PREM 19/171

PART 4

SECRET

Confidential Filing

Economic Strategy
Pay and Prices. Monthly Economic Report.

ECONOMIC
POLICY
Pt 1 May 1979
Pt 4 Oct 1979

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~12-10-79~~							
~~22. 10. 79~~							
~~23-10-79~~							
~~2-11. 79~~							
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PART ~~4~~ 5. begins:-

Misc 14(80) 6 1·2·80.

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TO BE RETAINED AS TOP ENCLOSURE

Cabinet / Cabinet Committee Documents

Reference	Date
E(79) 13th Meeting, Minute 2	23/10/79
E(79) 63	30/10/79
E(EA)(79) 68	15/11/79
E(EA)(79) 22nd Meeting, Item 2	19/11/79
MISC 14(79) 3rd Meeting, Minutes	26/11/79
E(79) 72	30/11/79
E(79) 84	11/12/79
E(79) 87	31/12/79
E(80) 1st Meeting, Item 3	15/01/80
E(EA)(80) 6	21/01/80
E(EA) 80 3rd Meeting, Item 2	23/01/80
MISC 14(80) 4	24/01/80
MISC 14(80) 6	28/01/80
MISC 14(80) 7	29/01/80
E(80) 5	30/01/80

The documents listed above, which were enclosed on this file, have been removed and destroyed. Such documents are the responsibility of the Cabinet Office. When released they are available in the appropriate **CAB** (CABINET OFFICE) CLASSES

Signed OWayland Date 2 March 2010

PREM Records Team

Papers removed from file

Date 8.12.80

MISC 14(80)5

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Econ Pol

Department of Employment
Caxton House Tothill Street London SW1H 9NA
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Switchboard 01-213 3000

T P Lankester Esq
10 Downing Street
LONDON SW1

30 January 1980

Dear Tim,

PAY PROBLEMS IMMEDIATELY AHEAD

Following the word we had this morning, you might find the attached table useful. It sets a scene until the end of February.

see Nat. Ind (Steel) Pt 4

A note on the Welsh strike is also attached.

Yours
Douglas.

D B SMITH

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PUBLIC SECTOR NEGOTIATIONS JANUARY- FEBRUARY 1980

Likely Settlement Date	Normal Operative Date	Industry	Comments
January	1 November	British Leyland (cars) (120,000)	Company offer of 5% (10% for top skilled group) conditional on acceptance of changes in working practices to improve efficiency is subject to ballot, result expected 12 February.
January/ February	1 January	London Docks	Offer of 12% against claims of 20-40%. TGWU imposing overtime ban and one-day strikes; NASD threatening strike from 11 Feb. Cash limit tight. PLA threaten to close India and Millwall docks from 1 July if manpower reductions and improved performance not achieved.
January	1 January	British Shipbuilders (80,000)	Unions' claim is for 20% plus reduced hours. No offer has been made. Will await outcome of steel.
January	January	British Aerospace (40,000) (various plants)	Negotiations in progress at plant level. Settlements not expected to be out of line with the 14% (covering periods from 14-17 months) reached at Chester.
End-January	7 December	Water Services Manuals (33,000)	Union seeking to catch up with Electricity and Gas and a settlement seems likely to exceed 20%. 17% offered on 28 Jan, further offer expected 1 Feb.
End-January February	Mid-January	Gas Supply Manuals (40,000)	Large claim lodged. Negotiations in train. Outcome not expected to be much under 20%.
January/ February	13 December	NHS Ancillaries (213,000)	13% offered on 18 Jan acceptance likely (in line with LA manuals.

Likely Settlement Date	Normal Operative Date	Industry	Comments
January/ February	1 January	NHS Ambulancemen (17,000)	13% offered on 29 Jan and being put to members. Acceptance possible.
January/ February	4 November	Local authority craftsmen (various groups, 95,000)	13% offered to all groups. Rejected by building workers (81,500) but unions are recommending acceptance to engineers and electricians. All groups expecting comparability studies (Standing Commission or in-house) by about April
January/ February	January/ February	Rolls Royce Ltd (30,000) (various plants)	Negotiations in progress. Some settlements, based solely on extra productivity, have been reached at 15-25%.
Mid-February	8 Sept 1979	British Waterways Board non-manual staff (800)	Referred to Standing Commissio on Pay Comparability 12 June 1979. Report likely mid-February.
February	1 January	NHS craftsmen (13,000)	No offer yet made. Electricians will seek to follow electricial contracting industry, and others to follow their lead.
February	1 January	NHS building operatives	No offer yet made. Unions seek inclusion in the common grading structure covering all other NHS maintenance workers; management prepared to negotiate this if based on a job evaluation.
February (not likely but possible)	17 March	Electricity Supply manuals (96,000)	Claim not yet submitted.
February (not likely but possible)	1 February	Electricity Supply Technicians/ Engineers (29,000)	Claim not yet submitted. Likely to await-and match - the electricity manuals settlement.

CONFIDENTIAL

Ref. A01130

PRIME MINISTER

Strategy Proposals
(E(79) 84)

BACKGROUND

In June last year you asked a number of Ministers to make specific proposals for initiatives on the Government's Economic Strategy. Ministers put forward about 75 proposals, mainly concerned with improving the supply side of the economy. E Committee considered these proposals in July (E(79) 6th Meeting, Item 4), agreed a division into about 25 priority items and 50 non-priority items, and commissioned MISC 14, under the Chancellor of the Exchequer, to be responsible for the follow-up work.

2. The Chancellor reported back to E Committee on the priority items last October (E(79) 13th Meeting, Item 2). His present paper deals mainly with the non-priority items.

3. The original distinction between priority and non-priority items was that the priority items were likely to show results more quickly, not that they were necessarily more important than the non-priority items. So some of the topics in this paper are of major importance. In addition, MISC 14 have sifted through the non-priority items and have identified seven themes, some covering more than one item, on which they suggest that attention should be concentrated.

HANDLING

4. You will want the Chancellor of the Exchequer to introduce his paper. There are three issues for decision, set out in his paragraph 19, and you might take them in turn -

(i) Does the Committee agree with the selection of items for special attention?

(ii) If so, does the Committee endorse the specific recommendations for action or further work on them?

(iii) Does the Committee endorse the proposals for action on the remaining non-priority items set out in Annex B?

5. The Chancellor also gives a progress report on the priority strategy items, at Annex A to his paper, of which the Committee is simply invited to take note.

Does the Committee agree with the selection of items for special attention?

6. You will want to see whether anyone has any comments on the selection. I suggest that you aim to keep this part of the discussion fairly short, with a strong presumption in favour of keeping the classification much as it is. The classification does not materially affect what happens next. But it is useful to follow up with particular vigour. The existing list is not sacrosanct, but if it becomes too long its point will be lost. On the other hand I should be suspicious of any attempts by sponsoring Ministers to get their items taken off the list.

Does the Committee agree with the recommendations for action or further work on the selected issues?

7. I think you will need to go through the seven topics (plus any which have been added) item by item.

I. Education Training and Industrial Needs

8. The main point here is that the CPRS will shortly be submitting a report on this subject to Ministers. The Chancellor proposes (paragraph 9) that the report should first be considered by MISC 14, plus the Secretaries of State for Employment and Education (to which I would add Scotland because of the differences in the Scottish education system). You might invite the Committee to agree to that proposal, and ask MISC 14 to report back to the Committee as soon as possible.

9. On the detailed points, you will want the views of the Secretary of State for Industry on the Finniston Report as well as on the subject in general, the Secretaries of State for Education and Science and for Scotland on the educational aspects, and the Secretary of State for Employment, particularly on apprenticeships. As there is no need for firm decisions at this stage other contributions can be kept fairly short and simply designed as guidance for MISC 14.

II. Incentives to work

III. Redundancy payments

10. Officials are working on both these subjects and will report back to Ministers as soon as possible. There are no decisions for the Committee to take at this stage.

IV. Financial Management of Companies

11. The report on current cost accounting will be coming to E(EA) shortly. The other proposed actions are mainly for the Secretaries of State for Industry and for Trade, and you might check that they are content with the proposals.

V. Small Firms

12. This item refers to a number of pieces of work by officials which should come back to Ministers as soon as possible. There is nothing for the Committee to decide at this stage, but it may be worth stressing the need for quick and positive action.

VI. Public Purchasing Policy

13. We are expecting the Chancellor of the Exchequer and the Secretary of State for Industry to submit a paper on this subject to E Committee later this month. There is no need for discussion at this stage.

VII. Collaboration between Public and Private Sectors on Exports

14. The recommendation is directed mainly to the Secretary of State for Trade so you will want to see what he thinks, and then see if other Ministers want to join in.

Does the Committee endorse the proposals for action on the remaining non-priority items set out in Annex B?

15. Annex B contains a number of recommendations, mainly for officials to consider further and report back, but also in some cases for individual Ministers to take action direct. I doubt if any of these recommendations will be contentious, and I am sure you will not want the Committee to discuss them in great detail. But you will want to ask if anyone has any comments. If not, the Committee might give a blanket endorsement.

The priority items

16. You might also see if anyone wants to comment on any of the priority items at Annex A, though there is no need for decisions on these.

CONCLUSIONS

17. Subject to the discussion, you might guide the Committee to -

(i) Agree with MISC 14's selection of seven policy issues for special attention.

(ii) Agree with MISC 14's recommendations about those seven policy issues (mainly, though not entirely, a question of waiting for further reports).

(iii) Invite MISC 14 to take account of the Committee's discussion, particularly in their own forthcoming discussion of education and training.

(iv) Agree MISC 14's recommendations on the remaining non-priority strategy items in Annex B to the paper.

(v) Take note of the progress on priority items recorded in Annex A.

M.V.
AP

(Robert Armstrong)

14th January, 1980

PRIME MINISTER

AW

I thought it would be helpful to send you a very brief note of the main points which came out of our discussion over dinner last week.

1. THE PROBLEM AND THE KEY TASKS

1.1 We are trying to do something that has not been done before - to make Britain face economic reality, however tough, and to do so in such a way that the Government ~~repay~~ reaps an electoral reward rather than an electoral rebuff.

1.2 If economic turnaround happens faster than expected, then we have lost nothing. It is a matter of insurance to get the necessary second five years.

1.3 We agreed that the strategy can be reduced to three central tasks - economic stabilisation, starting the development of a new trade union role (both of which require Government "toughness") and, thirdly, establishing new voting criteria to help the electorate see that we are being cruel to be kind, not being tough for its own sake.

1.4 The strategy paper now in preparation, which describes these three tasks and how to organise ourselves to carry them out, must also help to unite and educate colleagues. The strategy is very obvious to us but not fully understood or even accepted by all the colleagues. G.H. suggested I talk it through with colleagues on a one-to-one basis, as we did with Stepping-Stones.

/2. STABILISATION

2. STABILISATION

2.1 This is the one economic result we must be able to offer the electorate if we are to win in 1983/4. Real growth may take longer, but stability is essential.

2.2 Monetary control in a credit economy is extremely difficult. Much (fairly incomprehensible) work being done in the Treasury.

2.3 Given that the monetary levers do not work reliably, more important than ever to get public spending down, since this makes everything else easier.

2.4 My agenda paper referred to "establishing a coherent position on public sector and nationalised industry pay". By this, I did not mean a simple minded standard rate or response. I meant that it was necessary to think through the situations carefully in advance ("crisis management" in section 5 below).

2.5 We discussed gradualism versus the shock package. Shock package meant, for example, de-indexing among other things. The idea is to dramatise, ensure that everyone feels the shock (ie. it's not vindictive or discriminatory) and that we can get a number of tough things all over at once, early, while there is still time for the resulting benefits to flow over the subsequent three years.

3. TRADE UNION ROLE

3.1 The virtual absence of moderate leaders who are really moderate and really can lead means that we have to initiate further reforms which strengthen shop floor moderates against militants.

3.2 Agreed, therefore, that we are only starting with the present Bill. Need a team approach, as in STEPPING-STONES, to generate ideas and momentum. The Department of Employment will be an obstacle.

