative, and by the standards of the 1970s that is fair enough. But at any other time that I can recall, a prospect of about 6% a year (if we're lucky) would have been regarded with horror. So I would prefer to be a bit more ambitious if we can.

3. This instinct is reinforced by the immediate outlook. It seems to me that there is a relatively high risk of a substantial fall in the oil price. I very much agree with Sir D Wass' comment (at our meeting with the Governor on Friday) that the logical response to such an eventuality, and its possible impact on the exchange rate, is to adjust the fiscal stance. Moreover the latest evidence from the domestic economy, where I feel that the MP paper possibly overstates the impact of dissaving, and understates the impact of lower inflation on (eg) mortgage costs and hence disposable incomes, points the same way. Yet at the same time the low level

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of discretionary savings, emphasised by Alan Walters at our most recent funding meeting, also points - or so it seems to me - to the advisability of a cautious PSBR for 1983-84.

4. So I think the case for a somewhat lower PSBR than the £8 billion that we took as our benchmark at Chevening is made out.

5. Secondly, what we say. The PSBR path in Table 4 looks distinctly bumpy. If we went for £7½ billion in 1983-84 we would eliminate the upward blip from what we expect to be the outturn in 1982-83. Paragraph 21 suggests that this would be consistent with a small positive fiscal adjustment in 1984-85. For my part, bearing in mind that we are talking about figures a long way inside the margins of error, I would be rather less worried about a marginally higher figure - say £7 billion - for 1984-85 if that gave us room to offer a slightly more appetising-looking fiscal adjustment for that year: that would also, incidentally, give us a somewhat smoother path on into 1985-86.

6. Moving on to the monetary aggregates, we face an awkward quandary over what to do about M1. The forecast suggests that it is likely to move beyond the 7-11% range suggested in the 1982 MTFS. I do not think anybody is seriously suggesting we should go therefore to a higher range for all aggregates: that would give the markets a very undesirable signal. But I thought it was striking how our assembled outside pundits last week sounded pretty unanimous (it was about the only thing they did sound unanimous about) in discounting M1 and homing back on £M3 - even those like Gordon Pepper who last year went overboard on MI's significance. Hence I feel rather more optimistic about our ability to get away with something like a repetition of the 1982 Red Book formula for M1, as suggested in paragraph 18 (a) of Mr Monck's submission of January 26. But given the fragility of the exchange rate, the desirability of giving the right signals to the market about our inflation ambitions, and perhaps most of all the grounds for concern about the possibility of a turn-round in velocity, I would far prefer to see us go for the 6%-10% range in a context which made it clear that we were thinking primarily of £M3.

7. Finally, there are the stated inflation forecasts. So far as I can see from the 1982 Red Book and its predecessors, precedent requires us to offer RPI forecasts for Q4 1983 on Q4 1982, and Q2 1984 on Q2 1983 (why, I am not entirely clear, but there it is). Given the hazards and worries about later periods, that is obviously quite enough. If I understand it right the MP paper, which talks in terms of GDP deflators, advises us to go for 6% for Q4 1983 on Q4 1982, and I think one has reluctantly to agree that anything better would be unlikely to carry conviction. While the AS had a figure of 5% for the RPI, it would be difficult not to make any allowance for the fall in sterling. Moreover the lower we go for Q4 1983 on Q4 1982, the further we would have to depart from the Treasury internal forecast in order to claim to carry on the good work into the forecast for Q2 1984 on Q2 1983: and that, to my mind, is of <u>crucial</u> importance. So I would settle for 6% on the RPI in 1983 and - at worst - 5½%, for Q2 1984 on Q2 1983 (I would far rather go for 5% if we could defend it). Then we have to give the GDP deflator 'assumptions' for 1984-85 and 1985-86. I would infinitely prefer Assumption B, since Assumption A leaves us in 2 years' time pretty well where we start. But it is starkly at variance with the internal forecast, and would lack all credibility unless we go for the lower PSBR option and lower monetary range. Even then it might be wiser to go for 4½% in 1985-86 rather than 4%.

8. There is also the phraseology. I am not overwhelmed by MP's suggestion in paragraph 5. The reference to sustainable growth & employment is becoming a little reminiscent of the Brazilian cavalry in 'Road to Rio'; and the reference to inflation has a bit too much of a nuance of saying we have won. I would prefer something more on the lines of:-

> "Government policies have already achieved the lowest rate of inflation for more than ten years, and are designed to make possible further progress to stable prices, thereby creating the environment for the restoration of the long-term competitiveness of British industry and commerce,

upon which alone a sustainable recovery in employment must depend. The Medium Term Financial Strategy describes the financial framework required for the fulfilment of this objective".

9. As to the exchange rate, I think we should stick with 'no major changes'. It has at least the virtue of consistency.

JOCK BRUCE-GARDYNE

FROM: JOHN GIEVE

DATE: 7 February 1983

PRINCIPAL PRIVATE SECRETARY

cc Financial Secretary
Economic Secretary
Minister of State (R)
Minister of State (C)
PCC
~~Mr Burns~~
Mr Cassell
Mrs Lomax
Mr Odling-Smee
Mr Monck
Mr Evans
Me Sedgwick
Mr Shields
Mr Riley
Mr Ridley
Mr French
Mr Harris

THE MEDIUM TERM FINANCIAL STRATEGY

The Chief Secretary has read Mr Burns' minute of 3 February and the paper attached to it. He has the following comments.

Objectives - He is content with the revised formulation in para.5 of the paper.

Monetary ranges - Like Mr Burns, he would go for Variant A of Table 2 of the paper.

PSBR - Rather than either of the Variants in Table 5 of the paper, he would favour a path of £8 billion in 1983-84, £7 billion in 1984-85, and £6 billio in 1985-86. This would maintain the downward pressure more convincingly than Variant A but less harshly than Variant B.

Economic assumptions - He favours Variant A in Table 9. He thinks this is better for public expenditure presentation. Variant B may look more ambitious on inflation, but would, in his view, strain credibility excessively.

JG

JOHN GIEVE

151/2

FROM: E P KEMP
7 February 1983

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Economic Secretary
Sir Douglas Wass
Mr Burns
Mr Middleton

BUDGET PROGRESS MEETING TOMORROW - PSBRs ETC

Looking again at Mr Burns minute of 3 February about the MTFS etc and my own note of earlier today about overall progress, I thought it might be helpful if I set down very briefly the link between these so far as the PSBR goes.

2. In short the position is as follows :-

a. Variant A in Mr Burns Table 5 (PSBRs of £8 billion for 1983-84 and 1984-85) would just permit Budget C - the dearest in Table A - so far as 1983-84 goes, and show a handsome fiscal adjustment for 1984-85.

b. Mr Burns Variant B (PSBRs of £7½ billion for 1983-84 and £6½ billion for 1984-85) would permit very little more than my Budget A - the lower end of the ranges for the various components now before us.

c. The Chief Secretary's own variant (£8 billion in 1983-84 and £7 billion in 1984-85) would permit my Budget B - which is approximately midway between the upper and lower end of the ranges of the various components now before us.

3. To put this point another way, if we go for Mr Burns' Variant A we keep all three Budgets alive; if we go for the Chief Secretary's variant we only keep Budgets A and B alive, while if we go for Mr Burns' Variant B we are right down to the lowest end at Budget A only.

4. All this of course is based on the assumption that the arithmetic remains as shown - and it could easily change; and that the forecast stays solid - and on this we have the oil price risk to note.

EPK

E P KEMP

A35

Mr Burns

From: P E MIDDLETON
7 February 1983

Chancellor of the Exchequer

MTFS

1. You might like a short note to provide a guide for tomorrow's discussion. The key issue as Mr Burns says in his covering note is the Government's objective on inflation, the numbers that go with this, their credibility in terms of consistency with the inflation objective and the short term implications for output.

2. The decisions which are sought are set out on p18 of the MTFS paper. They are:

A MONETARY RANGES (see Table 2)

i. Retain last year's monetary ranges and extend by a year

or ii. Reduce the centre points by 1% point.

These are discussed in paras 6-14 of the note. No one argues for higher ranges. Mr Walters favours (ii) above. Mr Burns (i). The outsiders were broadly content with (i) but some inclined to (ii). The Bank incline to (i).

3. The question is closely related to those in Mr Monck's minute. One of the main arguments for the status quo is that the ranges can, with very little strain encompass all the target aggregates. So this may be the point to decide whether or not we want separate targets for different aggregates. Note: if we reduce the MTFS ranges by 1% it will be difficult not to apply the same principle to 1983-84.

B THE PSBR (see Table 5)

i. Stick to the present MTFS path

ii. Have a slightly steeper downward progression.

4. The tougher option tends to go with the more determined looking counter-inflationary stance shown in lower monetary ranges. But it does not have to. Mr Walters inclines to the lower PSBRs - so do I. But the outsiders certainly did not, Mr Burns does not and neither does the Bank. A lower PSBR carries implications for this year's package and the size of the fiscal adjustment in 1984-85.

C ACCOMPANYING NUMBERS (Table 9)

5. We have to put a lot of other numbers with the money and PSBR

173/2

figures. These are discussed in paras 7-9 of Mr Burns' cover note and 24-39 of the main note. You do not of course have to stick to forecast numbers - either ours or outsiders - they have proved sufficiently wrong to give you a considerable amount of discretion. But you will wish to select a credible set to defend before the Select Committee and others. The danger is that we start talking about precise substitution between lower prices and higher output. The key question in Table 9 is does inflation performance with A look good enough, or credible enough when set alongside the alternative money and PSBR ranges and outside forecasts. With B the question is does output performance look credible when set against the policies thought to be necessary to achieve these inflation numbers.

D OTHER POINTS

6. There are two lesser but important issues:

i. What we say about objectives (paras 2-5)

ii. What we say about the exchange rate (paras 15-17). There are some changes here now that "no major changes" is taken to mean 10% down from now - which is not the assumption. "Broadly unchanged" might be better.

E GENERAL

7. We want a firm steer on the substantive points so that we can have a go at a draft. You do not have to take final decisions until you see how it looks when set out with an accompanying text.

P E MIDDLETON

CONFIDENTIAL

FROM: T BURNS
DATE: 15 FEBRUARY 1983

CHANCELLOR

cc. Chief Secretary
Financial Secretary
Economic Secretary
Minister of State (R)
Minister of State (C)
PCC
Mr Cassell
Mrs Lomax
Mr Odling-Smee
Mr Monck
Mr Evans
Mr Sedgwick
Mr Shields
Mr Riley
Mr Ridley
Mr French
Mr Harris
Mr Turnbull
Mr Bell
Mr Melliss
Mr Norgrove
Mr A Walters (No. 10)

MEDIUM TERM FINANCIAL STRATEGY

I attach a draft of the MTFS, along the lines agreed at last week's overview meeting.

2. We have used the higher monetary ranges and inflation assumptions, and the Chief Secretary's proposed path for the PSBR.

3. Paragraphs 13 and 14 present alternative passages on the exchange rate (short and long), and two ways of expressing the assumption about the future path of the exchange rate.

4. The economic assumptions are set out in paragraph 19. We have displayed two ways of describing the inflation assumption. Alternative A gives separate figures for the GDP deflator in 1984-85 and 1985-86, as last year. Alternative B provides only an average figure for the last two years. Averaging would be consistent with our treatment of real output, where we have never shown the year to year path, and it could be presentationally convenient if we wanted to concede that there might be a hump in inflation, but we were uncertain about timing.

But it would have real disadvantages for public expenditure. A year to year path is needed to convert the cash figures into cost terms. More important, there is an operational need for realistic inflation assumptions, in each year, to allow Departments to plan sensibly. Any path we provided for use within Whitehall would almost certainly reach the Select Committee.