3.3 We can collect all the ammunition about the affects of union obstruction and re-launch the Stepping-Stones propaganda, while the development of new measures goes ahead.

4. ESTABLISH NEW VOTING CRITERIA

4.1 On the face of it a boring task but probably more difficult than the other two and just as important. The tougher we have to be to put things right, the harder we have to work to make people thank us for it. Not a simple business.

4.2 Keith mentioned the idea of senior Ministers having individual "minority welfare" interests. Also the CPS study on the Labour movement - possibly affecting the way in which political parties are financed.

5. ORGANISE TO MAKE IT HAPPEN

5.1 We talked only briefly on this. I have since discussed first steps with Keith and our report will elaborate.

5.2 We see the need for a steering group (perhaps the Stepping-Stones SG, give or take one or two people); with three task teams for the main tasks (not just for the union reform, as we discussed at dinner) and an initial team to develop a coherent approach to the management of problem events or crises (steel, miners, railwaymen, etc). We tried to use BL as a model for this, aiming to establish with reasonable clarity the problem, political and economic objectives, negotiating strategy, well before action is joined.

5.3 Teamwork is the key, it must involve colleagues to lead the way, selected officials, advisers, Central Office/CRD. This gives a richer mixture of brains and experience, better cohesiveness under fire. Policy Unit's contribution will be to help develop methodical approach, so that team becomes productive.

5.4 With no team approach, it will be a muddle. A team approach without method will also be a muddle. We will need teams, method and time in the diaries to think it through and work it out.

Copies go to Geoffrey & Keith.

JOHN HOSKYNS

8 January 1980

Original returned to J Hoskyns.
Econ Pol.

PRIME MINISTER

THE "LONG CAMPAIGN" PAPER

I attach the first two short sections of the paper and a list of its contents.

I am particularly concerned about the subject of Section 3, "Stabilise the Economy". The sheer power of the process by which inflation and British-style pay bargaining erodes the industrial base and the self-indexing shambles of the public sector and public spending generally, makes mincemeat of our economic policies. It isn't just a matter of cutting expenditure but of uncoupling it from the index, so that the Government does not have a blank cheque commitment to pay, which is quite outside its control. I have commenced on the indexing syndrome (eg Ezra's proposals to the NUM, the NCB's indexed-price contract with the CEGB).

At the same time as indexing all the wrong things, Governments have had a completely closed mind on automatic valorisation, absolute commitment to indexing tax bands; there was the whole farce of funny money budgeting, Government guarantees of public utilities borrowing against the exchange rate risk and so on. We have had 15 years of mental confusion which has all but destroyed the economy.

We will make little progress until we bring the whole thing into a stable state. I gave Keith papers on this in 1977, tried to raise it during the Policy Search Team's work in the first half of 1978, touched on it again in the briefing note (of which I sent you a copy at the time) before Geoffrey Howe's "Fentiman" day in March this year.

I am glad to see that this topic is now high on the agenda, and that CPRS are looking at de-indexing. We may have to grasp some very big nettles indeed in this area. But if we do so, tackling the problem from both ends (cutting the pay-out and raising the pay-in) the big numbers could start to come right surprisingly quickly.

I have sent copies of the attached papers to Peter Thorneycroft and Angus Maude.

JH

JOHN HOSKYNS
14 December 1979

CONTENTS

GOVERNMENT STRATEGY: PAPER NO. 3

1. INTRODUCTION

1.1 This paper suggests a strategic framework for starting the process of economic recovery, including the winning of a second 5-year term, which is essential if that economic recovery is to take place.

1.2 The paper is not intended as an exhaustive shopping list of Departmental policies. It is concerned with the objectives we must achieve, rather than those we would like to achieve.

1.3 The paper takes the ideas originally put forward in the first paper of 12 June 1979 and the second paper of 18 July 1979, developing them in more detail, as the basis for a programme of action which will take us through to 1984.

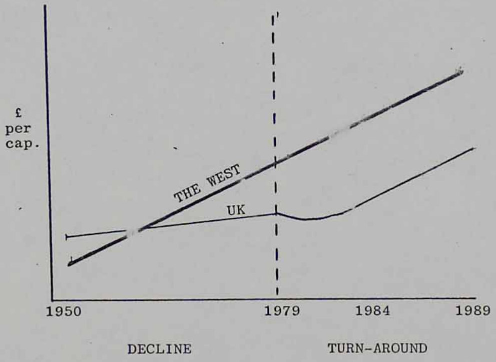
1.4 An important purpose of the paper is to help those colleagues who are less directly involved in "economic turn-around", to see their own Departmental policies in the context of the Government's "must" objectives. It therefore covers ground familiar to those already closely involved. Whether or not the approach proposed is accepted, the chances of success over the next 4 years will depend to a large extent on a shared grasp of the problems we are trying to solve, and a strategic approach which is well understood and fully agreed by all colleagues.

1.5 Like earlier papers, the general tone is one of economic pessimism; the paper assumes that the UK problem is, at any point in time, always greater than it looks; and the chances of any Government solving it, always smaller than most people realise. The emphasis is therefore on "aiming off" to intercept the problem instead of doing, as previous Governments have done, too little, too late.

2. GOVERNMENT'S OBJECTIVES AND STRATEGY

2.1 The Government's objective is to set the country on a self-sustaining economic (and psychological) recovery path. Our dilemma is that it is difficult (we would say impossible) to achieve this objective quickly enough for the fruits of that achievement to help us to win the next election. We have a 5-year term, in which to achieve a 10-year task. To say that we must achieve our objective in 5 years because that is all we have got, is to ensure failure. Instead, we have to break the 5-year constraint, by pursuing a carefully thought out 4-year election campaign alongside the introduction of policies for recovery. An important part of our approach is to make the public understand this dilemma as clearly as we do ourselves.

2.2 In our first Strategy Paper, we represented the total process as an over-simplified diagram:



Since that paper, it has already become clear that the process of stabilisatión will be harder, and the J-curve probably longer, than we had anticipated.

2.3 Economic recovery requires the achievement of two subsidiary objectives:

(i) Laying the basis for the revival of the private sector, during the first 5 years.

(ii) Winning the 1983/4 General Election, so that the private sector revival can really get started in the second 5 years.

2.4 Any democratic Government trying to arrest economic disintegration faces a familiar dilemma: the choice between popular policies or popular results. The greater the problem it has to solve, the riskier it becomes to pursue "low risk" policies. The measures needed to lay the foundations for economic revival are so rigorous that they could lose us the next Election.

2.5 Just as the original Stepping Stones paper of two years ago suggested that the union problem could be turned into an electoral opportunity, so this paper suggests ways in which tough policies may in fact be stepping stones towards winning the next Election.

2.6 These two subsidiary objectives - private sector revival and 1983/4 Election victory - require in turn the achievement of the following tasks, which are dealt with in detail in the remainder of this paper:

<u>SECTION 3</u> STABILISE THE ECONOMY

This description is not compatible with rigorous action — sounds too pla[illegible]

<u>SECTION 4</u> DEVELOP A NEW ROLE FOR THE TRADE UNIONS

<u>SECTION 5</u> UPDATE THE TORY STEREOTYPE

<u>SECTION 6</u> ESTABLISH NEW VOTING CRITERIA

<u>SECTION 7</u> ORGANISE TO MAKE IT HAPPEN

2.7 In addition to these tasks, we are already ambarked on the "Accelerator" programme which is looking at all possible measures to speed up the recovery of the private sector, by removing obstacles to free enterprise and encouraging the start-up and growth of new and small businesses.

2.8 Any analysis of Britain's post-war decline soon reveals a complex network of interacting factors, sometimes cause, sometimes effect. Recovery must have the same characteristics. It will flow from a number of measures interacting together. The essence of any strategic approach is to start with the objective, the destination, and then work backwards, in time, to see what the route to that objective looks like in terms of work to be done. Once that is done, we can decide in detail who is to do what, and when.

2.9 This process of getting ourselves organised to pursue a coherent long-term strategy takes time. With the clock ticking away and only 4 years to go, it also requires nerve. There is a constant temptation to "launch a second front now", but past experience suggests that this simply degenerates into a series of half-cock initiatives, each of which peter out over two or three months leaving people feeling more confused and less energetic as Election year draws closer. Such an approach is clearly seen by the electorate, who are quick to sense a confused and panicky Government - exactly the opposite of what it is looking for in times of stress and strain.

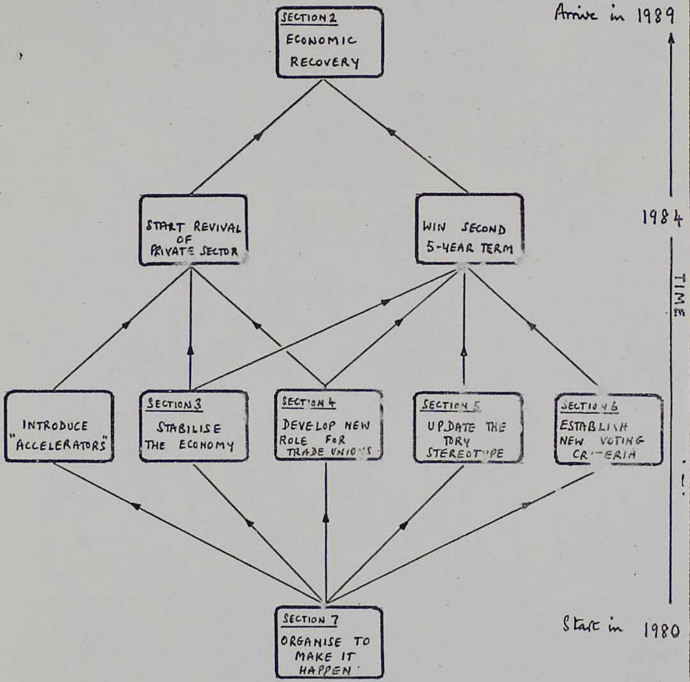
2.10 A strategy is not a laundry list of Government policies. It is a network of measures - policies and messages - assembled into a coherent programme which will, with luck and good timing, trigger new behaviour leading to different results. We can depict this network (which is in fact the structure of this paper) as a simple diagram (see Appendix A).

2.11 Each task of course breaks down into many bits and pieces. But once we have such a framework, we are likely to do a little better (and a little may be the difference between long-term success and failure) in allocating our time, Departmental resources and political capital to doing what matters. The guiding principle should be "Do everything that is necessary, nothing that is not" - simple to say, difficult to do.

The existence of such a framework also gives us a better chance of turning micro-economic problems (eg British Leyland) into political stepping stones.

2.12 Of course the framework and the detailed programme must be regularly modified, on the military principle that "no plan survives contact with the enemy". But that is not a reason for having no plan in the first place.

THE STRATEGIC ROUTE: 1980-1989



Econ Pol Original on:- Public Exp: Pt 7

CONFIDENTIAL

Ref. A0939

PRIME MINISTER

Pay and Price Provisions for the 1980-81 Cash Limits

(C(79) 60)

BACKGROUND

You discussed this paper with the Chancellor of the Exchequer and others at your meeting on Friday. The Chancellor has now circulated it in a slightly amended form. The main difference is the omission of any indication of the 'volume squeeze' on different programmes.

2. There are two issues here: the effect of these proposals on the volume of public expenditure next year; and their impact on pay negotiations.

Effect on the volume of public expenditure

3. Cabinet will be discussing, later on this Agenda, the Chancellor's proposal to re-open the expenditure totals for next year. He is asking for a total reduction of £1 billion. On certain assumptions, the 'volume squeeze' implied in this paper on cash limits could add a further £450 million to this reduction. This would be true if the overall rate of inflation were 17 per cent (as the current forecasts suggest) and the Chancellor's proposals for a 14 per cent allowance in cash limits were accepted. The squeeze would be particularly tight on the Defence Budget, for two reasons:

(i) Experience shows that the rate of increase in defence goods and services is rather faster than that in the economy as a whole (the "sophistication factor"); this is compounded by the fact that goods which would be classified as 'capital' in other programmes, for which the Chancellor proposes to allow between 15 and 16 per cent, are treated as current expenditure on the Defence Budget, and get only 14 per cent.

(ii) The Government is committed to pay whatever increases are recommended by the Armed Forces Pay Review Body (AFPRB) whose report should be implemented on 1st April. This year's report is a straight up-dating one: but recent trends in pay settlements in the private sector suggest that the AFPRB will recommend something nearer 17 per cent than 14 per cent; this would put a further squeeze on the Defence Budget. The Secretary of State for Defence, who believed that he had done a satisfactory private deal with the Chancellor over the size of the Defence Budget, involving provision for the nuclear deterrent, will react adversely to this (see my separate note).

4. There are two ways of easing the Defence dilemma. It has already been agreed that a decision on the uplift factor to arrive at Civil Service pay cash limits for 1980-81 should be deferred until next February so that account can be taken in setting it of the indications which will be then available of the likely outcome of PRU. This arrangement will cover the Civil Service staff in Defence as well as civil servants more generally. A similar operation could be conducted for armed forces' pay relating in their case to the likely outcome of the AFPRB report. The alternative would be to set a higher number now - say 17 per cent - for armed forces' pay only, based on the best guess which can be made of the AFPRB results.

5. Similarly it would be possible, if Cabinet agreed, to set a higher price assumption for Defence expenditure on equipment - say 15 or 16 per cent - on the "capital goods" analogy referred to above. This could be continued with or calculated separately from the armed forces pay factor.

6. The impact of the squeeze on other programmes is smaller: but in the case of the Health Service could be as much as £85 million. Mr. Jenkin is prepared to consider some cuts there, but might argue that the cash limits squeeze involves double-counting. Other spending Ministers, who are affected to a rather smaller extent, might argue the same. To this, the Chancellor will reply that the proposals give a little more leeway than the cash limit applied to local authorities: but this was (as his paper admits) because the local authorities have the alternative of taking the strain of the rates, or of running down cash balances. All in all, Ministers will argue that the Cabinet decided the appropriate volume of public expenditure in the summer. If that has to be reopened, it should be done openly (in the way suggested by the Chancellor in the next paper) and not through the back-door.

Public sector pay

7. One additional reason for settling cash limits at this stage is to put some pressure on public sector pay.

8. Ministers have already agreed the treatment of the nationalised industries and the local authorities. The approach appears to have worked, in the case of the NCB. It may not work so well with the BSC, where other factors have intruded. Negotiations in the local authorities continue: but our latest information is that there is a reasonable chance of a settlement at, or around, the 13 per cent provision built into cash limits for the RSG.

9. The picture in the Health Service is less clear: the negotiators will probably defer a settlement until they see how the local authority talks go. A cash limit for the water industry is being separately negotiated. In the past, the water workers have set the tone for local authority negotiations (and have of course considerable industrial muscle). This year, however, they seem to be biding their time, and there is a good chance that the local authority settlements would be reached without the risk of blackmail from the water workers.

10. It has already been agreed to leave over the cash limit for Civil Service until February. First indications are that the PRU evidence will point to something like 17 per cent. There is a margin for negotiation built in to the system, but even so a 14 per cent limit would be likely to impose a very considerable further volume squeeze.

11. The Government has no option on the armed forces - see above. The other two Review Body Groups (Doctors and Top Salaries) are, fortunately, small in numbers, and can be accommodated within cash limits without too much trouble.

12. Special provision has been made for the outstanding 'Clegg' awards for university teachers and nurses. That leaves the police (who are not subject to cash limits at all) and the fire service (who can probably be fitted into the Home Office overall total) and a few smaller groups like the Atomic Energy Authority (who settled earlier in the year at a figure which it may be difficult to accommodate within the proposed limits).

13. The picture thus seems reasonably containable: but Ministers have had no comprehensive account of the way these different negotiations fit together, and of the pattern which is emerging. You might wish to ask the Chancellor to produce one for a later meeting.

HANDLING

14. You will wish the Chancellor to introduce his paper, and perhaps to ask the Chief Secretary to supplement it. You might then call for comments from some of the big spending Ministers: Social Services; Defence; Environment; Education and Science; Industry; Energy. You might suggest that Ministers distinguish between the effect on the volume of expenditure and the effect on pay negotiations (though there is of course an inter-play between the two). The Chancellor suggests no alternative to his stark 14 per cent: and I think this is what the Cabinet will eventually settle for. But compromise positions may be necessary. Those open to you include:

(i) an extra ½ per cent or so on the inflation allowance all round;

(ii) special provision for the services most affected; notably the Defence Budget and the Health Service. It may be that in the special case of defence the Cabinet may be prepared to indicate a willingness to compromise on the lines suggested in paragraphs 4and 5 above. There is less scope for compromise in Health. Details would best be left to be settled bilaterally between the Chancellor and the Ministers concerned.

(iii) A procedural device: either postponement of publication of the estimates and cash limits (which would inevitably arouse Parliamentary curiosity if not criticism); or some additional overall and unallocated contingency margin which could be publicly identified at the time. Provided that this was not allocated to individual programmes, and remained clearly under the control of the Chancellor and the Cabinet, this need not be too damaging to confidence, though, as compared with the discipline of cash limits clearly set and announced in advance, these expedients are very much second-best.

CONCLUSIONS

15. The outcome of the meeting will be either:

(i) to approve the pay and price provisions proposed by the Chancellor in Annex A to his paper /with any modifications agreed in discussion/;

<u>or</u>

(ii) to invite the Chancellor to discuss with spending Ministers modified cash limits to apply to their particular programmes /in which case you will want to identify the Ministers concerned/;

<u>or</u>

(iii) to invite the Chancellor to consider further procedural modifications of his approach (e.g. a new unallocated contingency margin - see paragraph 14(iii) above) and to bring fresh proposals to the Cabinet at a subsequent meeting;

and <u>possibly</u>

(iv) to invite the Chancellor to bring before the Cabinet a comprehensive paper on progress in public sector pay negotiations in the light of cash limits already set or shortly to be announced.

ROBERT ARMSTRONG

(Robert Armstrong)

<u>12th December, 1979</u>

Ref: A0937

Original on:- Public Exp: Pt 7

CONFIDENTIAL

PRIME MINISTER

The Economic Outlook and Public Expenditure
(C(79) 61)

BACKGROUND

The Chancellor of the Exchequer has now circulated the paper which he discussed informally with you and others on Friday. At that meeting there was general support for the Chancellor's proposals, although Mr. Prior (who left before the end) is not wholly reconciled, and can be expected, I think, to voice his reservations in Cabinet. The Chancellor has not yet had the separate talks with Mr. Pym (who only gets back on Wednesday night) and Mr. Heseltine envisaged last Friday. Nor have any further approaches been made, so far as I know, to other members of the Cabinet. But the Chancellor's intentions have been well-trailed in the Press, and his move will come as no surprise. His paper contains the £1 billion target for 1980-81 and a £2 billion target for later years. But, at your request, it does not contain detailed proposals for individual programmes.

HANDLING

2. I imagine you will want the Chancellor to introduce his paper briefly. You might thereafter like to take advantage of Friday's softening-up meeting by inviting some of the participants to speak. A possible sequence would be: Sir Keith Joseph or Mr. Nott (broadly allies); Mr. Prior (likely to be opposed); Mr. Jenkin or Mr. Whitelaw (supporters again). But after that, you will want to throw the discussion open, and give most members of Cabinet a chance to join in.

3. To judge by Friday's discussion, these are the points which may come up:-

(i) The uncertainty of forecasting the PSBR. This is not an argument for inaction because the penalties of guessing wrong are too high. Most commentators now believe - with the Chancellor - that the

PSBR is likely to be unacceptably high next year, and are expecting corrective action. It will be easier to compensate later for overkill now, than to fail to do enough now and have to cut expenditure or increase taxes by more later.

(ii) In a depression, the Government will still be able to finance a PSBR of this kind at reasonable interest rates, and/or without adding to the money supply. The same arguments hold: the Government cannot afford to take a risk. Although there are some slight signs that the rise in interest rates is working through to bank lending, the Government borrowing requirement remains disturbingly high.

(iii) In a recession, the appropriate response is to allow the PSBR to increase somewhat. This argument would be stronger if the PSBR was not already uncomfortably high. But the Chancellor has to finance the real PSBR, and not some hypothetical constant-employment PSBR, in the markets.

(iv) If the PSBR must be reduced, the answer is to increase taxation not to cut expenditure. The scope for increasing direct taxation is severely limited, particularly if the Chancellor decides not to reverse the 'Rooker-Wise' amendments and increases would in any case be quite contrary to the Government's broad strategy Because of the big VAT increases this year, there is no scope here - though the yield will rise with inflation. Petrol, alcohol and tobacco are the traditional remedies. A respectable case can be made for an increase in petrol duty, on energy saving grounds; the duties on alcohol ought at least to keep pace with inflation. But all indirect taxation affects the RPI, and it may seem odd to seek to counter inflation by deliberately - and again - increasing consumer prices. Other remedies - PRT, NIS, or increased Employee Contributions, are worth considering. But all except PRT feed through to industrial costs.

(v) If expenditure must take the strain, we should take credit for a reduction in the EEC Budget. Mr. Walker is bound to revert to this point but the only sensible answer is 'not until we are sure of it'.

(vi) The Defence Budget should take its share. I have sent you a separate minute about the minefields in this area, through which you will need to step very carefully. You will need to bear in mind that the Cabinet does not yet know of the earlier deal between the Chancellor and the Secretary of State for Defence.

(vii) Law and Order. Mr. Whitelaw has offered to find his share somewhere - possibly on the Fire Service. You may wish to ask him if that can be done without unacceptable damage to standards of fire cover. Cabinet will probably accept that the main Law and Order programme must be preserved.

(viii) Social Security. The discussion on Friday of 'indexation' will help here - and there may be a little more to come when E has come to conclusions on the taxation of social security benefits. The Secretary of State for Social Services will, I think, argue on the latter point that the right course is to wait until benefits can be taxed. He will probably resist any attempt to cobble together an interim scheme for reduction of benefits meanwhile. Any action on indexation of course will require further and contentious legislation.

(ix) Costs of Administration. The Cabinet's most recent discussion of Civil Service numbers was disappointing, and some may wish to reopen the question. The separate proposals on cash limits in C(79) 60 will impose their own general squeeze. Cabinet has decided against another general manpower exercise. Further pressure on this front is best brought to bear in the course of public expenditure reviews, and the right course is probably to pursue extra savings case-by-case, in the course of bilaterals with spending Ministers. You might invite the Chancellor to associate CSD Ministers with his studies where appropriate (leaving it to the CSD to suggest the appropriate cases).

(x) Offsets. Mr. Heseltine made it clear, in an earlier discussion, that he would be more inclined to offer further savings in the housing and rents programme, if some part of the proceeds were recycled to 'accelerator' proposals. The discussion in E on Wednesday will have illuminated this problem. It seems unlikely that the two Heseltine schemes would work, and the Chancellor has grave reservations about finding room for any sweetners of this kind at all. In the event, therefore, Mr. Heseltine may have to be told rather than asked to find more. He will be the less likely to be co-operative if he foresees the prospect of losing part of the Local Government Bill.

(xi) Procedure hereafter. You were anxious to avoid any further negotiation in full Cabinet. Friday's meeting was not keen on reviving the idea of a 'star chamber' group on the lines of MISC 11 in the summer. I believe that on this occasion it is preferable for the discussions to be conducted bilaterally, extended as necessary on the lines I suggested in my earlier minute. You yourself should keep out of that stage of the exercise, so as to preserve your own freedom of action until final decisions come to be taken in Cabinet.

(xii) Public Expenditure White Paper. If Cabinet approves these proposals, the publication of the 'later years' White Paper will have to be postponed from January until nearer the Budget. The discussion in Cabinet provisionally planned for 20th December would be correspondingly set back.