5. The post-Budget forecast update is not yet complete, and firm decisions on the numbers are best left until later, but you asked how the short-term forecast of the RPI squared with the MTFS assumptions about the GDP deflator. The figures might look as follows:

		per cent changes on a year earlier	
		RPI	GDP deflator
1983 Q4	FBI assumpt 6½	6-6½ (forecast)	
1983-84			5½-6 (forecast)
1984 Q2	6½-6	6½-7 (forecast)	
1984-85			5½ (MTFS assumption)

We would expect the rise in the RPI to Q2 1984 to be larger than the rise in the GDP deflator to 1984-85 because of the proposed MTFS assumption of falling inflation and because of the effect of import prices on the RPI (but not, directly, on the GDP deflator). The figure of 7 per cent for the RPI in 1984 Q2 is the forecasters' best guess; a lower figure would be more obviously consistent with the MTFS assumption. You will want to look closely at the published figures for 1983 Q4 and 1984 Q2 on a consistent basis.

Next Steps

6. We are to discuss this draft at your meeting on Thursday, with a view to sending a revised draft over to the Bank by the weekend, for a meeting with the Governor on Monday. You may want to take another look at the precise inflation assumptions for the MTFS later in the week, when you consider the section of the Financial Statement on the short-term forecast.

T.B.

T BURNS 12/3

FROM: T BURNS
DATE: 15 FEBRUARY 1983

CHANCELLOR

cc. Chief Secretary
Financial Secretary
Economic Secretary
Minister of State (R)
Minister of State (C)
PCC
Mr Cassell
Mrs Lomax
Mr Odling-Smee
Mr Monck
Mr Evans
Mr Sedgwick
Mr Shields
Mr Riley
Mr Ridley
Mr French
Mr Harris
Mr Turnbull
Mr Bell
Mr Melliss
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Mr A Walters (No. 10)

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		RPI	GDP deflator
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1983-84			5½-6 (forecast)
1984 Q2	6½-6	6½-7 (forecast)	
1984-85			5½ (MTFS assumption)

We would expect the rise in the RPI to Q2 1984 to be larger than the rise in the GDP deflator to 1984-85 because of the proposed MTFS assumption of falling inflation and because of the effect of import prices on the RPI (but not, directly, on the GDP deflator). The figure of 7 per cent for the RPI in 1984 Q2 is the forecasters' best guess; a lower figure would be more obviously consistent with the MTFS assumption. You will want to look closely at the published figures for 1983 Q4 and 1984 Q2 on a consistent basis.

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T.B.

T BURNS

CONFIDENTIAL

Or Alan ?

MEDIUM TERM FINANCIAL STRATEGY - DRAFT

1. Government policies have helped to bring about a rate of inflation that is already well into single figures. The objective over the medium term is to continue reducing inflation, and to secure a lasting improvement in the performance of British industry, so providing the foundations for ~~a~~ sustainable growth in output and employment. Firm financial policies are an essential means to this end. The medium term financial strategy sets out the framework within which policy is operated.

2. Control of the money supply is a central part of this strategy. In judging the rate of monetary growth needed to reduce inflation, the Government will continue to take account of structural influences on the different monetary aggregates, as well as the behaviour of other financial indicators, including the exchange rate. Fiscal policy is designed to be consistent with this monetary framework and with the overall objective of reducing inflation. ~~The relationship between monetary growth, interest rates and fiscal policy is not a simple one. But~~ Over a period of years, a reduction in public sector borrowing, as a proportion of GDP, has a key part to play in securing a fall in interest rates, in both real and nominal terms~~, as inflation comes down~~.

3. The extent of the recovery in real activity over the next few years depends critically on bringing down cost increases, in all sectors of the economy. Lower domestic costs will enable British industry to compete more effectively, at home and abroad, without adding to inflationary pressures. Despite recent gains, UK productivity is still low in comparison with other major industrial countries. The long term health of the economy depends on further efforts to close this gap. Moderation in pay will help to ensure that improved efficiency is reflected in higher output and employment.

4. The Government will continue to pursue policies to strengthen the supply performance of the economy, by providing greater incentives for work, enterprise and saving, and by improving the working of markets. A lower rate of inflation will provide the right macro-economic environment in which these policies can succeed.

Recent Financial Conditions

5. Monetary conditions have developed broadly as intended over the past year; in the year to February, the growth of the key monetary aggregates was within the target range of 8-12 per cent. Combined with the rapid fall in inflation, this contributed to a substantial fall in interest rates. By mid-November, short term rates had come down to 9 per cent but, as the exchange rate weakened, market rates, and with them base rates, rose to around

11 per cent. In recent weeks however short term interest rates have fallen back to around [ ] per cent.

Table 2

MONETARY GROWTH 1982-83

Percentage growth

	M_o(1)	M1	M2	£M3	PSL1	PSL2
February 1982-February 1982	[3½]	[11½]	[6]	[10]	[9]	[8½]

(1)Monetary base, wide definition

6. £M3 grew by 10 per cent over the target period. During the spring and early summer the rate of growth was close to the bottom of the range. There was some rise in the late summer and autumn, but since December growth has again slowed down. PSL2 grew by less thn £M3 - [8½] per cent in the year to February - in part reflecting the fact that a large proportion of building societies' inflows were into term shares which are not included in PSL2. Although such shares have become more liquid in recent years, as facilities for early withdrawal have been offered, there is generally still a significant penalty for early access in the form of a period of notice and loss of interest. The growth of bank lending followed much the same profile as that of £M3, a period of slow growth being followed by a period of acceleration and then a return to slower growth. This variation was attributable largely to borrowing by companies, borrowing by persons remaining relatively high and steady through the year.

7. M1 grew more slowly than £M3 over the period 1979-81. Last year as expected M1 responded to the fall in interest rates and its growth rate rose. By the autumn, it exceeded that of £M3 ~~[though by the end of the target period, it showed signs of slowing down -]~~ finishing at [11½] per cent over the period as a whole. Narrower measures of money continued to grow slowly. While non-interest bearing M1 rose by [8½] per cent over the year as a whole, the monetary base grew by only [3½] per cent, despite lower interest rates, possibly reflecting a trend decline in the importance of notes and coins relative to other means of payment. The new monetary aggregate, M2, which is intended to provide a better measure of transactions balances, grew by [6] per cent, though lack of past data still makes it difficult to interpret the behaviour of this series.

8. Other financial indicators pointed to moderately restrictive monetary conditions. As in other industrial countries real short term interest rates remained high. While the prices

of some financial assets rose strongly, the increase in real asset prices was modest. House prices stopped falling and showed some tendency to rise ~~more rapidly~~ towards the end of the year. For most of the year the exchange rate was strong. The fall after October could be taken to suggest that conditions were becoming less restrictive, though it seems to have owed more to external factors, such as concern about oil prices [and, possibly, to political uncertainties.]

9. Against this background, the growth in real money balances, on most measures of money, largely reflects the fall in inflation and points to a recovery in real activity. Given ~~a stable framework for~~ the nominal money supply, higher real money balances are an important mechanism by which lower inflation can help to raise the level of activity.

Monetary Policy

10. In recent years the economic significance of the wider aggregates has been affected by changes in savings behaviour and by structural changes to the financial system, associated in part with the ending of direct controls. These developments led to last year's decision to raise the monetary ranges. ~~Experience over the past year tends to support that move.~~ Inflation has fallen fast despite the overrun on previous years' monetary targets, and monetary growth within the new target range set for 1982-83 ~~seems to have~~ been consistent with maintaining a ~~moderately~~ restrictive stance.

11. As announced in the Budget Speech, the target range for 1983-84 is to be set at the 7-11 per cent indicated last year. Sustained progress in reducing inflation will require a further fall in monetary growth over the next few years along the lines shown in table 3. The precise target ranges for 1984-85 and 1985-86 will be decided nearer the time.

Table 3

RANGES FOR MONETARY GROWTH

	1983-84	1984-85	1985-86
Percentage change during year	7-11	6-10	5-9

12. The path shown in table 3 applies to both broad and narrow measures of money. However, as noted in the last year's FSBR, a ~~sustained~~ reduction in interest rates, as inflation comes down, is likely to lead over time to a shift back into non-interest bearing forms of money. The size and timing of these effects is uncertain, but if interest rates maintain [resume] their downward path, and other indicators suggest that conditions remain

moderately restrictive, some overshoot of the target range for 1983-84, as it applies to narrow money - especially M1 - could be appropriate.

13. Alternative A. The interpretation of monetary conditions will continue to take account of all the available evidence, including the exchange rate, as explained in last year's Financial Statement. However, these factors cannot be taken into account in setting monetary objectives in advance. The ranges shown in Table 3 have been constructed on the assumption that there is no major change in the exchange rate from year to year. ~~[The exchange rate is broadly unchanged]~~.

CST prefers

real interest rates, term structure

14. Alternative B. The interpretation of monetary conditions will continue to take account of all the available evidence, including the exchange rate. The exchange rate is an important route through which changes in the money supply affect inflation and, particularly when the monetary aggregates appear to be giving conflicting or misleading signals, it may convey useful information about the overall stance of policy. This will not invariably be the case, since the exchange rate can also reflect developments in the rest of the world, and is often subject to considerable short term volatility. Even so, exchange rate movements may affect inflationary expectations and can disturb the link between the money supply and prices, at least temporarily. This may influence the judgement about the appropriate stance of policy. Such changes cannot readily be taken into account in setting monetary targets. The ranges shown in table 3 have been constructed on the assumption that there is no major change in the exchange rate from year to year. [The exchange rate remains broadly unchanged].

CST prefers

Fiscal Policy

15. Sustained progress on both inflation and interest rates requires continued fiscal restraint. During the 1950's and 1960's the PSBR averaged about (2½-2¾ per cent of GNP). As Chart [ ] shows, there was a strong rise in this ratio during the first half of the 1970's, peaking in 1975-76, when the PSBR reached nearly 10 per cent of GDP. High fiscal deficits over this period were associated with high inflation and interest rates.

16. Government policies have been directed at achieving a progressive reduction in public sector borrowing over the medium term. The path that has been followed has also taken account of the depth of the recession. Two years ago the PSBR path was raised substantially for this reason, though the generally declining profile was retained. The PSBR was reduced from [5 per cent] of GDP in 1979-80 to [3½ per cent] (£8.7 billion) in 1981-82.

17. The estimated outturn for 1982-83 is [£8 billion] equivalent to about [3 per cent] of GDP. This is some [£1 billion] lower than the Autumn Statement forecast, and about [£1½ billion] lower than expected at the time of the Budget [though still some way above the 2¾ per cent figure envisaged in the 1980 FSBR]. [The PSBR is the balance between very large flows on either side. Over the past decade the average error on forecasts for the year ahead made at Budget time has been equivalent to some £4½ billion and, on forecasts made the following autumn, about £2 billion.] Identifiable factors contributing to the lower outturn this year include unexpectedly high receipts from North Sea oil taxes, reflecting a higher sterling oil price, and underspending in some areas of public expenditure, notably local authority capital. [Say something about aiming for centre of target]

18. The PSBR for 1983-84 is forecast to be [£8 billion], equivalent to about 2¾ per cent of GDP, as suggested a year ago and in the Autumn Statement. The fiscal projections summarised in table 6 show a further reduction in the PSBR as a proportion of GDP, to around [2¼] per cent in 1984-85, and [1¼] 3/4 per cent in 1985-86. This path should leave room for a fall in interest rates, within the monetary guidelines, over the next few years. The figures for 1984-85 and 1985-86 are illustrative. Decisions about the appropriate size of the PSBR in any particular year will be taken nearer the time.