CONCLUSIONS

4. If the discussion goes the way you want, the conclusions might be:-

(i) to recognise that the prospects for the PSBR next year and in subsequent years require further savings of the broad order of £1 billion in 1980-81 and of £2 billion a year in 1981-82 and subsequent years - without any final commitment to exact numbers at this stage.

(ii) To invite the Chancellor of the Exchequer and the Chief Secretary to open discussions with spending Ministers and to bring proposals, and options, to the Cabinet in January.

(iii) To agree to postponement of the Public Expenditure White Paper until March.

ROBERT ARMSTRONG

(Robert Armstrong)

12th December, 1979

CONFIDENTIAL

1. Mr Lankester
To see
2. File.

CABINET OFFICE

70 Whitehall, London SW1A 2AS Telephone 01-233 8319

From the Secretary of the Cabinet: Sir Robert Armstrong KCB, CVO

Ref: A0919

11th December 1979

Dear Clive,

I am sending herewith a note of the meeting on the Economic Outlook and Public Expenditure which the Prime Minister held at 10 Downing Street on Friday, 7th December at 9.00 am.

In view of the nature of the discussion I am copying the note only to the Chancellor of the Exchequer. It is of course available here, if any of the other Ministers present wish to refresh their memory of the discussion.

I am sending copies of this letter to the Private Secretaries to the Home Secretary, the Chancellor of the Exchequer, the Secretaries of State for Industry, Employment, Social Services, Trade and Energy, the Chief Secretary, Treasury and to Sir Kenneth Berrill.

Yours ever
Robert Armstrong

C. A. Whitmore, Esq

ec Econ Pol (Pub Ex) Pt 7

4

MINUTES OF A MEETING AT 10 DOWNING STREET AT 9.00 AM ON 7 DECEMBER 1979

Present: Prime Minister
Home Secretary
Chancellor of the Exchequer
Secretary of State for Industry
Secretary of State for Employment
Secretary of State for Social Services
Secretary of State for Trade
Secretary of State for Energy
Chief Secretary, Treasury
Sir Robert Armstrong
Sir Kenneth Berrill
Mr P Le Cheminant, Cabinet Office
Mr P Mountfield, Cabinet Office

THE ECONOMIC OUTLOOK AND PUBLIC EXPENDITURE

The meeting considered a draft memorandum by the Chancellor of the Exchequer on the Economic Outlook and Public Expenditure, a further draft memorandum by the Chancellor of the Exchequer on Pay and Price Provisions for the 1980-81 Cash Limits, and a paper by the CPRS on the Economic Outlook.

THE CHANCELLOR OF THE EXCHEQUER said that, in his judgement, it was now necessary to reopen the Cabinet's previous decisions on Public Expenditure, and to seek savings of at least £1 billion in 1980-81 and of £2 billion in each year thereafter. He invited the Group to endorse this conclusion before he circulated his paper to Cabinet. All advisers in the Treasury agreed that there was no feasible alternative. He began from the imperative of maintaining the present monetary discipline. The position was worse than had seemed in the Autumn. Oil prices had risen, pay settlements had been higher than expected, we had still to secure a reduction in our contribution to the EEC budget, and the Cabinet had not agreed on public expenditure cuts on the scale he had proposed. The long term objective of a prosperous and vigorous economy would be at risk if as a result of a failure to take the necessary decisions on public expenditure high interest rates were maintained and taxes had to be increased in the next two years. The Parliamentary Party and outside commentators alike expected a further reduction in public expenditure, and it would be damaging to confidence if it were not achieved.

In discussion the following points were made -

a. It was argued on the one hand that the Government's monetary targets could not be achieved at reasonable interest rates without a reduction in the public sector borrowing requirement (PSBR) at least in real terms. If increased taxes were to be avoided, this meant that public expenditure had to be reduced. Against this, it was argued that the PSBR was a residual difference between two very large figures both subject to wide margins of error. Its forecasting was necessarily inexact, as were its effects on the money supply. Moreover, in a recession private sector demands would be declining, and it should be possible to finance the Government financing requirement at acceptable interest rates. It was too early to evaluate the impact of the most recent set of measures. There were cogent political and social, as well as economic, grounds for avoiding a further round of public expenditure cuts. It would be better to wait for the Budget. If further fiscal action was then thought necessary, consideration should be given to increases in some indirect taxes: there were, in any case, good social arguments for increasing the tax on tobacco and on drink, and sound energy arguments for increasing petrol tax, though all these would increase the Retail Price Index (RPI).

b. The economy paid a high price for the national obsession with the need to keep pace with the RPI. There was a good case for allowing some increases, notably the increase in world oil prices, to be passed on directly to the community, which could not be insulated from world trends. It might be possible to present the RPI in a way which distinguished these movements from others. Too much public expenditure was already related, directly or indirectly, to movements in the RPI. Many social security benefits, along with public sector pensions, were directly indexed. Indirectly, increases in prices led automatically to pressure on public sector pay, and therefore on public expenditure, and indeed on pay in the rest of the economy. There was a strong case for breaking out of this RPI trap. This would involve breaking the statutory and non-statutory protection of benefits, where this could be done without retreating from Manifesto commitments.

c. The social security programmes would have to make a substantial contribution to any future expenditure cuts. There was, however, a case for looking at rates of contribution as well as rates of benefit. These proposals could not be separated from those on the taxation of short term benefits which were shortly to be considered by E Committee. A considered approach on those lines was preferable to any immediate cut in general benefits. In any case, unless the structure of the National Insurance Fund - which was supposed to be maintained in broad balance - was changed the impact in any increase in contributions on the PSBR would be small. Moreover, increased contributions merely drove up unit costs for employers and tended to reduce employment or drive up prices.

d. Economies would have to be sought in other areas of public expenditure as well as social security programmes. While the armed forces proper must clearly be exempt, there might be a case for looking again at the Defence 'tail'. The Law and Order programmes were too small to make any significant contribution, and in present circumstances it would be wrong to make any major reductions. But there were other Home Office services, like the Fire Services, which could be re-examined. A major contribution would also have to come from housing and rents, and it might be necessary to look again at tax relief for mortgages. It would also be desirable, within the overall constraints of a reasonable PSBR, to leave room for a package of incentives for small firms and for the encouragement of investment generally as well as to leave room for other contingencies, including British Leyland. Apart from cash limits, where the Chancellor's proposals would involve an overall 'squeeze', it would be wrong to seek further across-the-board reductions. The search should concentrate on specific policy changes. Discussions to this end would be better carried out bilaterally, between Treasury and spending Ministers, than in full Cabinet, provided that sufficient political endorsement could be found for the overall target.

e. More dramatic solutions might be considered. For example, it had several times been proposed that the standard rate of income tax should be brought down to a low figure, say 15 per cent, to be financed largely by the abolition of personal allowances. Schemes of this kind deserved further study. Alternatively, income tax could be abolished altogether and replaced by a modified poll tax on the lines of the National Insurance Surcharge, collected direct from employers. The developing oil situation also provided a further major potential source of revenue. A steep increase in petrol taxation, could be entirely justified on energy saving grounds and rising oil prices gave scope for further increases in Petroleum Revenue Tax (PRT) which would not affect the RPI.

THE PRIME MINISTER, summing up the discussion, said that the Ministers present broadly supported the Chancellor's approach to public expenditure. He should now circulate his paper to Cabinet, for discussion next week, without at this stage indicating any firm figures for reductions. He should meanwhile discuss his proposals with some of the Ministers most directly affected. He should also circulate his paper on Cash Limits in the form at which it had been sent to her. He should circulate to Ministers present a note about the possibility of a 15 per cent standard rate of income tax with no personal allowances. He should arrange for a wide-ranging study to be made, by the Treasury and the CPRS, of the scope for 'de-indexation', covering wage bargaining, social security benefits, direct and indirect taxation, public sector pensions and the effect of world oil prices on the retail price index. This paper should be sent to her in the first instance.

The Meeting -

Took note, with approval, of the Prime Minister's summing up of their discussion, and invited the Chancellor of the Exchequer to be guided accordingly.

11 December 1979

£1,000. / 2,000.

Prime Minister Econ Pol.

There is also an interesting note (Flag E) from Mr Howell. His main point is that we must de-link public expenditure from the RPI - which means mainly social security.

TL 6/12

CONFIDENTIAL

Ref. A0879

PRIME MINISTER

The Economic Outlook and Public Expenditure

Brief for Ministerial Meeting, 9.00 am 7 December

BACKGROUND

There are four papers for this meeting:

A
Flag A

(i) The Chancellor's minute of 27th November, copied to those attending the meeting, covering a draft paper on 'the Economic Outlook', originally intended for Cabinet.

Flag B

(ii) The Chancellor's paper on 'Pay and Price Provisions for the 1980-81 Cash Limits' which he sent to you at the end of last month (undated). He is recirculating this to the Ministers attending the meeting at your request; it is intended for Cabinet on 13th December.

Flag C

(iii) The CPRS paper on 'the Economic Outlook' which, as you asked, was circulated with Mr. Lankester's letter of 3rd December to the Ministers attending the meeting.

Flag D

(iv) A redrafted paper on 'the Economic Outlook and Public Expenditure' which is a condensed version of the first paper, extended with some paragraphs on public expenditure, suggesting postponement of the Public Expenditure White Paper and a fresh public expenditure cuts operation in the next month or two. The Chancellor proposes specific targets of £1 billion for 1980-81 and £2 billion reductions in the later years. If approved, this paper is intended for circulation to Cabinet for discussion on 13th December.

2. The CPRS paper ((iii) above) should serve as a brief on the substance of all this. I will not attempt to duplicate it. This note deals only with handling and procedure, and with a couple of points which were not covered by the CPRS.

3. The object of this meeting is to secure the approval of a few key Ministers before the Chancellor launches his proposals on the full Cabinet. The balance of the group was intended to cover both the Chancellor's natural allies and some potential critics. It is already clear that Mr. Prior feels he

has been outflanked (he and Mr. Jenkin are in a minority). He has told the Chancellor, during the NEDC briefing meeting, that he disagrees with the whole approach. This was before he had seen the Chancellor's detailed proposals either on cash limits or on further cuts. His line seems likely to be that forecasting is an inexact science; that the forecast £10 billion plus PSBR in 1980-81 may be an overstatement; that the outturn may be quite a bit better and that we should wait and see; that further public expenditure cuts will be damaging in themselves, and politically dangerous.

4. If the Ministerial Group on Friday agrees with the Chancellor, the next step will be for him to circulate his revised paper ((iv) above), with any further modifications to reflect the discussion, for discussion by Cabinet on 13th December. The Cash Limits paper ((ii) above) would be taken at the same time. Thereafter, you would establish a small 'star chamber' group of Ministers, rather on the lines of MISC 11 which met during the summer, to conduct the cuts operation and make recommendations to Cabinet. Final decisions would be needed some time before the Budget. The Group might need to start work early in January. I shall submit further advice about membership and mode of operation later.

5. There is a particular problem over the position of the Secretary of State for Defence. These papers have not been copied to him. He is away in Brussels, at a NATO meeting, on Monday, Tuesday and Wednesday of next week. The first he will hear of the cash limits proposal will be when he reads his Cabinet papers on Wednesday night. This, as Mr. Le Cheminant warned Mr. Lankester in an earlier note, may cause considerable difficulty for the Ministry of Defence because it implies a substantial squeeze on the volume of defence spending next year. In addition, the Chancellor wants to leave open the possibility of further cuts in the Defence programme. His new paper ((iv) above) deliberately does not mention this. The CPRS paper does. He had intended to speak privately to the Secretary of State for Defence before Cabinet. It is not now clear that there will be time for this. You may want a word with the Chancellor about the best way to handle the problem. Otherwise, there is a risk that the deal which the Chancellor struck with the Secretary of State following the previous Cabinet discussion will come unstuck.

6. There is a further problem over cash limits, not brought out in the CPRS paper (which was circulated before the cash limits paper was available). It concerns only 1980-81. The Chancellor says that the PSBR for 1980-81 would 'exceed £10 billion'. The latest figure is, I understand, £10.3 billion. But this is on the assumption that cash limits are set to accommodate the expected rate of inflation (17 per cent) rather than the 14 per cent which the Chancellor suggests in his separate cash limits paper. If cash limits were, in fact, set at 14 per cent, and inflation turned out to be 17 per cent, there would thus be an automatic squeeze of £450 million even before any further cuts were explicitly sought. If Ministers were minded to endorse the Chancellor's target of £1 billion reduction in 1980-81 it would be important to establish whether the cash limit volume squeeze was included in this total, or additional to it. (We have asked the Treasury to ensure that the Chancellor is ready to deal with this point). In any case, there is no one-for-one relationship between a cut in the volume of public expenditure and a fall in the PSBR. Other factors, including shortfall, complicate the calculation. The Chancellor's £1 billion is only a very rough indication of the scale of the problem - not a precise target.

HANDLING

7. I imagine you would want the Chancellor to introduce his paper, and you may then wish Sir Kenneth Berrill to say a word. The Chancellor may at some point wish to take a list of possible ways of meeting his target of £1 billion. Thereafter the discussion could be, as the CPRS suggest, structured round the series of questions listed in their paper. The point about cash limits arises on paragraph 13 of their paper, and you may want to bring it out clearly at that stage. The separate problems about Defence are best handled in a private word with the Chancellor.

CONCLUSIONS

8. The outcome of the meeting will, presumably, be agreement that the Chancellor should revise his paper - and possibly also his cash limits paper - in the light of discussion and circulate it to Cabinet at the beginning of next week. You may want to reserve a decision on the subsequent steps until you have heard the Cabinet discussion.

RtA

(Robert Armstrong)

6th December, 1979

cc Econ Pol PE7
Public Expend

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

6th December, 1979

Dear Tim,

THE ECONOMIC OUTLOOK, PUBLIC EXPENDITURE AND CASH LIMITS

On 27th November the Chancellor minuted the Prime Minister, with copies to other members of a small group of Ministers, with a draft Cabinet paper on the economic outlook, to be discussed at the group's meeting on 7th December. He indicated that a further Cabinet paper would be prepared on re-opening public expenditure.

The Chancellor has now decided that it would be better to combine discussion of the outlook, general economic policy and the implications for public expenditure in a single paper
... for Cabinet, a draft of which I now enclose for discussion by
... Ministers on Friday. Also enclosed for discussion at that meeting, as requested by the Prime Minister, is a draft Cabinet paper on 1980-81 cash limits.

Copies of this letter and of the enclosures go to John Chilcot (Home Office), Ian Ellison (Department of Industry), Ian Fair (Department of Employment), Don Brereton (Department of Health and Social Security), Stuart Hampson (Department of Trade), Bill Burroughs (Department of Energy) and Martin Vile (Cabinet Office).

Yours ever,

Tony Battishill

A. M. W. BATTISHILL

T. Lankester, Esq.,

PAY AND PRICE PROVISIONS FOR THE 1980-81 CASH LIMITS

DRAFT MEMORANDUM BY THE CHANCELLOR OF THE EXCHEQUER

The 1980-81 cash limits on the rate support grant (RSG) and the external financing limits on the nationalised industries were announced on November 16th. We now need to take decisions on the pay and price provisions in the Main Estimates for 1980-81 and in the other remaining cash limits.

A. Expenditure concerned

2. These are the limits on central government expenditure and on local authority capital expenditure. They cover over £25 billion (at 1979 survey prices). The main areas of central government expenditure include defence, the hospital and community health service and the universities. The limits cover numerous pay groups principally the armed forces, doctors, nurses, NHS ancillaries and university staff.

3. At this stage, we can leave on one side civil service pay: a global provision for the civil service pay settlement is to be made in a single Vote which need not be decided until February.

B. Provision

4. I propose that provision should be made for a 14 per cent increase between 1979-80 and 1980-81 in current costs covering both new pay awards and other current expenditure. This differs from past practice when a separate factor was used for pay and two other factors for the remainder of current expenditure but it follows the approach we agreed, for the RSG. The advantage of the RSG approach is that it avoids publishing

an explicit figure for pay which could become a starting point for negotiations.

5. I propose continuing past practice of using separate price factors for capital expenditure. Separate provision would be made for the outstanding comparability awards for the university teachers and for nurses. All the proposed factors are shown in Annex A.

6. These factors are based on the Industry Act forecast which showed a 14 per cent increase in the retail price index (RPI) between the fourth quarter of 1979 and the fourth quarter of 1980. They are also broadly in line with the figures supplied to the Government Actuary; these showed the same increase in the RPI and a 14 per cent increase in earnings between 1979-80 and 1980-81 for the economy as a whole (see Annex B).

7. As part of the RSG settlement, the local authorities were given a figure of 13 per cent for increases in the costs of their current expenditure generally. This cash limit represents a maximum contribution from the Central Government. We can justify the slightly higher figure of 14 per cent for Central Government cash limits on the grounds that for each Central Government service the cash limit is an absolute constraint whereas local authorities have greater flexibility and, in the last resort, their own balances to fall back on if inflation turns out higher than expected.

C. Implications for public expenditure plans

8. We cannot, consistently with our own published forecasts, make a higher provision than now proposed. And it is essential, in our first full year, to hold expenditure within the cash limits we set.

9. The effect of the cash limits on services will depend both on inflation generally and on public service pay settlements. If these costs increase faster than provided for, the cash limit will be bound to result in further reductions in the volume of expenditure. The size of these will depend on the mix of different types of expenditure on each service.

10. Any forecasts of inflation are inevitably subject to a wide margin of error, but it would be unrealistic if my colleagues do not allow for the possibility that the cash limits will require some further reduction in the volume of the services for which they are responsible in 1980-81. All spending authorities must manage their resources throughout the financial year in such a way that they keep within the cash limits even if costs rise faster than provided.

Conclusion

11. I invite the Cabinet to agree the pay and price provision proposed in Annex A.

ANNEX A

Provisions proposed for 1980-81 cash limits (based on the Industry Act forecast)

		% increase 1980-81 on 1979-80
i)	New pay awards and price increases on current expenditure *	14.0
ii)	Capital Expenditure:-	
	Construction	
	- Housing	15.8
	- roads	16.4
	- other	15.5
	Land	15.0
	Other capital expenditure	15.9

iii) Outstanding comparability awards

a) nurses in the range 20-25 per cent annual increase in earnings. This assumption will be replaced by the actual figure if the Clegg Report is available in time.

b) university teachers in the range 15 - 20 per cent annual increase in earnings.

* Apart from the global provision for civil service pay which will be settled later.

ANNEX B

Published figures

a. Assumptions given by the government to the Government Actuary for use in his report on the National Insurance Fund:

- Economy wide increase in earnings (including outstanding public sector comparability) of 14 per cent between 1979-80 and 1980-81

- RPI increase 14 per cent 1979 (Q4) to 1980 (Q4).

b. Industry Act Forecast:

- No earnings figure. Refers to "a progressive reduction in the rate of settlements over the coming year" by implication from the underlying increase of 15-16 per cent mentioned for this year.

- RPI increase 14 per cent 1979 (Q4) to 1980 (Q4).

c. RSG cash limit:

- increase in costs of 13 per cent between 1979-80 and 1980-81.

 CC Econ Pol Public Expenditure PE 7 6/12/79.

THE ECONOMIC OUTLOOK AND PUBLIC EXPENDITURE

Memorandum by the Chancellor of the Exchequer

Introduction

I have been taking stock of the economic situation. The general strategy remains the only feasible one but the difficulties we face are greater than we had any reason to expect. I consider that we need to look again at our public expenditure plans and it was evident at our 15 November discussion that many members of the Cabinet share this view. It is imperative to get our policies properly established in our first year of office.

Recent Developments

2. Three developments cause particular concern:-

(i) With strong wage inflationary pressures, poor trading, productivity and competitiveness performance and the unpromising outlook for world trade following the further large increases in oil prices, the economy is inevitably moving into a recession from which there could well be only a slow recovery;

(ii) despite the action I took in the Budget, underlying monetary growth has been much higher than expected;

(iii) inflationary expectations, and hence pay pressures, remain high and intractable.

3. This outlook was reflected in the recent Industry Act forecast which brought out in particular the deteriorating prospects for output and for reducing the rate of inflation next year; and some of the assumptions underlying that forecast (eg on earnings and interest rates) could be over optimistic. Recent non-government forecasts, such as that prepared by the London Business School, point in very much the same direction.

Action so far

4. The measures taken in the Budget established our credibility from the start by signalling our resolve to maintain strict

monetary control backed by fiscal policies consistent with it. And the further measures of 15 November were dictated by the necessity of maintaining those policies in the face of the disappointing monetary and PSBR developments. The initial reaction in the markets was favourable and we have secured substantial gilt sales to help fund this year's PSBR. I hope that the other effects of the changes will now come through so that money supply growth comes into the target range, without even higher interest rates than those which we have had no alternative but to accept. But this will depend on a number of factors some of which we can influence - particularly the market's assessment of our determination to carry through our policies - and others which we cannot, eg developments overseas.

Future action

5. The overriding priority is to reduce inflation, as a necessary condition of resumed and sustainable growth. In parallel with this we must secure a major improvement in the supply side of the economy. To these ends our policies must embrace the following:-

(i) progressive reduction of the rate of growth of the money supply at tolerable interest rates;

(ii) further reductions in the burdens of income tax and capital taxation;

(iii) substantial reductions in the inherited public expenditure plans and in the size and role of the public sector generally.

6. No compromise is possible on (i). Otherwise the credibility of any government's strategy on inflation would be destroyed. Nor can we compromise on our objective of restoring incentives by reducing taxation. Our weakness on the supply side is still acute and we urgently need to take further measures to remedy this. The single most important contribution we can make is to reduce taxation <u>at all income levels</u>. But, with the worsening economic prospects, and the difficulty evident from Dublin of getting an acceptable reduction in our EEC contributions,

there is now little prospect of attaining our inflation and tax objectives on the basis of the public expenditure plans agreed so far by Cabinet.

7. Disappointment with the 1980-81 White Paper (whose plans were some £2 bn higher than the target the Chief Secretary and I set) contributed to the unsettled market conditions that necessitated the 15 November measures. Many in the markets were hoping for an unequivocal reduction in the volume of expenditure and the PSBR for 1980-81.

8. For the period immediately after 1980-81 a similar situation is in prospect. The Chief Secretary and I warned the Cabinet in September that even with the reductions we proposed it would be hard to hold the PSBR in the later years to around its present proportion of GDP without some real increase in taxation. In the event the plans agreed by the Cabinet are more than £1 bn higher for most of the years concerned; and the economic prospect has worsened, as reflected in government and independent forecasts. Thus on any prudent assessment of the economic outlook the present expenditure plans seem incompatible with slower money supply growth unless we have even higher interest rates or higher taxes, or both.

9. Chronic structural weaknesses in the economy - low productivity growth and poor trading performance as well as the tendency to higher inflation - appear to have intensified in recent years. These problems cannot be overcome quickly and given also the worsened prospects for the world economy after the further rise in oil prices the medium term prospects for GDP growth are now poor. It is against this background that the Treasury's medium term analysis has been carried out. It suggests that the policy conflicts are likely to be most acute in the next two years. For example, to bring inflation down well into single figures by 1983 entails getting monetary

growth in that year down to 7% (and the PSBR to 2½% of GDP, which should allow interest rates to fall). On present expenditure plans this would require tax increases equivalent to around 5p on the basic rate of income tax by 1981-82. There would be no prospect of any real reduction in personal taxes from today's levels before 1983.

10. Two key conclusions emerge. First, however difficult the short-term, the centre piece of our anti-inflation strategy - progressive reduction in monetary growth - remains the only feasible one. But second, stabilisation of our expenditure plans at their presentlevels is not enough. (And, depending on the treatment of debt interest, it is arguable whether we have even done that.) Unless we reduce plans further we shall not be able to avoid serious damage to our taxation objectives and the risk of even higher interest rates than those we have now. This is also becoming increasingly clear to the financial markets and without changes there is a serious risk of a series of tensions in the markets, of which that last month was only a first example. Most important, it is also becoming clear to our supporters in Parliament that further action on public expenditure is needed.