CST prefers A
FST prefers A

19. The fiscal projections in tables 4-6 are based on the public expenditure plans shown in the Public Expenditure White Paper (Cmnd 8789), updated where necessary to take account of Budget changes and estimating changes. Further details for 1982-83 and 1983-84 are given in Part V, tables [ ]. Real output is assumed to grow by 2½ per cent a year on average over the period. The general rate of inflation, as measured by the GDP deflator, is forecast at 6 per cent in 1983-84; ~~Alternative A~~ in the later years, inflation is assumed to fall to 5½ per cent in 1984-85, and 5 per cent in 1985-86 ~~[Alternative B in the last two years inflation is assumed to average 5 per cent a year]~~. These assumptions imply a growth of money GDP of 9 per cent in 1983-84, and an average of about 8 per cent a year, in the last two years.

Public Expenditure

MR

20. The plans announced in the Public Expenditure White Paper imply an increase in general government expenditure of about [5 per cent] in 1983-84 and each of the two later years, [and a fall in public expenditure as a proportion of GDP from [ ] in 1982-83 to [ ] in 1983-84 and [ ] in 1985-86, given the assumed growth of money GDP]. Table 4 shows the relationship between the planning total for public expenditure and general government expenditure in national accounts terms (the definition of public expenditure lying behind the general govenment borrowing requirement).

Table 4: General Government Expenditure

£ billion, cash

	1981-82	1982-83	1983-84	1984-85	1985-86
Public expenditure planning total[1]					
Planning total adjustments[2]					
[General government expenditure. Special sale of assets]					
Differences due to policy measures and economic assumptions[3]					
National accounts adjustment[4]					
Interest payments					
Total expenditure in national					

Footnotes

[Lines 3 and 4 could be dropped]

Revenue

21. The growth of Government revenues over the medium term will depend on the growth of incomes spending and prices, as well as policy decisions. Revenue is projected on the conventional assumption of constant indexed tax rates and allowances at the proposed 1983-84 levels. National Insurance contribution rates in future years are assumed to be adjusted to maintain the present balance of income over expenditure in the Fund. [Projections of North Sea tax revenues assume that the North Sea fiscal regime is changed as proposed in the Budget and that oil prices remain around their present levels for the next two yers and then rise broadly in line with world inflation.]

22. On these assumptions, general government receipts are projected to rise by [ ] between 1982-83 and 1984-85 (closely in line with the growth in total money incomes]. Government revenues from the North Sea may [fall slightly as a proportion of general government tax receipts, from around [ ] in 1982-83 to about [ ] . . . .].

Table 5: General Government Receipts

£ billion, cash

	1981-82	1982-83	1983-84	1984-85	1985-86
Taxes on incomes expenditure and capital					
National Insurance and other contributions					
Interest and other receipts					
Accruals adjustment					
Total					
of which North Sea tax[1]					

[1] [Royalties, Supplementary Petroleum Duty (in 1981-82). Petroleum Revenue Tax (including advance payments from 1983-84) and Corporation Tax from North Sea oil and gas production (before Advance Corporation Tax set off).]

Public Sector Borrowing

23. The new projections of Government receipts and expenditure are brought tgoether in table 6 to provide projections of the general government borrowing requirement (GGBR) and the PSBR. The size of the fiscal adjustment [conventionally assumed to take the form of lower personal taxes] depends critically on the estimates of revenues and expenditure. These are subject to major uncertainties about, for example, the tax yield for an assumed set of tax rates, the behaviour of oil prices, and the actual level of public spending in relation to the plans.

Table 6: Public Sector Borrowing

£ billion, cash

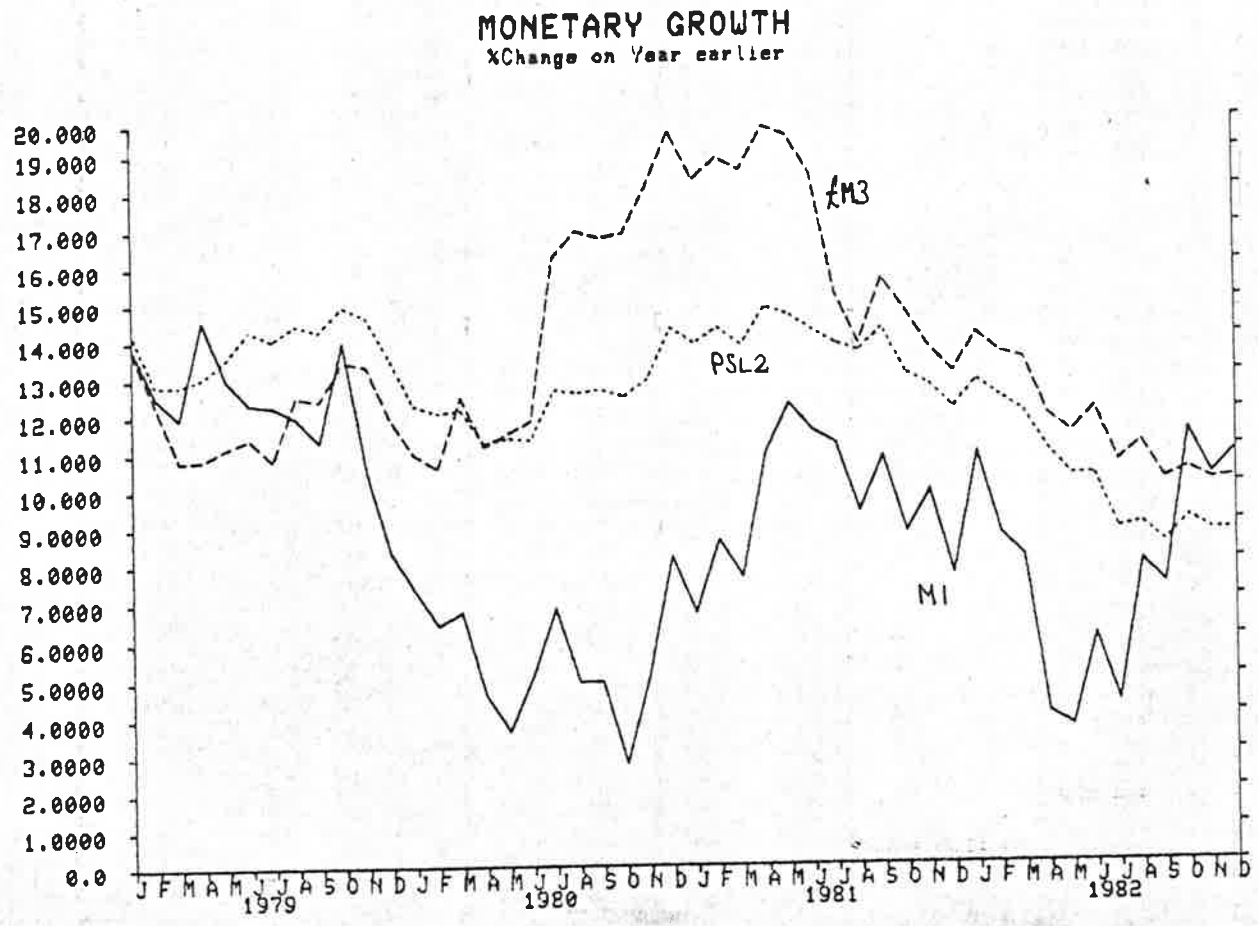
	1981-82	1982-83	1983-84	1984-85	1985-86
General government expenditure					
General government receipts					
Implied fiscal adjustment[1]					
GCBR					
PSBR	8.7	8	8		
as % GDP	3 ½	3	2 ¾	2 ¼	1 ¾
Money GDP at market prices					

[1] + means lower taxes or higher expenditure than assumed in lines 1 and 2.

[Comparison with 1982 revenue and borrowing projections: Table plus one or two paragraphs]

Conclusions

24. The projections shown in tables 4-6 are no more than illustrative of one particular evolution of the economy. If the domestic and world economies develop in a different way, the projections for public finances could be substantially affected. The policy response to such changes would depend on their nature, but the intention would be to hold firmly to main thrust of the strategy, by maintaining monetary conditions consistent with a continued trend to lower inflation.


MONETARY GROWTH
%Change on Year earlier
20.000
19.000
18.000
17.000
16.000
15.000
14.000
13.000
12.000
11.000
10.000
9.0000
8.0000
7.0000
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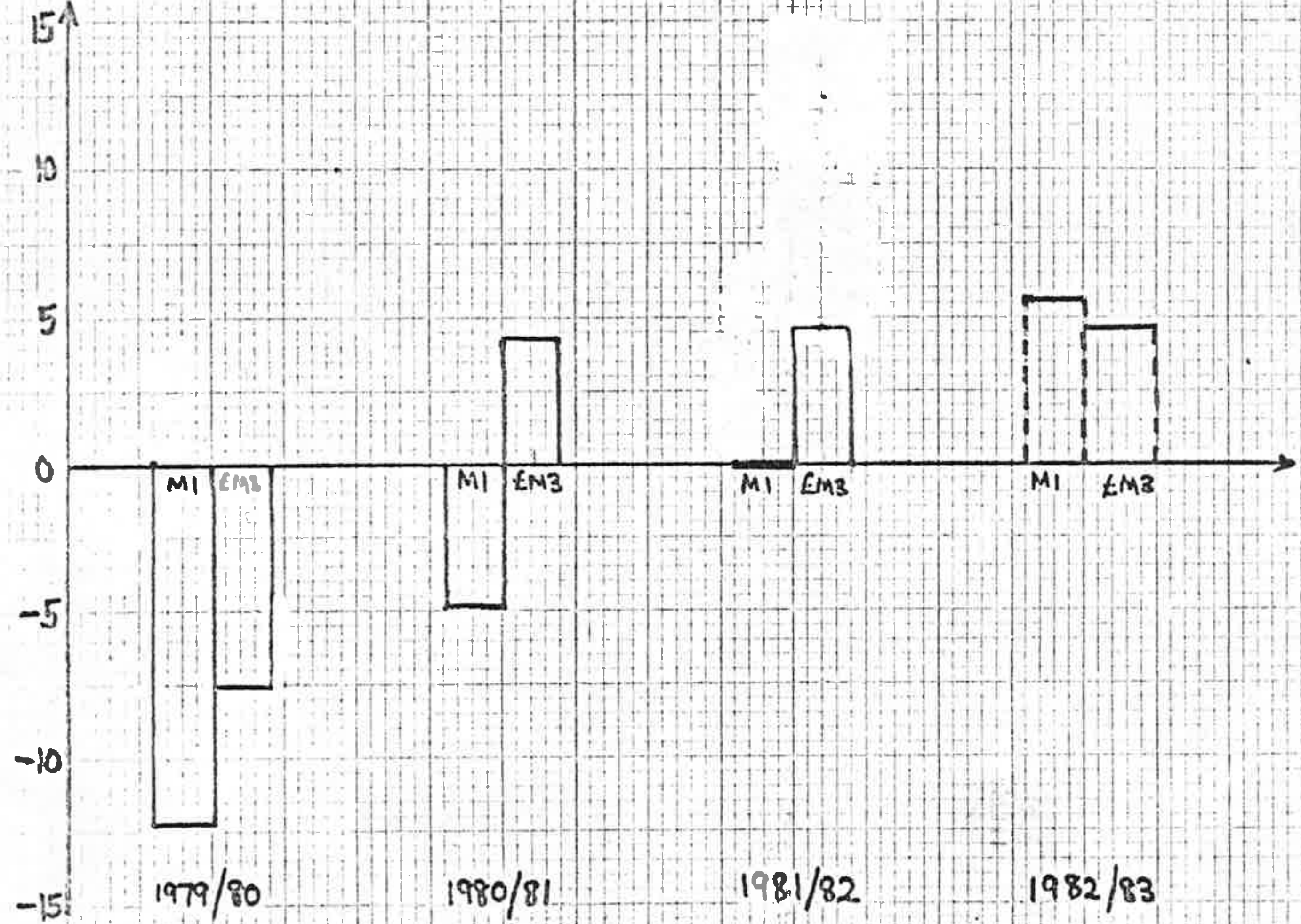
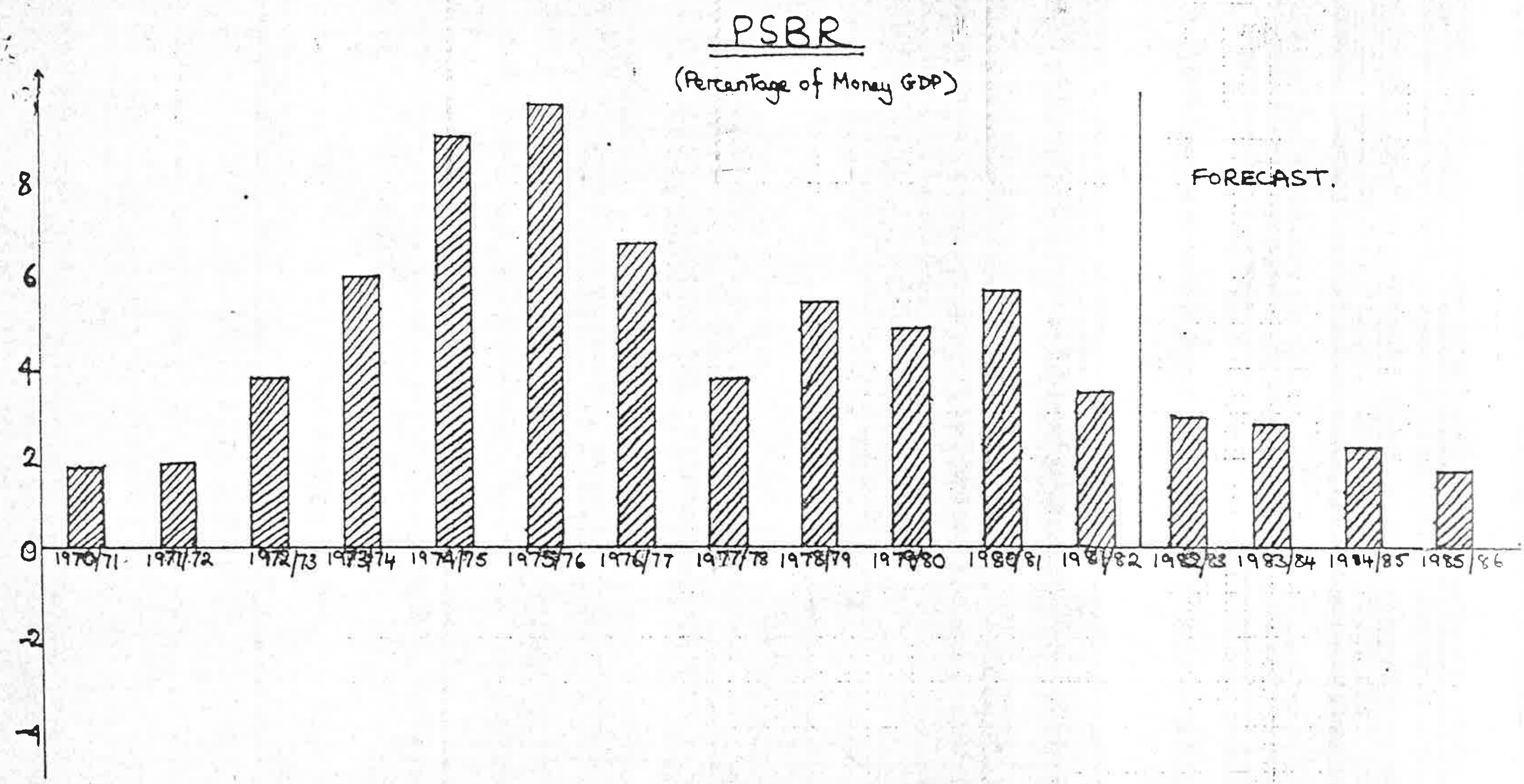
J F M A M J J A S O N D J F M A M J J A S O N D J F M A M J J A S O N D J F M A M J J A S O N D
1979
1980
1981
1982
£M3
PSL2
M1