Public Expenditure and the Second White Paper

11. I conclude that our public expenditure plans need to be reduced. It is difficult to say with confidence precisely what further reductions would be required to meet our monetary and tax objectives. On the Treasury's projections, the PSBR for 1980-81 would on present expenditure plans exceed £10 billion, and rise to around £13 bn in 1981-82, or over 5% of GDP compared with the 4¼% expected this year. A PSBR at this level would be a major blow to confidence and it seems very unlikely that we could finance it without still higher rates of interest.

12. Our room for manoeuvre in 1980-81 is restricted. We have published our plans and they are being acted on by spending authorities. For example, it would be difficult now to ask local authorities to make further reductions in their current expenditure. But we need to hold the cash limits and to make whatever further savings we can. One important decision for 1980-81 not yet taken concerns the uprating of child benefit. There is also the question of further savings on housing investment. In all we ought to be looking for a total volume reduction of the order of £1 billion.

13. In 1981-82 a reduction of the order of £2 bn appears to be needed. If the total is not to rise again we must carry this reduction forward to the two subsequent years.

14. We can only make reductions of this order by fundamental new decisions on the major programmes. The social security programme, which constitutes over a quarter of public expenditure, will need to be a major source of the further savings.

Second White Paper

15. If the above is accepted it points to postponing the White Paper hitherto scheduled for January. We do not want to publish figures we are subsequently going to revise; and to do so would make the revisions more difficult to achieve. Any economic projections published with the figures would also reveal the inconsistencies I have described; but equally refusal to publish supporting economic material would lead observers to conclude themselves that the figures did not add up. We certainly would not publish any convincing or viable financial plan incorporating the present expenditure figures. So I conclude that we should postpone the White Paper.

16. The decision to postpone implies that we shall achieve the necessary reductions. To delay the White Paper and then publish plans that were still too high would be the worst of all worlds.

17. Nor could we let the uncertainty run on too long. We need to publish the White Paper not later than the Budget and preferably in March. This will require an intensive operation which we should aim to complete by the end of January.

Conclusion

18. I recognise the difficulty of the decision I am asking the Cabinet to make, and of the subsequent decisions necessary to implement it. But without this decision it will become widely apparent that our policies are inconsistent and that our expenditure plans are incompatible with our monetary and taxation objectives; and that there is a serious risk that even more painful measures would become unavoidable.

19. I therefore propose that:-

(i) we undertake an exercise, which we should aim to complete by the end of January, to identify savings of £1 bn in 1980-81 and £2 bn a year in 1981-82 and subsequent years;

and (ii) we postpone the next Public Expenditure White Paper and aim to publish it in March.

cc Econ Pol,
Pt 7. Public Expenditure.

These items not discussed.
For record of Mtg - see Master Set.

PRIME MINISTER

MEETING WITH THE CHANCELLOR

I understand that the Chancellor will want to raise the following points:

(i) He will have with him draft papers for Cabinet on the economic outlook and public expenditure, and on the pay and price assumptions for cash limits. The paper on the economic outlook and public expenditure apparently covers the same economic ground as the draft which he sent round last week, but it includes proposals on the reopening of the public expenditure decisions as well. I imagine the pay and prices paper will simply repeat the proposals which you saw over the weekend, but which you said you would like discussed by the "inner group" on Friday morning. If you are agreeable, the Chancellor will circulate the drafts of these two papers to the "inner group" after the meeting.

(ii) The Chancellor has some inkling of the November money supply figures, and will be reporting on them. Apparently, the overall figures are likely to be reasonable; the bank lending figures continue at a high level but other factors (presumably including sales of gilts) have offset this.

(iii) The Chancellor will report on today's NEDC meeting, which - as I told you - did not go off too badly. He will also report on his efforts to persuade Len Murray to attend the January meeting. I understand that Murray is proving hard to get - partly because he does not want to break into his holiday, and partly because, if he did come, it would appear to his trade union colleagues that he thought they could not manage without him. (In this connection, Mr. Basnett told me at this evening's party that, as far as he was concerned, this morning's meeting was totally unproductive. He said that the TUC would not walk out of any of the major bodies such as

/NEDC,

NEDC, MSC, etc.; but he still could not rule out their walking out of some of the less important ones. Mr. Basnett went on to say - for what it is worth - that he was very concerned that there seemed to be no attempt by the Government to reach any kind of consensus with the trade unions. Ministers did not even seem interested in talking. Finally, he said that he and his colleagues would welcome an initiative from you to meet them before too long.)

(iv) The Chancellor is bothered about the FCO's posture on EMS - in particular, the recent statement by Lord Carrington in Brussels. I quote:

> "Fourth is the need for greater monetary stability. The British Government's present domestic policies will I hope convince you of the importance we attach to this objective. The European Monetary System is an important and welcome step, and Britain fully supports this initiative. We are not yet full members of the EMS, but that reflects only present economic realities, not a lack of will. We intend to join the exchange rate mechanism as soon as conditions permit and in particular as soon as the implications for sterling of being a petro currency are clear."

I believe the Chancellor would like your support for pulling the FCO into line - i.e. not being quite so bullish about EMS.

(v) He may want to mention the right of entry review, which is coming up in Cabinet. (There is a note on this in the Cabinet folder.)

S J Pike Duty Clerk
pp TPL

5 December 1979

A

CO

SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SW1P 4QJ
01 211 6402

Ek J Hoskyns
16/1/80. P. Mountfield

Rt Hon Geoffrey Howe
HM Treasury
Parliament Street
LONDON SW1

4 December 1979

Dear Geoffrey

In your personal and confidential memorandum of November 26th on the Economic Outlook you asked for colleagues' views. I endorse entirely your objectives and conclusions but would like to add some additional thoughts on how best we proceed towards them.

As you say at para 6 (1) our overriding commitment is to 'deceleration in the rate of growth of the money supply at tolerable interest rates'. This is a commitment which we are regretably not at present fulfilling since interest rates are clearly not at tolerable levels. You are, of course, right that the only way out of this position is through renewed measures to contain and reduce public spending, thus preventing the ballooning PSBR which then has to be financed at these appalling levels of interest rates.

But I would like to examine a little more closely why our public expenditure totals continue to swell so persistently, despite all our efforts. The following points are worth bearing in mind.

20 per cent of total public expenditure is directly related to the RPI. That is to say, if the RPI moves one point upwards, this automatically generates additional public spending of approximately £160 million (at 1979 prices) within a year or so.

A further 30 per cent is wages and salaries, which are linked one way or another with the RPI, about half informally, through the dangerous comparability doctrines embodied in Clegg and PRU, and abo[ut] half through expectation, custom and assumption about 'the going rate' compensating at the least for the RPI increase. Again this may all take a year or so to come through.

Thus it needs no new policy decision at all for public spending to lurch upwards in due course. We have only to stand still while, for example, crude oil prices add, as they could in due course, 3½-4% gross to the RPI, to be confronted eventually with the need fo[r] substantial further public spending increases, demanding large fresh cuts elsewhere, or new borrowing if it is to be contained.

In the sixties British policy makers looked at ideas of indexing and monetary correction and vowed we would not go the way of Brazil. As with most such vows the opposite happens. We are now, ten years later, a largely indexed economy, with our powers to reimpose monetary sanity vastly curtailed.

Indeed the RPI 'detonator' blasts in two directions. The way we have organised things not only does it sweep public spending upwards whether the cause is mortgage rates (sic)or the Ayotollah. It prevents us raising prices, charges and duties in the public sector to levels which would increase revenues, curb monetary growth and encourage energy conservation.

I see no break in this chain unless we can make at least some progress on three fronts:

First, we must reduce drastically the volumes of public spending automatically linked to the RPI, and therefore currently outside our control.

Second, instead of enshrining the R.P. index we must do everything possible to dethrone it. To mention it in the same utterance as the subject of pay is asking for trouble. Our efforts to get other indices - output, after-tax purchasing power, prices excluding 'imported' price increases, for example - into the debate about proper levels of national remuneration, whether earnings or benefits, must be redoubled.

Third, the obsessional link between pay settlements and the RPI must somehow be broken, or drastically weakened. The linkages that need to be far more strongly established are between pay and output pay and profits, pay and capital.

Our cash limits approach to public sector pay provides the essentia negative half of this picture by bringing home that if wage increas are pushed through to match the RPI then jobs have to go and the available funds shared between the remainder. But on the positive side I think there is a good deal more to be done, both through propaganda and measures, to strengthen the incentives to relate pay to output, profits and to the performance of capital. We are miles behind other market economies in the numbers of wage-earners and families that are directly involved in the 'ownership' part of society and thus see their standard of living as dependent on the performance of capital. So we can hardly be surprised at the way in which, to an almost unique extent, British workers remain convin that their living standards depend on their wages catching up with the latest RPI figure they have heard mentioned.

There is now no escaping more hard public spending decisions ahead. But vigorous efforts on the three fronts mentioned here are, I beli an essential concomitant of further moves to curb public spending, if those moves are to succeed. They would give us greater freedom not merely to bring under some degree of control the enormous areas

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(3)

of public spending which lie outside our control, but also to increase revenues through charges and prices (and deflect the consequences of the oil price increases immediately ahead) without triggering off more public spending, leading to the need for still more cuts, or still higher interest rates, or both.

Yours ever

David

D A R Howell

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MFS
Econ Policy

10 DOWNING STREET

From the Private Secretary

B/F 6.12.79
for Mtg.

3 December 1979

The Chancellor has already circulated a draft paper on the economic outlook, which will be discussed by Ministers here at No. 10 at 0900 hours on Friday 7 December. As an aid to this discussion, the Prime Minister has asked me to circulate the enclosed note by the CPRS.

I am sending a copy of this letter and enclosure to John Chilcot (Home Office), Ian Ellison (Department of Industry), Stuart Hampson (Department of Trade), Bill Burroughs (Department of Energy), Ian Fair (Department of Employment), Don Brereton (Department of Health and Social Security) and Martin Vile (Cabinet Office).

T. P. LANKESTER

A.M.W. Battishill, Esq.,
HM Treasury.

1

rd 29.11.79

cc Mr Wolfson
Mr Duguid
cc Econ Pol, Pt 4 Public Expenditure

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

Prime Minister
These proposals will cause trouble in Cabinet because of the likely volume squeeze (see para 9). But higher figures would make the Chancellor's PSBR problems almost impossible. I think he should circulate his paper as proposed.

~~Agree~~? TL 29/11

PRIME MINISTER

PAY AND PRICE PROVISIONS FOR THE 1980-81 CASH LIMITS

The 1980-81 cash limits on the rate support grant (RSG) and on nationalised industries were announced on 16th November. We now need to take further decisions on the pay and price provisions for the remaining cash limits.

2. These are the limits on central government expenditure and on local authority capital expenditure. The provision should be approved by Cabinet and is on the agenda for 6th December. I shall be circulating a paper for that but I wished to inform you first what I have in mind to propose.

3. This is a major decision on public expenditure in 1980-81. The cash limits involved cover over £25 billion (at 1979 survey prices).

4. The main areas covered by central government expenditure are defence, health and universities, and the pay groups they cover, including the armed forces, doctors, dentists, nurses, and ancillaries, and university staff. We can leave civil service pay on one side for the time being since we have decided to make a global provision in a single vote which does not need to be decided until February.

/5. For the RSG

5. For the RSG we provided for a 13 per cent increase in costs (in this case all current, not capital) between 1979-80 and 1980-81 arising from new pay awards and from price increases. It would be desirable to follow the same approach here and use a single figure for cost increases on current expenditure.

6. This differs from past practice when a separate figure has been used for pay and two price factors used for the remainder of current expenditure. The advantage of the unified figure as for the RSG is that it avoids publishing an explicit figure for pay which could quickly become a starting point for negotiations. With prices expected to rise faster than pay, a single figure is likely to bear down more heavily in those areas with a relatively high proportion of current expenditure other than pay - notably defence. I think this has to be accepted in present circumstances.

7. I propose to continue past practice of using separate price factors for capital expenditure.

8. The provisions which I suggest are set out in the Annex. They are in line with the Industry Act forecast and the Government Actuary's Report, and should not cause surprise. The provision of 14 per cent for increases in current expenditure arising from prices and new pay awards is slightly higher than the 13 per cent used in RSG; but the 13 per cent for the RSG was part of a package in which we maintained the RSG grant percentage at 61 per cent; and unlike local authorities, the Central Government services generally have no other sources of finance to fall back on.

9. Even so, these provisions are almost certainly less than the increases in pay and prices which will actually occur. So they imply a squeeze of the volume programmes

/previously agreed.

previously agreed. On the basis of the Treasury's economic forecast, prepared two months ago now, the squeeze might be some £400-450 million (at 1979 survey prices), of which £140 million would fall on defence and £85 million on the NHS. On latest indications the actual squeeze will almost certainly be more.

10. Since our recently published plans for 1980-81 now look high in relation to our PSBR and tax objectives, some squeeze is welcome. But some of our colleagues will find difficulty with it, and I do not advocate attempting a larger squeeze by this route. If in the end widespread increases had to be made in cash limits in our first full year, it would seriously damage the cash limit system. I think that the figures I am suggesting strike the most appropriate balance.

11. If you agree, I will circulate a paper to Cabinet accordingly.

12. I am copying this to Sir Robert Armstrong.

(G.H.)
29 November, 1979

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ANNEX

A. Published figures

a. Government actuary

- Economy wide increase in earnings (including outstanding public sector comparability) of 14% between 1979-80 and 1980-81.

- RPI increase 14% 1979 (Q4) to 1980 (Q4).

b. Industry Act

- no earnings figure. Refers to "a progressive reduction in the rate of settlements over the coming year" by implications from the underlying increase of 15-16% mentioned for this year.

- RPI increase 14% 1979 (Q4) to 1980 (Q4).

c. RSG cash limit

- increase in costs of 13% between 1979-80 and 1980-81.

B. <u>Provisions proposed for 1980-81 cash limits</u> (consistent with Industry Act forecast)

		% increase 1980-81 on 1979-80
i)	New pay awards and price increases on current expenditure	14.0
ii)	Capital Expenditure:-	
	Construction	
	- Housing	15.8
	- roads	16.4
	- other	15.5
	Land	15.0
	Other capital expenditure	15.9

iii) Outstanding comparability awards

a) nurses in the range 20-25% annual increase in earnings. This assumption will be replaced by the actual figure if the Clegg Report is available in time.

b) university teachers in the range 15-20% annual increase in earnings.

CM

2 MARSHAM STREET
LONDON SW1P 3EB

My ref: H/PSO/17003/79

Your ref:

28 November 1979

Dear Geoffrey

When John Nott wrote to you on 12 November, he urged that the non-priority item in the Strategy exercise covering industrial concentration should be given higher priority. I had also come to feel that the tax and legal aspects of the problem needed detailed and urgent consideration. As John Nott says this is a very technical area; and Departmental responsibility for it falls in his Department and yours. However, I would support his proposal that we should bring in the technical people from the City to any consideration of this issue as well as the Civil Service experts. As seen from the City, the problems of de-concentration may look rather different.

You will also appreciate that we shall have massive resistance to the implications underlying this area of investigation.

Copies of this letter go to recipients of John Nott's letter.

Yours ever

MICHAEL HESELTINE

The Rt Hon Sir Geoffrey Howe QC MP

Prime Minister

This note is generally very helpful and should point up the issues for discussion (though I don't believe medium-term monetary targets are on until we are seen to be sticking to the existing targets). Would you like this circulated for next Friday's discussion?

TL 30/11

CONFIDENTIAL

Qa 04358

To: MR LANKESTER

From: SIR KENNETH BERRILL

Flag A

next Friday

The Economic Outlook

1. I have seen the paper attached to the Chancellor's minute of 27 November, which is shortly due to be discussed by a small group of Ministers under your chairmanship.

2. The CPRS strongly supports the line taken by the Chancellor and would like to offer some comments as a contribution to the discussion. We have therefore produced the attached note. If you felt that this was a useful way of bringing out the main issues you may feel that this should be circulated to the Ministers concerned on the small group.

3. I am sending a copy of this minute to Sir Robert Armstrong.

KB

28 November 1979

Att

CONFIDENTIAL

29 NOV 1979

THE ECONOMIC OUTLOOK

Note by the Central Policy Review Staff

In the paper attached to his minute of 27 November the Chancellor of the Exchequer argues that, on any realistic assessment of the economic prospect, the public expenditure plans which Cabinet have endorsed are incompatible with the Government's monetary and taxation objectives.

2. This is not altogether surprising. As the Chancellor has pointed out, the decisions on public expenditure fell far short of what he had said would be required; and recent developments have increased that requirement, not reduced it. In particular the economy is moving into sharp recession and there is unlikely to be an early recovery given the present outlook for world trade and our current performance on inflation and productivity.

3. This does not in any sense demonstrate a "failure" of the Government's strategy. Ministers recognised from the start that the first task was to break the inflationary spiral; and that this almost certainly meant that economic conditions - growth, unemployment, inflation - would be poor in the first 2-3 years, even if the Government adhered strictly to the main features of the strategy. In practice, they have been blown somewhat off course. The economy has been slow to respond to monetary controls and fiscal changes. Monetary growth has been too high; the income effects of cutting personal taxation appear to many to have been largely offset by indirect taxes and higher interest rates; "stable" public expenditure will still be a rising proportion of a falling GNP; Civil Service numbers have yet to fall. In all these respects it can be argued that the strategy has not yet been given a chance.

4. The diffulties in pursuing the strategy are immense but, as an aid to considering them, we suggest that Ministers may find it helpful to work through the following questions.

(1) Control of Inflation

5. We assume that Ministers will want to confirm (i) that controlling inflation remains their first priority, and (ii) that no contingency planning should be undertaken for a formal incomes policy. If so, the reliance placed on strict monetary discipline is that much the greater, since a reasonable deceleration of inflation almost certainly implies one or two years in which money incomes have to rise less than prices.

Monetary Targets

6. There is a compelling need to reduce inflationary expectations: otherwise the operation of monetary policy will be painful indeed and the bankruptcies and unemployment will hit the weak rather than the greedy (big firms can get credit easier than small). Among the possibilities for reinforcing the current stance on monetary policy and influencing expectations are:-

(i) Setting a target rate of growth for money supply for a period some years hence eg 7% as the centre of the range for 1983. Would this be a sharp enough contraction? Would it carry conviction?

(ii) Setting a target path for money supply in the coming years eg that the centre of the range would fall by ½% or 1% a year. This might look less like "virtue tomorrow" than (i) above, and therefore be better received.

(iii) Charting a downward course for the PSBR, either in absolute terms or as a proportion of GNP. This could add credibility to the money supply targets, and discourage undue reliance on interest rates. Against this we would argue that a second monetary target is unnecessary for confidence; undesirable in closing off sensible policy options of a counter-cyclical kind; and conceivably impossible to adhere to (the deeper the slump the more the PSBR tends to widen).

(iv) Devising a medium-term financial plan which charted not only monetary growth, but also the course of tax and public expenditure.

Fiscal Targets

7. Any substantial forward commitment on monetary growth would, of course, have implications for the Government's tax and expenditure aims, whether they were spelled out in a financial plan or not. Ministers therefore need to reach a judgement now on the broad fiscal balance for at least the next 2-3 years.

(2) Tax Objectives

8. The long-term aim is to reduce the basic rate of income tax to 25%. This is probably unattainable during the lifetime of the present Government. On present plans and assumptions the overall burden of taxation would almost certainly have to be increased over the next 2-3 years. As the scope for increases in indirect and corporate taxes is limited, personal tax rates would probably have to be raised as well - perhaps by a substantial amount.

9. Are Ministers prepared to trim their tax objectives? Is it more realistic to aim at a basic rate of say, 27 or 28% in 4 years' time? (As a rough ready reckoner 1% off the basic rate is equivalent to about £0.7 bn of public expenditure).

(3) Public Expenditure

10. With present prospects for inflation and growth it is difficult to escape the conclusion that even relatively modest tax and monetary objectives are incompatible with current public expenditure plans. If the plans are to be reopened, the following are among the general considerations Ministers will need to take into account:-

(i) For 1980-81 the scope for savings is necessarily more limited than for later years. Plans have been announced; RSG and nationalised industry cash limits have been promulgated; social security upratings have been set; a greater proportion of capital expenditure has been committed. A "crash" cuts exercise for 1980-81 would be more readily understood against the background of an economic "crisis". The potential trade-off between tax and expenditure is a less compelling justification, particularly if the main target is inflation and expenditure savings take the form of increased charges or reduced subsidies/benefits.

(ii) If there are to be further savings for the later years, is it worth publishing the decisions already taken, even on a provisional basis? Will this not mean that the Government will be criticised twice over for making "cuts"?

Priorities

11. Ministers will need to consider whether the planned expenditure growth on Defence and Law and Order should be protected. Subject to that, the following would seem to be among the main possibilities for substantial

further savings:-

- an across-the-board volume squeeze (perhaps through cash limits) with minimal exemptions. There is some scope for this in 1980-81 (central Government) and much more in subsequent years.
- a moratorium on capital expenditure (to be avoided if possible).
- a further cut in housing (capital); and increased rents in later years.
- employment services (MSC programmes).
- the social security programme (well over one-quarter of total programmes). Can we afford to go on uprating benefits by prices? Is there a case for "prices or earnings, whichever is the less"? Need there be any uprating of Child Benefit next year (not statutorily required)? Can Earnings Related Supplement be abolished?

Conclusion

12. The heart of the Government strategy is the breaking of inflation by strict adherence to monetary targets. At the same time the productivity of the economy is to be stimulated by reducing the size of the public sector, reducing the level of taxation (especially direct tax) and increasing incentives. The monetary and fiscal objectives are of a piece, in that a large public sector and a large PSBR will make the monetary targets that much more difficult to sustain.

13. At the moment the Government has yet to get on course for its strategy. The CPRS believes that there is no way of reconciling the Government's objectives with the public expenditure plans recently endorsed. It believes that the prospect would look immensely better if those plans were reduced by, say, £1 bn in 1980-81, and £2 bn in each of the following two years. Thereafter one would hope that inflation would have been reduced and the economy would have turned round but, given the uncertainties, it seems doubtfully worth while to plan that far ahead at this stage. If public expenditure savings of this order are thought unrealistic, Ministers should recognise that their underlying strategy will have little chance to prove itself over the next 2 or 3 years.

NJT has seen.
29.11.

Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

28th November, 1979

Dear Tim,

3/12

I am afraid there were some infelicities of drafting in my letter to you of 27th November, which should be replaced by the following:-

"You may have seen reports in today's papers of a reference by the Chancellor to an earnings increase over the next year of 14 per cent. There are no signs that this reference, made during an interview on "Weekend World" last Sunday has been misunderstood, but against the possibility that it is raised during Questions on 27th November, it might be as well if I briefly set out the background.

The 14 per cent figure is that used in the recently published Government Actuary's Report (Cmnd 7771) as an illustrative assumption. As the Chancellor pointed out on Sunday, the figure is not a norm, or even a forecast; it is simply one, relatively more sensible, level of earnings increase than the 18 per cent which had been referred to by participants on an earlier programme. It should also be noted that the figure of 14 per cent relates to the overall rise in earnings and not to settlements which would have to be rather lower."

I hope no damage has been done.

Yours ever,

MH

(M.A. HALL)
Private Secretary

T. Lankester, Esq.,
Private Secretary,
10, Downing Street

c/c H Vile.

Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

PRIME MINISTER

You agreed that I should put a paper to Cabinet before Christmas reviewing the economic outlook in the light of most recent economic developments which might first be considered by a smaller group of Ministers under your Chairmanship.