Growth in Real Money Balances.

(% change through year in nominal money stock deflated by the GDP at Market Prices Deflator)




PSBR
(Percentage of Money GDP)
FORECAST.
8
6
4
2
0
-2
-4
1970/71
1971/72
1972/73
1973/74
1974/75
1975/76
1976/77
1977/78
1978/79
1979/80
1980/81
1981/82
1982/83
1983/84
1984/85
1985/86

E.3

FROM: ADAM RIDLEY
15 February 1983

CHANCELLOR

cc CST
EST
Mr Burns
Mr Middleton

THE MTFS AND INFLATION

I have a number of anxieties about the MTFS which were not dealt with at your recent meeting to discuss the draft circulated with Terry Burns' minute of February 3. Not having the papers for the meeting recently laid on for Thursday, February 17, and as time is passing it seemed best to put my thoughts on the record now rather than wait so late that their proper circulation became impossible.

2. The first issue is the rather sharp contrast between assuming for MTFS purposes an inflation path such as:

	A	B
1983/84	6	5½
84/85	5½	5
85/86	5	4

for the GDP deflator (cf. Table 9 attached to Burns' minute) while forecasting a path for this and other prices such as the following:

	GDP Deflator Forecast		RPI	Wholesale prices
1983/84	5.6	1983	7.3	7.1
84/85	6.9	84	7.9	7.0
85/86	7.1	85	7.6	8.8
		86	8.2	9.7

Sources: Burns Table 9. Forecast report "Activity & Inflation" Table 18, p.31.

3. There seem to be several problems or risks involved in doing so:

(1) The GDP deflator cited conveys an impression of the likely future level of inflation which is misleadingly reassuring. RPI inflation is likely to run 1% p.a. faster, and wholesale price inflation 1½% p.a. faster.

It would seem a bit odd to adopt an MTFS which we privately believed implied such high RPI inflation for the next four years.

(2) On any of the three inflation measures adopted, it would be odd to publish or imply an inflation rate which fell substantially over the medium term if one believed it was in truth on an upward trend.

(3) To go ahead and publish figures like those in variants A and B while the internal forecast is somewhat discrepant is of itself a little disconcerting, even if one thinks the model is wrong. But it is particularly disconcerting when the difference between the two marks the difference between an MTFS which appears to work and one which, so it can be alleged, the Government itself does not believe will get inflation down.

4. Such issues suggest several possibilities:

(1) Its all a matter of margins of error. Price projection is a doubtful art. A discrepancy of 1 or 2% p.a. neither need or should disquiet one.

(2) The model is simply wrong. Monetary targets such as those suggested would in practice deliver lower inflation than it now suggests.

(3) Though the model relationships may be right, some of the constraints or exogenous assumptions are wrong (in the "right" direction).

(4) The model would show lower inflation at the end of the day, but the period covered is too short to allow the lags to work themselves out.

5. The margins of error possibility is not very reassuring. It is slightly implausible anyway (implying a series of accidents which just happen to push the inflation trend the wrong way each year for 3 or 4 years). If they happen to leave one so awkwardly on the wrong side of the rising/falling inflation divide then *prima facie* there is a strong case for a different and tougher central thrust to policy than that assumed. It is clearly possible that the model relationships are wrong. But what do we actually believe? Not being very close to the model these days,

I am not sure and worried lest the model is at least qualitatively right. It is equally clearly possible that the constraints or (de facto) exogenous assumptions are a source of error. To be specific, I do not find the present exchange rate profile very plausible. Instead of a flattish effective rate of 80±1 for the next 2 years or so, I would assume that a further short-run fall is very likely and, far more important, that a significant and lasting jump after an election is near-certain if this Government is re-elected. This would suggest an inflation path in 1984/85 and perhaps 1985/86 which is rather more likely to fall (ceteris paribus), though there could well be more of a hump in 1983/84. The idea that the kind of monetary targets proposed might deliver lower inflation "at the end of the day" is not very plausible. While it is easy enough to think in terms of our currently enjoying an adventitious advancement of the lower inflation which one would normally have expected only to enjoy in 1984 or later, such an explanation does not square very well with the steady upward trend of RPI and wholesale price increases in paragraph 2 above. One is also impelled to ask oneself when the end of the day is, and at what inflation rate.

6. So much for the possibilities if the internal projections are in some sense wrong. What, on the other hand, if they are broadly right? There are then three directions in which one might go.

(1) lower the monetary targets; or

(2) assume monetary policy will be so managed as to achieve growth rates in the lower part of the ranges; and/or

(3) postulate an intensification of other cost reducing policies such as Union and Labour Market reform, or a greater such influence as time passes and measures already taken bite progressively harder.

One assumes (1) and (2) could well mean some steepening of the PSBR profile too.

7. It may be retorted to all (or most) of this that of course we do not, cannot and should not take the model's projections of inflation very seriously. This Government has, right from the start, set out a policy framework which is not model-based, for excellent reasons, and with some real successes not least on the inflation front. And there is undoubtedly much in such a view - I would certainly defend it forcibly myself as a general proposition and in many specific respects. However it is my impression that up till this year the model's price projections have been distinctly more reassuring than those now before us, even if they pointed to some upturn in inflation in the more distant future. This time, in contrast, they are suggesting no further success at any point, and a halt to the reduction in inflation at a disquietingly high floor. Should one not, therefore, stop and think a little more and deeper before going fixing this year's MTFS?

8. Then there are one or two presentational matters. With the RPI known to be likely to increase over the next 6-12 months and outside forecasters also projecting an acceleration, one wonders what risk there is that figures such as those discussed at the beginning of this note might become publicly known, e.g. through a TCSC cross-examination (or request for papers)? This could be of special concern in a pre-election atmosphere.

9. Finally there is the question of what would seem a sensible kind of price profile to have, in the published MTFS, whether implicit or explicit. My own instinct is that the Government will want to aspire to an RPI increase of 4% or so by 1986 (or less) which would seem to mean a growth in the GDP deflator of around 3% maximum, as against the present forecast of 7% and figures in variants A and B of 5 and 4%. In addition there is a very strong case in this year's circumstances for seeking to convey to the world outside some kind of confidence that the MTFS can carry one over the imminent hump. How are we to do this? I suppose that the simplest and best way might be for the Chancellor to say soon - e.g. in the Budget speech, broadcast or subsequent debates - something to the effect that in the next Parliament the Government will, by continuing the MTFS, be "pressing on towards the objective of considerably lower inflation than we have today." A remark such as this would convey the flavour of getting to an

RPI growth rate of say 3% p.a. plus a little without actually pinpointing a precise figure. If questioned on this as both Ministers and officials are sure to be, he could say, truthfully enough, that no one has claimed (or should ever do so) that monetary discipline and targets will deliver a precise inflation figure by a stipulated date. Its the broad objective that counts, and that, evidently, is what he is talking about with a realistic and responsible degree of imprecision. If asked what inflation target is implicit in the MTFS, he would, again say "a rate of increase considerably lower than today's", and go on to stress that the MTFS is not so much a 4 year plan as a rolling strategy which is modified as needed to ensure the delivery of the Government's objective.

A N RIDLEY

CONFIDENTIAL

FROM: C D HARRISON
DATE: 16 FEBRUARY 1983

PS/CHANCELLOR

cc Chief Secretary
Financial Secretary
Minister of State (R)
Minister of State (C)
PCC
Mr Cassell
Mrs Lomax
Mr Odling-Smee
Mr Monck
Mr Evans
Mr Sedgwick
Mr Shields
Mr Riley
Mr Ridley
Mr French
Mr Harris
Mr Turnbull
Mr Bell
Mr Melliss
Mr Norgrove
Mr A Walters (No.10)
Mr Burns

Attach to orgume

MEDIUM TERM FINANCIAL STRATEGY

The Economic Secretary has made the following comments on Mr Burns' submission of 15 February and the draft MTFS.

2. On the possible inflation forecasts in paragraph 5 of Mr Burns' covering note, it seems to the Economic Secretary that it is crucially important that the <u>slope</u> should be downwards. So he feels it would be worth swallowing an RPI of 6½% for 1983 Q4 (which is below many outside forecasts), and then certainly not more than 6½% - 6% if it can be defended - for 1984 Q2. (Moreover, 7% for 1984 Q2 would not sit comfortably with a GDP deflator for 1984-85 of 5½%). Similarly, if the forecast GDP deflator for 1984-85 is indeed to be 5½%, then 6% must be the best which can be shown for 1983-84.

3. Moving to the draft MTFS, the Economic Secretary notes that table 3 in last year's MTFS, showing monetary growth over the past 6 years, has been dropped. Clearly such a table is not vital; but could it possibly be worth a few cheap brownie points?

4. On paragraph 7, he is not sure how sustainable the first bracketed clause is, which suggests that M1"showed signs of slowing down by the end of the target period."

5. In paragraph 9, he would insert the words "and contracting" after "stable" in line 3.

6. In paragraphs 13-14, he prefers alternative B. But he would suggest adding the words "and political uncertainties at home" after "world" in line 6. However, whether alternative A or B is chosen, the Economic Secretary feels that last year's sentence about the importance of the exchange rate in monitoring domestic monetary conditions and in taking policy decisions (paragraph 2.11) should not be omitted; to do so would give undesirable signals.

7. In paragraph 17, it might be clearer to add the words "for the year now ending" after " envisaged" in line 4.

8. In line 4 of paragraph 18, surely "one and a quarter" should read "one and three quarters" (see table 6).

9. In paragraph 19, the Economic Secretary would prefer alternative A to alternative B. Apart from the awkwardnesses referred to in paragraph 4 of Mr Burns' covering note, alternative B might suggest that the Treasury was expecting some additional adverse influences on prices in 1985-86 beyond those which were generally anticipated.

10. The Economic Secretary is not sure why the line in table 4, on special sales of assets, should be dropped.

11. To be consistent with last year's MTFS, insert "in cash terms" after "government revenues" in paragraph 21.

pp C D HARRISON

CONFIDENTIAL

FROM: T BURNS
DATE: 18 FEBRUARY 1983

CHANCELLOR

For Monday's meeting

cc. Chief Secretary
Financial Secretary
Economic Secretay
Minister of State (
Minister of State (
PCC
Mr Cassell
Mrs Lomax
Mr Odling-Smee
Mr Monck
Mr Evans
Mr Sedgwick
Mr Shields
Mr Riley
Mr Ridley
Mr French
Mr Harris
Mr Turnbull
Mr Bell
Mr Melliss
Mr Norgrove
Mr A Walters (No.10)

MEDIUM TERM FINANCIAL STRATEGY

I attach a further draft of the MTFS taking account of some of the suggestions from yesterday's meeting. In the time available it has only been possible to make relatively simple changes.

2. This is the version the Governor will have for Monday's meeting.

TB

T BURNS

MEDIUM TERM FINANCIAL STRATEGY - DRAFT

1. Government policies have helped to bring about a rate of inflation that is already well into single figures. The objective over the medium term is to continue reducing inflation, and to secure a lasting improvement in the performance of British industry, so providing the foundations for sustainable growth in output and employment. Firm financial policies are an essential means to this end. The medium term financial strategy sets out the framework within which policy is operated.

AW.

2. Control of the money supply is a central part of this strategy. In judging the rate of monetary growth needed to reduce inflation, the Government will continue to take account of structural influences on the different monetary aggregates, as well as the behaviour of other financial indicators, (including the exchange rate.) Fiscal policy is designed to be consistent with this monetary framework and with the overall objective of reducing inflation. Over a period of years, a reduction in public sector borrowing, as a proportion of GDP, has a key part to play in securing a fall in interest rates, in both real and nominal terms.

AW.

3. The extent of the recovery in real activity over the next few years depends critically on bringing down cost increases, in all sectors of the economy. Lower domestic costs will enable British industry to compete more effectively, at home and abroad, without adding to inflationary pressures. Despite recent gains, UK industrial productivity is still low in comparison with other major industrial countries. The long term health of the economy depends on further efforts to close this gap. Moderation in pay will help to ensure that improved efficiency is reflected in higher output and employment.

4. The Government will continue to pursue policies to strengthen the supply performance of the economy, by providing greater incentives for work, enterprise and saving, and by improving the working of markets. A low rate of inflation will provide the right macro-economic environment in which these policies can succeed.

Recent Financial Conditions

AW

5. Monetary conditions have developed broadly as intended over the past year; in the year to February, the growth of all the key monetary aggregates was within the target range of 8-12 per cent. Combined with the rapid fall in inflation, this contributed to a substantial fall in interest rates. By mid-November, short term rates had come down to 9 per cent but, as the exchange rate weakened, market rates, and with them base rates, rose to around

11 per cent. In recent weeks however short term interest rates have fallen back to around [ ] per cent.

Table 2

MONETARY GROWTH 1982-83

Percentage growth

	M_o(1)	M1	M2	£M3	PSL1	PSL2
February 1982-February 1982	[3½]	[11½]	[6]	[10]	[9]	[8½]

(1)Monetary base, wide definition

6. £M3 grew by 10 per cent over the target period. During the spring and early summer the rate of growth was close to the bottom of the range. There was some rise in the late summer and autumn, but since December growth has again slowed down. PSL2 grew by less thn £M3 - [8½] per cent in the year to February - in part reflecting the fact that a large proportion of building societies' inflows were into term shares which are not included in PSL2. Although such shares have become more liquid in recent years, as facilities for early withdrawal have been offered, there is generally still a significant penalty for early access in the form of a period of notice and loss of interest. The growth of bank lending followed much the same profile as that of £M3, a period of slow growth being followed by a period of acceleration and then a return to slower growth. This variation was attributable largely to borrowing by companies, borrowing by persons remaining relatively high and steady through the year.

7. M1 grew more slowly than £M3 over the period 1979-81. Last year as expected M1 responded to the fall in interest rates and its growth rate rose. By the autumn, it exceeded that of £M3, finishing at [11½] per cent over the period as a whole. Narrower measures of money continued to grow slowly. While non-interest bearing M1 rose by [8½] per cent over the year as a whole, the monetary base grew by only [3½] per cent, despite lower interest rates, possibly reflecting a trend decline in the importance of notes and coins relative to other means of payment. The new monetary aggregate, M2, which is intended to provide a better measure of transactions balances, grew by [6] per cent, though lack of past data still makes it difficult to interpret the behaviour of this series.

8. Other financial indicators pointed to moderately restrictive monetary conditions. As in other industrial countries real short term interest rates remained high. While the prices of some financial assets rose strongly, the increase in real asset prices was modest. After

falling for the past two years, house prices showed some tendency to rise towards the end of the year. For most of the year the exchange rate was strong. The fall after October could be taken to suggest that conditions were becoming less restrictive, though it seems to have owed more to external factors, such as concern about oil prices and sharp movements in other currencies [and, possibly, to political uncertainties.]

9. Against this background, the growth in real money balances, on most measures of money, largely reflects the fall in inflation and points to a recovery in real activity. For a given growth in the nominal money supply, higher real money balances are an important mechanism by which lower inflation can help to raise the level of activity.

Monetary Policy

10. In recent years the economic significance of the wider aggregates has been affected by changes in savings behaviour and by structural changes to the financial system, associated in part with the ending of direct controls. These developments led to last year's decision to raise the monetary ranges. Monetary growth within the new target range set for 1982-83 has been consistent with maintaining a reasonably restrictive stance, and inflation has fallen fast despite the overrun on previous year's monetary targets.

11. As announced in the Budget Speech, the target range for 1983-84 is to be set at the 7-11 ~~per~~ cent indicated in last year's Financial Statement. A substained reduction in monetary growth is needed to keep inflation on a downward trend. Illustrative ranges for the next few years are shown in table 3. Precise targets for 1984-85 and 1985-86 will be decided nearer the time. [Further reductions in monetary growth will be needed in subsequent years].

Table 3

RANGES FOR MONETARY GROWTH

	1983-84	1984-85	1985-86
Percentage change during year	7-11	6-10	5-9 2-6

12. The path shown in table 3 applies to both broad and narrow measures of money. However, as noted in the last year's FSBR, lower interest rates are likely to lead over time to a shift back into non-interest bearing forms of money. The size and timing of these effects is uncertain, but if interest rates maintain [resume] their downward path, and other

indicators suggest that conditions remain moderately restrictive, it may be appropriate to allow M1 to grow more rapidly than the target range for 1983-84.

13. As explained in last years Financial Statement, the interpretation of monetary conditions will continue to take account of all the available evidence, including the exchange rate, structural changes in financial markets, and the behaviour of relative and real interest rates. However, these factors cannot be taken into account in setting monetary objectives in advance. The ranges shown in Table 3 have once again been constructed on the assumption that there is no major change in the exchange rate from year to year.

Fiscal Policy

14. Sustained progress on both inflation and interest rates requires continued fiscal restraint. During the 1950's and 1960's the PSBR averaged about (2½-2¾ per cent of GNP). As Chart [ ] shows, there was a strong rise in this ratio during the first half of the 1970's, peaking in 1975-76, when the PSBR reached nearly 10 per cent of GDP. High fiscal deficits over this period were associated with high inflation and interest rates.

15. Government policies have been directed at achieving a progressive reduction in public sector borrowing over the medium term. The path that has been followed has also taken account of the depth of the recession. Two years ago the PSBR path was raised substantially for this reason, though the generally declining profile was retained. The PSBR was reduced from [5 per cent] of GDP in 1979-80 to [3½ per cent] (£8.7 billion) in 1981-82.

16. The estimated outturn for 1982-83 is [£8 billion] equivalent to about [3 per cent] of GDP. This is some [£1 billion] lower than the Autumn Statement forecast, and about [£1½ billion] lower than expected at the time of the Budget, though still some way above the 2¼ per cent figure envisaged for the year now ending in the 1980 FSBR. Identifiable factors contributing to the lower outturn this year include unexpectedly high receipts from North Sea oil taxes, reflecting a higher sterling oil price, and underspending in some areas of public expenditure, notably local authority capital.

17. The PSBR for 1983-84 is forecast to be [£8 billion], equivalent to about 2¾ per cent of GDP, as suggested a year ago and in the Autumn Statement. The fiscal projections summarised in table 6 show a further reduction in the PSBR as a proportion of GDP, to around [2¼] per cent in 1984-85, and [1¾] per cent in 1985-86. This path should leave room for a fall in interest rates, within the monetary guidelines, over the next few years. The figures for 1984-85 and 1985-86 are illustrative. Decisions about the appropriate size of the PSBR in any particular year will be taken nearer the time.

18. The fiscal projections in tables 4-6 are based on the public expenditure plans shown in the Public Expenditure White Paper (Cmnd 8789), updated where necessary to take account of Budget changes and estimating changes. Further details for 1982-83 and 1983-84 are given in Part V, tables [ ]. Real output is assumed to grow by 2½ per cent a year on average over the period. The general rate of inflation, as measured by the GDP deflator rose by 7 per cent in 1982-83. It is forecast to rise by 6 per cent in 1983-84. (The relationship between this forecast for the GDP deflator and the more widely known Retail Price Index is discussed in Part 3). In the later years, inflation is assumed to fall to 5½ per cent in 1984-85, and 5 per cent in 1985-86. The implications of these assumptions for the growth in money GDP are shown in table 6.

Public Expenditure

19. The Public Expenditure White Paper implies an increase in the planning total of about [5 per cent] in 1983-84 and each of the two later years, [and a fall in public expenditure as a proportion of GDP from [ ] in 1982-83 to [ ] in 1983-84 and [ ] in 1985-86, given the assumed growth of money GDP]. Table 4 shows the relationship between the planning total for public expenditure and general government expenditure in national accounts terms (the definition of public expenditure lying behind the general government borrowing requirement).

Table 4: General Government Expenditure

£ billion, cash

	1981-82	1982-83	1983-84	1984-85	1985-86
Public expenditure planning total[1]					
Planning total adjustments[2]					
General government expenditure.					
Special sale of assets					
Differences due to policy measures and economic assumptions[3]					
National accounts adjustment[4]					
Interest payments .					
Total expenditure in national accounts terms					

Revenue

20. The growth of Government revenues in cash terms over the medium term will depend on the growth of incomes, spending and prices, as well as policy decisions. Revenue is projected on the conventional assumption of constant indexed tax rates and allowances at the proposed 1983-84 levels. National Insurance contribution rates in future years are assumed to be adjusted to maintain the present balance of income over expenditure in the Fund. [Projections of North Sea tax revenues assume that the North Sea fiscal regime is changed as proposed in the Budget and that oil prices remain around their present levels for the next two yers and then rise broadly in line with world inflation.]

21. On these assumptions, general government receipts are projected to rise by [ ] between 1982-83 and 1984-85 (closely in line with the growth in total money incomes]. Government revenues from the North Sea may [fall slightly as a proportion of general government tax receipts, from around [ ] in 1982-83 to about [ ] . . . . .].

Table 5: General Government Receipts

£ billion, cash

	1981-82	1982-83	1983-84	1984-85	1985-86
Taxes on incomes expenditure and capital					
National Insurance and other contributions					
Interest and other receipts					
Accruals adjustment					
Total					
of which North Sea tax[1]					

[1] [Royalties, Supplementary Petroleum Duty (in 1981-82). Petroleum Revenue Tax (including advance payments from 1983-84) and Corporation Tax from North Sea oil and gas production (before Advance Corporation Tax set off).]

Public Sector Borrowing

22. The new projections of Government receipts and expenditure are brought together in table 6 to provide projections of the general government borrowing requirement (GGBR) and the PSBR. The size of the fiscal adjustment [conventionally assumed to take the form of

lower personal taxes] depends critically on the estimates of revenues and expenditure. These are subject to major uncertainties about, for example, the tax yield for an assumed set of tax rates, the behaviour of oil prices, and the actual level of public spending in relation to the plans.

Table 6: Public Sector Borrowing

£ billion, cash

	1981-82	1982-83	1983-84	1984-85	1985-86
General government expenditure					
General government receipts					
Implied fiscal adjustment[1]					
GGBR					
PSBR	8.7	8	8		
as % GDP	3½	3	2¾	2¼	1¾
Money GDP at market prices	254	274			

[1] + means lower taxes or higher expenditure than assumed in lines 1 and 2.

[Comparison with 1982 revenue and borrowing projections: Table plus one or two paragraphs]

Conclusions

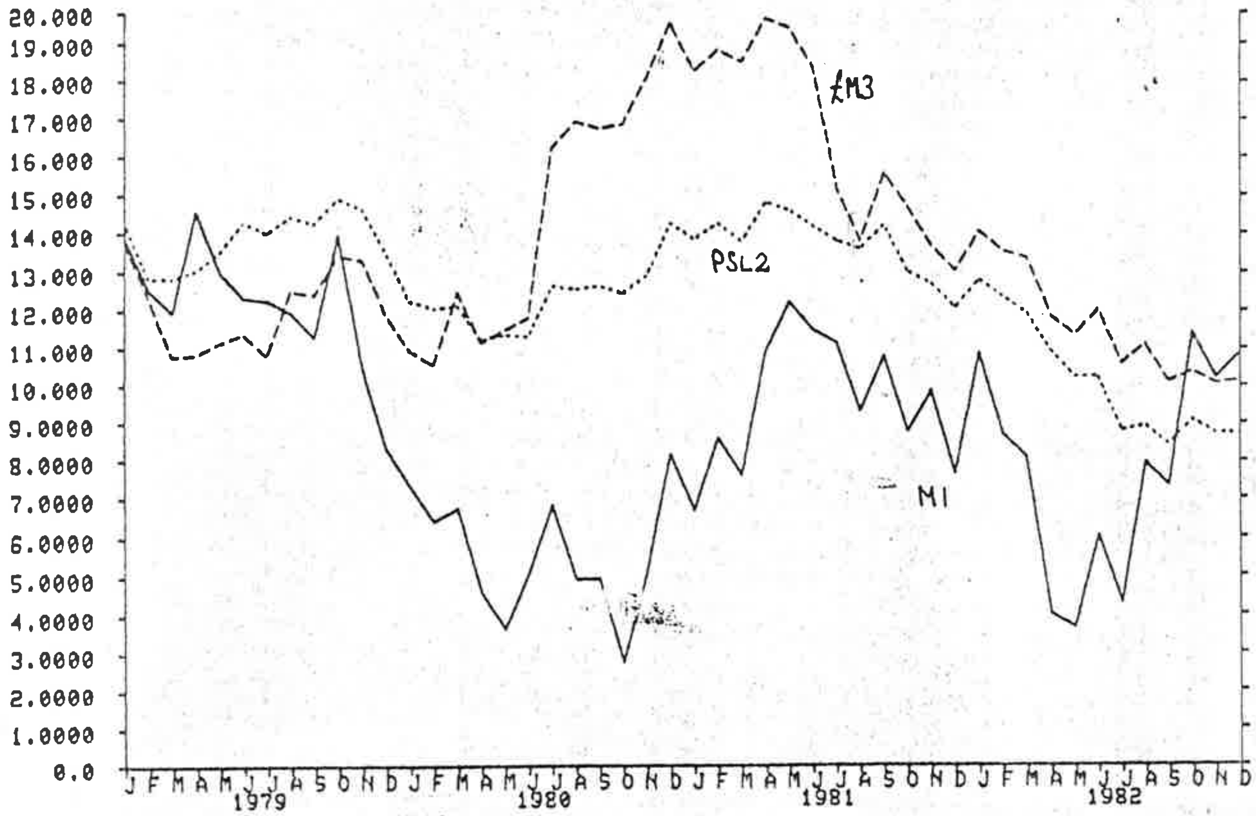
23. The projections shown in tables 4-6 are no more than illustrative of one particular evolution of the economy. If the domestic and world economies develop in a different way, the projections for public finances could be substantially affected. The policy response to such changes would depend on their nature, but the intention would be to hold firmly to the strategy, by maintaining monetary conditions consistent with a continued trend to lower inflation. The key to sustained recovery lies in reducing the growth of costs and increasing the returns to investment and enterprise. Within the financial framework set out here, this would make room for a faster growth in output, without damaging the outlook for inflation.

[24. Progress in reducing inflation over the next couple of years will depend, to some extent, on the strength of the cyclical recovery in output, both domestically and in the rest of the world. As explained in Part 3, the path of the Retail Price Index is liable to be

especially bumpy. But the Government's policies will continue to be directed towards achieving a progressive reduction in the trend of inflation from one cycle to another].

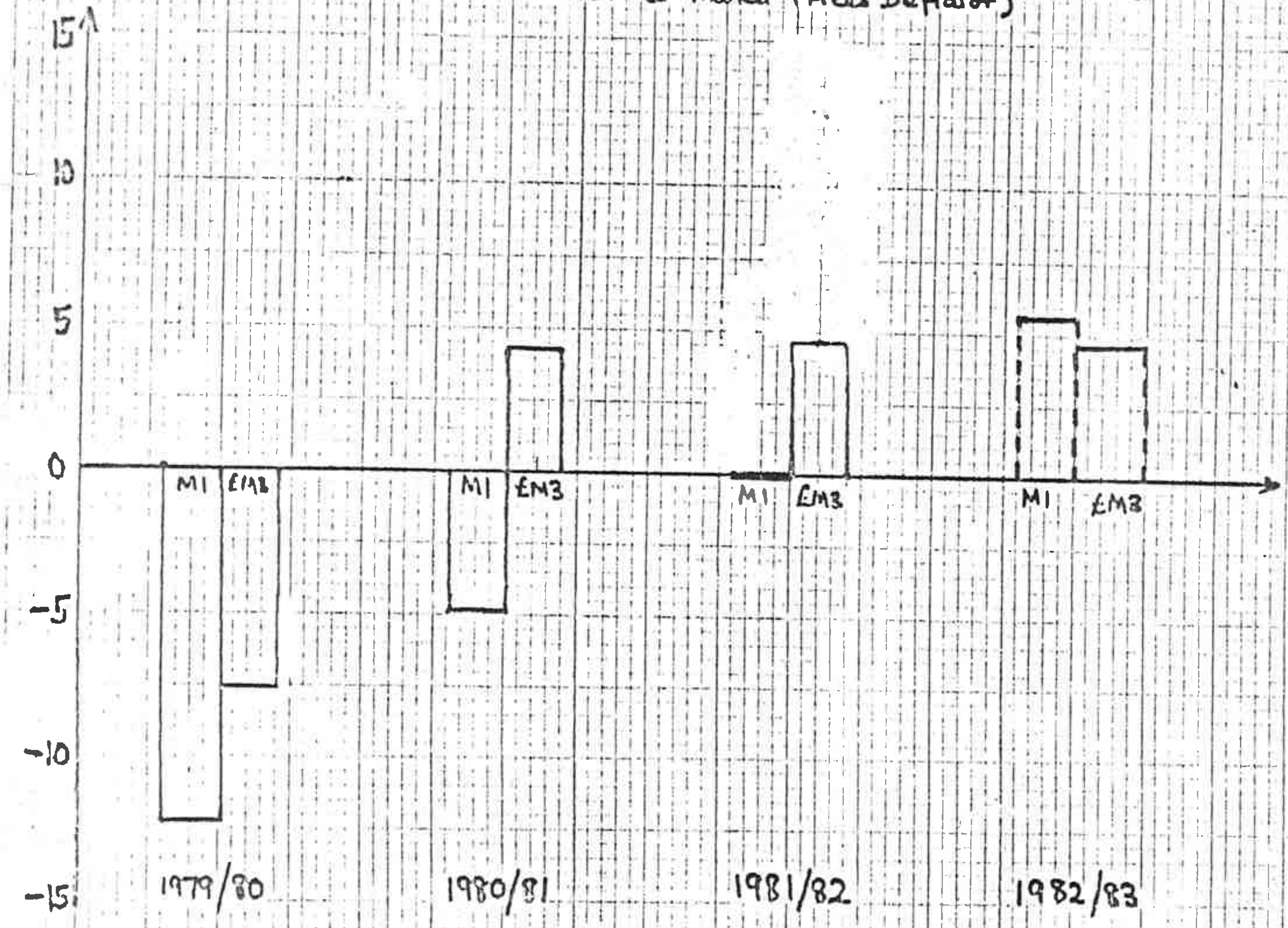
MONETARY GROWTH

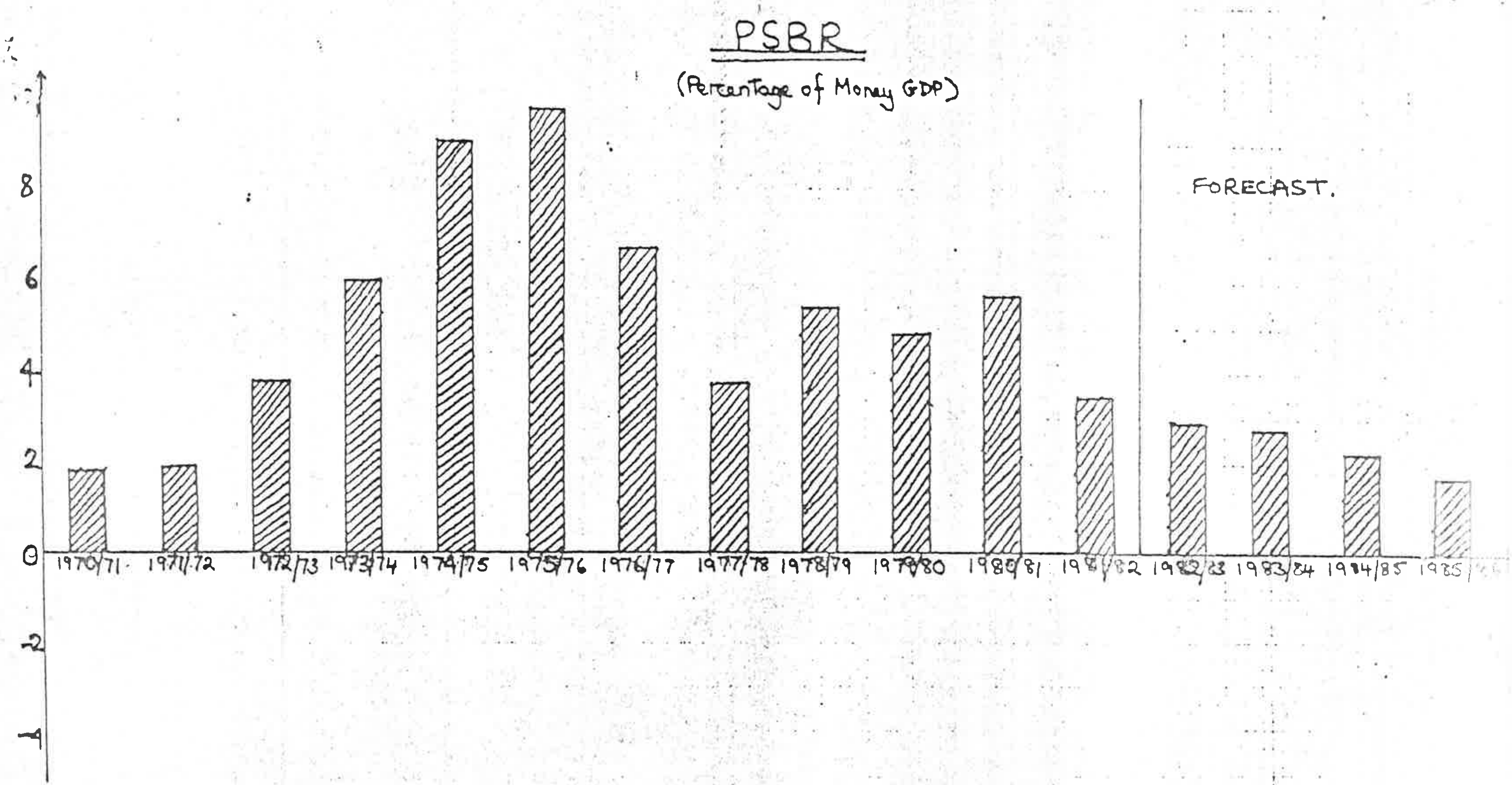
%Change on Year earlier



Growth in Real Money Balances.

(% change through year in nominal money stock deflated by the GDP at Market Prices Deflator)




PSBR
(Percentage of Money GDP)
FORECAST.
8
6
4
2
0
-2
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1970/71
1971/72
1972/73
1973/74
1974/75
1975/76
1976/77
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1978/79
1979/80
1980/81
1981/82
1982/83
1983/84
1984/85
1985/

A35

From: P E MIDDLETON
21 February 1983

Chancellor of the Exchequer

cc Economic Secretary
Sir Douglas Wass
Mr Burns
Mr Cassell
Mrs Lomax
Mr Ridley

MTFS MEETING WITH THE GOVERNOR

You might like to go through the following points with the Governor:

The MTFS

a. General points on the tone of the first 9 paragraphs. The precise words we use to describe the profile of monetary developments during the past year is still being discussed with the Bank.

b. Monetary Policy (paras 10-13)

i. Are the ranges in Table 3 agreed; they are a reiteration (and extension by a year) of the previous MTFS. The Governor is unlikely to dissent.

ii. Should the target for 1983-84 be 7-11 (as in para 11). It has informally been agreed with the Bank that the target should (like this year) be for 14 months starting in February.

iii. Para 11 raises the question about what can we say about monetary growth - and inflation - beyond the MTFS period.

c. Fiscal Policy (paras 14-18)

i. Is the path for the PSBR in para 17 about right. The Governor is unlikely to argue for lower PSBRs as a proportion of output.

ii. Is the wording in para 18 alright - describing the profile for inflation and output

d. Expenditure and Revenue (paras 19-21) do not really concern the Governor - though you may wish to ask if any points strike him.

e. The conclusion depends on the conclusion reached earlier about what could and should be about future intentions as

448/2

regards lowering inflation. But the Governor will have views on the right concluding line.

Other Matters

At the beginning or the end we ought to have a couple of minutes on the markets. The relevant points are:

a. The Governor's letter of 18 February seems quite acceptable it was broadly agreed at my meeting last week at which Alan Walters and the Bank were present.

b. But sterling got off to a tricky start. The oil market is still troublesome and we shall have some explaining to do over the trade figures on Thursday.

c. As a precaution we need to ensure that we can keep the market liquid if pressure develops on interest rates (there are no signs of this at present). This points to extending the arrangements for gilt repurchases which have been in operation to carry us over the revenue season. If so it would be best to do this tomorrow; we would not want it to appear to be anything to do with the trade figures.

PEM

P E MIDDLETON

BOE

A35

RECORD OF A DISCUSSION ON THE MEDIUM TERM FINANCIAL STRATEGY AT 2.15PM ON 21 FEBRUARY AT THE TREASURY

Present:	Chancellor	Governor	Professor Walters
	Economic Secretary	Mr George	Mr Cassell
	Sir D Wass	Mr Loehnis	Mr Kerr
	Mr Burns	Mr Goodhart	Mrs Lomax
	Mr Middleton		

The meeting considered the draft of the 1983 MTFS which had been circulated with Mr Burns' minute of 18 February.

2. The Chancellor suggested that the key issue was the appropriate target monetary ranges for 1983-84. It had been agreed that the target period should be 14 months, starting in February: the issue was whether the ranges should be 7-11, or 6-10. The latter might perhaps have a better impact on expectations about inflation.

3. The Governor thought it important to maintain consistency in successive MTFSs: the fact that RPI inflation had fallen faster than expected did not constitute a case for further ratcheting down the deceleration of monetary growth. And to go for a range of 6-10 would on the one hand cause concern by appearing to damage the prospect of recovery: it might, on the other hand, also raise issues of credibility. A range of 7-11 looked achievable, but to go for a lower range would probably necessitate adopting a separate, and higher, range for M1. Mr George added that the market reaction to 6-10 would be unfortunate, for it would imply that the task of reverting to a declining interest rate path would be harder.

4. Sir Douglas Wass and Mr Burns agreed with the Governor. To ratchet down to 6-10 would be seen as reducing the headroom for real growth. Professor Walters however thought that to stay with 7-11 would suggest acceptance that the process of working inflation out of the system would be long and slow. To go for 6-10 would

/signal greater

5B/2

signal greater resolve, and would have considerable symbolic value. If it was thought necessary to hold to 7-11 for 1983-84, it would be as well to move to 5-9 and 3-7 for the two subsequent years.

5. In further discussion, it was suggested that the markets expected the Government to hold to the path shown in the 1982 MTFS, and would find it difficult to reconcile a lower path with lower interest rates and higher output; that lowering the target ranges now could entail a significant tightening of policy in due course; that to the extent that inflation was likely to rise during the year the 7-11 range would impose a tighter discipline; and that a lower range would be likely - at least in the short term - to lead to higher interest rates.

6. It was agreed that the balance of advantage lay in retaining the path shown in table 3 of the draft MTFS, ie ranges of 7-11 in 1983-84, and 6-10 and 5-9 in the two subsequent years.

7. The meeting then considered a number of drafting points. It was agreed:-

a. that the discussion of M1 in para 7 should be condensed;

b. that the last sentence of para 11 should be omitted, but that the first sentence of para 12 should be subsumed in para 11, which should also set out the agreed target period;

c. that the reference, in para 13, to the exchange rate assumption deserved further study. It was argued that the reference to "no major change" could be construed as implying expectation/acceptance of a further 10 per cent fall; though it

was noted that

was noted that its replacement by a new phrase would be seen as significant, and might be no less likely to provoke questions;

d. that the PSBR figures in para 17 were provisional, and that decisions would be taken in due course in the light of a further forecast; and

e. that a full discussion of the relationship between the GDP deflator and the RPI might be required in para 18, or a foot-note to para 18, depending on the extent of the discussion in part 3 of the FSBR.

It was noted that the Bank would submit detailed drafting suggestions.

8. At the conclusion of the meeting, the Chancellor thanked the Governor for his letter of 18 February on short term interest rates. He accepted that in the light of current uncertainties, and particularly developments in the oil market, it would not be appropriate at present for the Bank to seek to bring down the general level of rates. But it was of course agreed that the Bank would resist any renewed threat of higher rates.

JOK.

J O KERR

22 February 1983

Distribution:

Those present

Chief Secretary	Sir A Rawlinson	Mr Kemp
Financial Secretary	Mr Littler	Mr Monck
Minister of State (R)	Mr Byatt	Mr Odling-Smee
Minister of State (C)	Mr Cassell	Mr Ridley
	Mr Evans	Mr Shields

IMMEDIATE

A31

NOTE OF A MEETING HELD IN THE CHANCELLOR'S ROOM, HM TREASURY ON MONDAY 28 FEBRUARY 1983 AT 2.40PM

Those Present:-

Chancellor of the Exchequer	Mr Basnett)	
Chief Secretary	Mr Chapple)	
Mr Burns	Mr Drain)	
Mr Middleton	Mr Gill)	
Mr Bailey	Mr Jarvis)	
Mr Kemp	Mr Jenkins)	TUC
Mr Hall	Mr Wood)	
	Mr Murray)	
	Mr Lea)	
	Mr Callaghan)	
	Mr Barber)	
	Mr Cave)	

TUC BUDGET REPRESENTATIONS

Mr Basnett, speaking on behalf of the TUC Economic Committee, said that the Committee had met the Chancellor a number of times since 1979 and each of the meetings had followed a similar pattern. The TUC had urged Treasury Ministers to expand the economy and reduce unemployment. They had stressed that if the Government failed to take action, more jobs and production would be lost and the recession would deepen. However, the Chancellor had always claimed that the Government had no alternative but to persist with the same strategy. On each occasion he had suggested that recovery was in sight but it had never materialised. However, at the last meeting the TUC had noted that all such traces of optimism had disappeared from the Chancellor's remarks. The Government appeared to be looking forward only to continuing stagnation and a rise of 300,000 in the numbers of unemployed. The TUC by contrast had not lost their optimism about the prospects of recovery. Their plea to the Chancellor to change his Budget policy was based not on rhetoric but on an appeal to the facts.

/2. Mr Basnett

2. Mr Basnett said that since the TUC's Economic Review had been published the Government had produced its White Paper and the press was full of stories that the Chancellor was planning a give-away Budget. The TUC would like to think that the Chancellor was contemplating an expansionary Budget but they remained sceptical. He noted that at the time of the Autumn Statement, the Chancellor had claimed that a fiscal adjustment of £1bn would not be expansionary but would simply reflect the PSBR undershoot. The Public Expenditure White Paper had reinforced this statement by showing that total public spending had fallen £2bn below plan. The Economic Committee therefore invited the Chancellor to confirm that a Budget boost of £2-3bn would not be expansionary but neutral in its effect. The Committee also invited the Chancellor's views on the TUC's argument that the starting point for any analysis of the Budget's effects must be based on the assumptionof full indexation of taxes, duties and benefits and the assumption that there would be no claw-back. The TUC's own proposals were set out in the Economic Review. They had been tested on the publicly available version of the Treasury model which had revealed that they would indeed promote recovery and that the trade-offs implicit in the strategy were favourable. In assessing the measures, the TUC had paid particular attention to their effects on inflation, productivity and competitiveness.

3. Mr Basnett suggested that it was not possible to conduct a sensible discussion on the question of how far the Budget should be weighted towards assistance for industry and how far towards help for individuals. The TUC believed that the level of effective demand in the economy determined industrial production more than any other factor, although they acknowledged that the balance of expenditure became increasingly important the lower the level of demand fell. They feared that the effects of a consumer boom would be dissipated in higher imports. It was for this reason that their own proposals had focused on an increase in public investment which would have a lower import content. The Committee

/would

The Committee would be interested to know whether the Chancellor was satisfied with the balance of expenditure in the economy or whether he felt that the Government was helpless to influence such factors.

4. Mr Basnett said that the TUC appreciated the impact which developments in the world economy had on the UK. They were not proposing that Britain should engage in a policy of competitive devaluation but rather that the Government should actively seek to foster co-ordinated expansion. They would therefore be interested to see what the Chancellor could achieve as Chairman of the IMF Interim Committee and what the Government's stance would be at the Williamsburg Summit. They would like to have his estimate of the level of unemployment at the end of 1983 and also his assessment of the effect of the recent fall in oil prices.

5. Finally, Mr Basnett recalled that when the Chancellor had met the TUC before the 1982 Budget he had said that he would like to open up the process of decision making. The TUC welcomed the greater amount of information contained in the Autumn Statement but this fell far short of a Green Budget. Mr Basnett suggested that the exercise recently undertaken by the IFS demonstrated what might be done to draw up real options for alternative Budget strategies. The Committee were concerned that the Government was still operating within the constraints of a Medium Term Financial Strategy set three years ago and that it had taken no account of any developments in the real economy since then. The TUC's own approach stood in sharp contrast.

6. The Chancellor said that for his part, he found the meetings with the TUC helpful and valuable. He would welcome more rather than fewer meetings since he believed they helped to broaden the area of common ground. He noted the Economic Committee's wish to

/open up the decision

open up the decision-making process. A similar wish on the part of the Government had underlain the publication of the Autumn Statement but decisions would always ultimately have to be taken by the Government itself. He shared the TUC's anxiety about the current level of unemployment. He himself wanted to see sustained growth in the economy which would offer genuine job opportunities However, developments in the domestic economy must be placed in a world context. Almost all countries found themselves constrained by the realities of the world situation. The TUC would be familiar with the charts which the CBI had presented to the NEDC the previous summer showing how the loss of both export and domestic markets had led to a loss of jobs at home. He referred to the disintegration of the fixed exchange rate system, largely attributable to excessive US budget deficits, and the problems now being experienced by some of the major oil producers. He appreciated that the constraints of the world situation posed problems for union leaders as well as for Governments. Yet if Governments ignored the need to restore stability to both the national and international framework, the position was bound to deteriorate and he referred to the experience of France. It was for this reason that the British Government had endeavoured with its Medium Term Financial Strategy to achieve for the UK budget deficit that which the US administration had failed to do for its own. The MTFS had been reappraised and modified both in 1981 and 1982 to take account of changing conditions but a strategy of this kind was essential if the economy was to move in the right direction.

7. Turning to the TUC's questions, the Chancellor emphasised that any fiscal adjustment in his 1983 Budget would not be a consequence of the 1982-83 PSBR undershoot. Of course, lessons could be learnt from the underspend of capital projects in the current financial year but measures for 1983-84 would be viewed

/on their merits

on their merits in the light of the Government's objectives. The Chancellor emphasised that he had no intention of introducing a give-away Budget but he noted that the TUC's own proposals were directed predominantly towards increases in consumption. Like all its predecessors, the present Government was not prepared to give forecasts of unemployment but the Chancellor agreed with the TUC on the need to see an increase in effective demand. Real demand had risen by about 3% over the last year and a similar rise was forecast in the Autumn Statement. In January the demand for cars had reached a record level. It was vital that this increase in demand should be met by increased production of domestic goods and services at competitive prices. He welcomed the fact that the TUC would assume full indexation of taxes and duties in their analysis of the Budget. Benefit rates did not form part of the Budget proper but the Chancellor commented that it was useful that the TUC had acknowledged that they should be taken into account in the Budget arithmetic. He drew attention to the Government's commitment to protect the real value of benefits during the present Parliament. Any changes over and above this would depend upon what room for manoeuvre he had in March. Finally, he referred to the effect of the oil price fall. The position was still unclear and account had to be taken of a number of factors. The fall in the oil price would in itself reduce oil revenues but to the extent that it also induced a fall in the £/$ exchange rate, there would be some offset. Reductions in the oil price could also encourage industrial activity which in itself would generate additional revenue.

8. Mr Chapple pressed the Chancellor to be more specific about the employment outlook. The Chancellor said that the rise of 300,000 in the numbers of unemployed to which Mr Basnett had drawn attention was not a forecast but an assumption made by the Government Actuary. He would not be announcing any revised assumptions at the time of the Budget but his statement would of

/course contain

course contain passages on the general economic outlook and would make qualitative,if not quantitative references to the unemployment prospect. He noted that although world growth had fallen in 1982 it was likely to rise in the current year and that the domestic forecast produced at the time of the Autumn Statement also gave grounds for believing that the rate of increase in UK unemployment would at least not accelerate further, although it was not possible to tell when the level would actually fall. In the light of this, Mr Chapple voiced his concern about overseas purchases made by the public sector. He referred in particular to the cable laying ship which the CEGB were buying from Korea. The Chancellor emphasised the UK's interest in maintaining an open world economic system. He pointed out that our own industry was heavily dependent on large overseas contracts. That said, the Government's general policy was to encourage the public sector to purchase from domestic sources wherever possible, although the UK's international obligations meant that this point could not be given great publicity.

9. Mr Murray expressed his concern that the Government no longer regarded full employment as a policy objective. In its attempt to reduce the rate of inflation, it had been prepared to take risks on the level of unemployment. In putting forward their own strategy, the TUC had preferred to take risks on the balance of payments and on inflation. They had emphasised the importance of taking co-ordinated action at an international level in order to avoid the problem that the UK might get out of step with other countries. Their proposals did not ignore the problem of competitiveness but stressed the need for joint action. The Economic Review thus enquired what risks it would be reasonable for the Government to undertake, how other countries could be encouraged to participate in co-ordinated action and what role the unions might play.

10. The Chancellor emphasised his passionate and manifest concern to

/reduce the level

reduce the level of unemployment but repeated that any attempt to stimulate activity which also provoked an increase in inflation would jeopardise the Government's chances of reducing unemployment. He wondered what would happen to pay and wages under the reflationary package which the TUC advocated and enquired whether this point would be covered in the proposed National Economic Assessment. Mr Murray said that the National Economic Assessment would cover all such issues but he pointed out that it was important to given the unions a more positive role than simply holding down pay; they also had an interest in increasing productivity, for instance. The Chief Secretary noted that there had been a 13% improvement in productivity since 1980. Mr Murray commented that this was a cylical phenomenon and Mr Lea drew attention to the diagram on page 15 of the Review which showed that productivity was now below the trend it had been on in the year before the Government took office. The Chancellor noted that nevertheless the rise in productivity was still ahead of the cycle.

11. Mr Basnett suggested that in considering the question of competitiveness, it was unfair to focus solely on pay. The Chancellor listed a number of the measures which the Government had introduced to reduce industry's costs but commented that if the Germans were prepared to endorse the case for pay moderation, notwithstanding the rise in unemployment in Germany, the UK should be willing to do the same. He recalled that the TUC had been pressing for a 10% fall in the exchange rate in the summer, this had now effectively taken place. He wondered whether they would recommend a further fall. Mr Murray replied that the TUC would welcome a further depreciation against the Deutschemark and the yen but the Chancellor pointed out that it did not lie within the Government's power to achieve this. Moreover, depreciation would add to industry's costs and so competitiveness could only be secured through a lower exchange rate if pay was kept under even tighter control. The Chief Secretary

/wondered

wondered how the Economic Committee thought that the further reduction in sterling could be achieved. Mr Murray stressed that the TUC had no target for the exchange rate and would not actively seek to push the rate down. However, if the measures they were proposing produced a fall in the rate, they would not attempt to counteract it.

12. Mr Lea explained that the Economic Committee had examined the constraints on their 3-5 year expansion programme and devised policies which could be put in place so that the strategy did not have to be abandoned because a crisis intervened. The Chancellor asked whether the TUC would accept that they must take some account of market reactions to their policies - for instance, on the level of the PSBR. Mr Murray thought that this should be less of a problem if a number of countries committed themselves to co-ordinated expansion. The Chief Secretary enquired whether the TUC would still recommend proceeding with their programme if attempts to secure international co-ordination failed. Mr Murray said that this would depend upon the circumstances but that he believed the proposals should be implemented nonetheless.

13. The Chancellor said that he hoped he had left the TUC in no doubt about his concern over the level of unemployment. Mr Murray replied that doubts remained. The Government were too complacent about the current situation. Mr Basnett commented that despite the reduction in inflation, unemployment was still very high and there was no sign of any improvement in the situation. Mr Murray asked whether, if the Government had known the unemployment outcome, it would ever have embarked on its current strategy. The Chancellor said that there was no genuine alternative to the course the Government had taken. Other countries had attempted to introduce different policies but had been forced to abandon them when they had not produced the right results. Mr Murray enquired what the Chancellor saw as the source of any increase in real demand. The Chancellor said that the fall in inflation should lead industry to take a more optimistic view

/of the

of the future and thus to increase investment and production. He noted that the UK was now seen as one of the few countries whose economy would be growing in 1983.

14. In conclusion, Mr Basnett thanked the Chancellor for meeting the Economic Committee. He hoped that his March Budget would be designed to create jobs and not votes. The Chancellor in reply said that he believed that the survival of democratic government depended on the integrity of governments in demonstrating that they took a long-term view and that economic problems could not be solved more easily or quickly than reality suggested.

15. The meeting closed at 3.50pm.

MOM

MISS M O'MARA

Distribution:

Those present
Financial Secretary
Economic Secretary
Minister of State (C)
Minister of State (R)
Sir D Wass
Mr Lovell
Mr Cassell
Mrs Lomax
Mr R I G Allen
Mr Ridley

DR. JUR. OTTO GRAF LAMBSDORFF
BUNDESMINISTER FÜR WIRTSCHAFT

Bonn, 18. April 1983

EXCHEQUER
25 APR 1983
ACTION: Mr Littler.
COPIES TO: Mr Unwin. Mr Kemp. Mr Lavelle

Mr Burns
cc. Mr Littler
Mr Kemp
Mr Lavelle. GH. 26/iv 26/4

Chancellor of the Exchequer,
the Right Honourable
Sir Geoffrey Howe QC MP
Parliament Street

London SW 1

This is the way in which to present our fiscal adjustment, without becoming a locomotive? [illegible] to see, in light of my earlier comment

Dear Chancellor of the Exchequer,

Thank you very much for your detailed message about the 1983/84 budget presented to the House of Commons on 15 March, which you sent me through Ambassador Sir Jock Taylor.

Your additional information on the key targets of economic policy in the United Kingdom have been most useful to me. Your latest budget clearly reflects the really considerable achievements of your domestic economic strategy which has in recent years been designed especially to control inflation mentality, excessive public sector borrowing and too large a public deficit.

As far as I can see, the 1983/84 budget should be expected to have a slightly expansive effect on overall demand due to the tax and surcharge cuts for which it provides and the proposed measures to enhance the employment situation and to strengthen the competitiveness of industry. This is entirely in line with a consistent and prudent economic strategy at international level with a view to strengthening the fundamentals permitting sustained economic recovery.

I am very much looking forward to intensifying, at the next German-British summit, our exchange of views on current economic policy problems.

Yours sincerely,