... 2. A draft paper is enclosed. I understand we are to discuss it in the smaller group on Thursday, 6th December. – now 0900 on Friday, 7 December.

3. The Chief Secretary and I have also in hand a second paper setting out some ideas on the possible timing and method of re-opening the public expenditure plans. We hope to let you see this very shortly.

4. I am copying this minute, with the draft paper, to the Home Secretary, the Secretaries of State for Industry, Trade, Energy, Employment and Social Services, and the Chief Secretary.

GH

(G.H.)
27 November, 1979.

PERSONAL AND CONFIDENTIAL

THE ECONOMIC OUTLOOK

Memorandum by the Chancellor of the Exchequer

Introduction

I have been taking stock of the economic situation in the light of the most recent developments. We knew when we took office that we had inherited an extremely difficult situation; and I have no doubt that our general strategy for tackling it remains the right one. But it is now clear that the difficulties we face - both domestic and international - are greater than we had any reason to expect, and I think the time is ripe to re-examine our specific approach in the future.

Recent Developments

2. I would single out three particular developments of concern:-

(i) With strong wage inflationary pressures, poor trading, productivity and competitiveness performance and the unpromising outlook for world trade following the further large increases in oil prices, the economy is moving into a recession from which there could well be only a slow recovery;

(ii) in particular, despite the action I took in the Budget, the recent figures have shown that underlying monetary growth is much higher than we had expected (£M3 has grown at an annual rate of over 14 per cent in the last four months - higher than at the time of the Budget);

(iii) although I believe that the message has got through that we shall stick to our monetary strategy, inflationary expectations, and hence pay pressures, are remaining high and intractable.

3. This more sombre outlook was reflected in the Industry Act forecast that I published last week. This brought out in particular the deteriorating prospects for output and for reducing the rate of inflation in the coming year. I would not wish to attach too much weight to the specific figures in the forecast; but the general direction in which the economy is now moving is clear and agreed by most outside forecasters.

Action so far

4. Given the timing of the election we made a good start in dealing with our dismal inheritance in the Budget. The combination of direct measures on the monetary side (including the increase in MLR to 14 per cent) and reductions in public expenditure in the current year established our credibility from the start and signalled our resolve to maintain strict monetary control backed by fiscal policies consistent with it. And the measures I announced on 15th November demonstrated our determination to maintain those policies in the face of the disappointing deterioration in the underlying monetary and PSBR situation that had come to light. The initial reaction in the markets was favourable and we have secured substantial sales of gilts to help fund the PSBR. I hope that the other effects of the change will now come through so that the growth of the money supply comes into the target range, without even higher interest rates than the already very high ones which we have had no alternative but to accept. But this will depend on a number of factors some of which we can influence - particularly the market's assessment of our determination to carry through our policies, including its reaction to the next expenditure White Paper - and others which we cannot, e.g. the effect of Iranian and US policies on the foreign exchange markets.

Future Action

5. But I fear that, faced with the sombre prospects referred to above, the action we have recently taken may only provide a temporary respite. I remain convinced that, if we are to master inflation as a necessary condition of resumed and sustainable

growth, the progressive reduction of the money supply must continue to have overriding emphasis. It is, in any case, a policy over which we have little choice in a world of floating exchange rates, as the experience of the previous Government has shown. But it is increasingly clear that we shall not be able to achieve this - at any rate in the lifetime of this Parliament - unless we are prepared to modify at least one of our other intentions or objectives.

6. To put this more explicitly, our declared policies at present embrace the following:

(i) An overriding commitment to deceleration in the rate of growth of the money supply at tolerable interest rates;

(ii) an objective of further reductions in the burden of personal taxation, with the long-term aim of reducing the basic rate of income tax to 25 per cent;

(iii) substantial reductions in the inherited public expenditure plans and in the size and role of the public sector generally.

7. In my view no compromise is possible on (i). Otherwise the credibility of our whole economic strategy would be destroyed. And, although I have made it clear publicly that the room for manoeuvre in next year's Budget is very restricted, I believe there is only limited scope for modifying our longer-term tax objective at (ii). At the very least - and this really falls far short of what we have set out to achieve - there must be no <u>increase</u> in the real burden of taxation. But, given the worsening of our economic prospects, I have to confirm that I see no way in which the above objectives can be attained on the basis of the public expenditure plans agreed by the Cabinet in July for 1980-81 and more recently for the later years of the Public Expenditure Survey period.

8. It is now clear that a measure of disappointment with the public expenditure plans for 1980-81 announced in the recent White Paper (which fell some £2 billion short of the target the Chief Secretary and I had set) was an important element in the unsettled market conditions that forced me to take further action on 15th November. The markets were expecting a reduction in the volume of expenditure, and the PSBR in 1980-81 and these expectations were disappointed. For the period after 1980-81 I fear that a similar situation is in prospect. The Chief Secretary and I warned the Cabinet in September that even with the expenditure reductions we were proposing for the later years it would be hard to hold the borrowing requirement to around its present proportion of GDP without some real increase in taxation. In the event the plans agreed by the Cabinet look like being more than £1 billion higher for most of the years concerned; and the economic prospect generally has worsened. On any prudent assessment, therefore, of the outlook for the economy over the next year the present public expenditure plans seem incompatible with achieving a slower growth of the money supply without even higher interest rates or higher taxes.

9. This conclusion is derived from the recent medium-term work on the economy in the Treasury. But the conflicts are likely to be at their most acute in the next two years. Again, as with the short-term prospect, I should not wish to place too much weight on specific figures. There are very large uncertainties and margins of error. But to allow for these I have had further work done on more optimistic assumptions. This shows that, for example, to get money supply growth down to 7 per cent by 1983 (2 percentage points below the middle of the present target range) and the PSBR to about 2½ per cent of GDP (which should allow interest rates to fall) would, on the expenditure plans approved by the Cabinet, imply increases equivalent to around 5p on the basic rate of income tax by 1981-82. And even on this optimistic view of the economy's performance in later years there would be no prospect of a basic rate of below 30 per cent until 1983.

Conclusions

10. For the reasons outlined above the path to low inflation and resumed and sustainable growth will be harder than we had earlier hoped or foreseen. It would be wrong to exaggerate this; but disastrous not to face up to it. In my view two key conclusions now emerge from recent developments. First, however difficult and unpopular the path in the short-term, the centre piece of our strategy against inflation - progressive reduction in monetary growth - remains the only feasible one. But second, unless we are prepared to scale down our spending plans we shall not be able to adhere to this without serious damage to our taxation objectives and the risk of even higher interest rates than the high rates that have proved necessary so far. I believe that this is also becoming increasingly clear to the financial markets and that unless we reduce our spending plans so that they are consistent with our other objectives we shall be confronted by a series of tensions in the financial markets, of which that earlier this month was only a first example.

11. I should be grateful for my colleagues' views. As a help to discussion the Chief Secretary and I have set out in a separate paper some ideas on the possible timing and method of re-opening the public expenditure plans. Subject to our discussion of these two papers I should like to consider when and on what basis we should consider re-examining the present public expenditure plans with the Cabinet, bearing in mind that the Cabinet noted that there was a case for so doing in their discussion on 15th November.

(G.H.)

H.M. Treasury

26th November 1979

27 NOV 1979

ACTION

National Economic Development Council

NEDC(79)65

POLICY ON THE ECONOMY

Memorandum by the Chancellor of the Exchequer

P.

Introduction

It is not difficult to define the main objectives of economic policy. At the centre is sustainable non-inflationary growth in output to provide more jobs and improved living standards - including better public services as well as higher private consumption. The real problem is in agreeing on the precise means of achieving these objectives. But even here there is probably more agreement than many commentators would suggest.

2. Before turning to the prospects for the coming year or so, and the broad policies that seem inescapable if the foundations for economic recovery are to be soundly laid, it must be recognised that the economic position puts powerful limits on what is feasible in the period ahead. This means that in the short run the scope for influencing underlying trends is necessarily small.

The historical context

3. Undoubtedly the most important general trends in the UK economy in the last 10 or 15 years have been poor productivity growth and continued inflation, reflected in weak industrial and trading performance and erosion of company profits. Some sectors - such as chemicals, instruments and electrical engineering - have grown rapidly since the war. And their productivity record has been good. Other industries for a variety of reasons have performed badly. For example under the impact of low productivity and industrial unrest the output of the UK car industry fell from 1.7m vehicles in 1973 to about 1.2m in 1978, whereas competitor countries increased their output markedly. As a result overseas competitors now have more than half the UK market for cars and employment in the home industry is suffering. The successful industries and companies are however a pointer to

what can be done, even though the dynamic sectors have not so far been a match for those in decline.

4. The rate at which the economy in aggregate has lagged behind has, of course, varied. At times we have done better but recently performance has weakened. For example, output per head in manufacturing rose by only ½ per cent a year between 1973 and 1978 - below previous trends and significantly slower than for most of our competitors. By contrast, money earnings rose fast and our relative labour cost competitiveness accordingly worsened. And, squeezed by cost pressures and competition from abroad, industrial and commercial companies' real rates of return averaged only about 4 per cent in the past 5 years, compared with around 11 per cent in the 1960s. All this has meant that, taken as a whole, our industry has not expanded to meet demand; manufacturing production last year, for example, was below its 1973 level, while the volume of manufactured imports had increased since 1973 by more than 30 per cent. This increasing inability of significant sectors of home industry to compete with overseas suppliers has been the main barrier to growth, not lack of demand.

Immediate prospects

5. Under the provisions of the Industry Act the government recently published forecasts for the period up to the end of 1980 and a number of other forecasts have also been published. Although there are differences of degree and emphasis, and the uncertainties are particularly large at present, three common features perhaps stand out:

(i) Inflation is still too high, with the underlying rate of increase in retail prices, for example, now around 1 per cent a month. All the forecasts predict a slowing of inflation during 1980 although the year on year figure seems unlikely to come down until the second half of the year. The government's forecast suggests that in the year to the 4th quarter of 1980 the RPI increase will be about 14 per cent, provided - and this is a key assumption - there is a progressive reduction in the size of pay settlements.

(ii) Nearly all forecasters predict a fall in GDP in 1980 after the fairly flat trend over the past year, although the precise course of this will depend on success in reducing inflation, the pace of world trade and our trading performance.

(iii) The current account of the balance of payments this year seems likely to be in deficit by up to £3 billion following the sharp increase in imports of manufactured goods, particularly in the first half of 1979, and a continued current account deficit, albeit at a reduced rate, is expected for 1980.

6. This outlook necessarily reflects world developments which increase domestic inflationary pressures and depress the demand for our exports. The effective price of oil, for example, is now 65 per cent higher than it was a year ago and the quickening of world inflation is one reason for the expected slower growth in the world economy. Output growth in the main industrialised countries seems likely to slow down from about 4 per cent in 1978 to little more than 1 per cent next year. And in turn markets for British exports of manufactures may grow by only about 4 per cent in 1980, less than half the rate enjoyed before 1974.

7. These international developments make the task of economic recovery that much more difficult. The shock effect of the oil price increase has worsened world inflation and has made the conduct of national economic policies, including monetary policies, more difficult. Nevertheless they must not be regarded as an excuse for failing to adopt the right measures for our own situation.

Future policies

8. This background and the history of previous attempts to improve our performance underline the fact that there are no quick or easy solutions. (A major test at present may indeed prove to be how far, given the general recession in prospect for the world economy as a whole, we can retain our present standards of prosperity.) But they highlight again two imperatives:

(i) If we are to avoid a long-term absolute decline in overall economic performance we should lose no time in laying foundations that will allow sustained non-inflationary expansion of the economy;

(ii) growth and living standards cannot improve unless resources are used more effectively and efficiently.

9. It is probably helpful to distinguish two main approaches to be followed in setting the right climate for renewed growth. First, it is common ground that government should try to set the right overall economic framework in order to ensure, as far as is within its power, a proper balance of resources between different sectors of the economy, that inflation is controlled and that a satisfactory external position is maintained. Second, within this framework, there must be substantial improvement in, and encouragement to, what has come to be called the "supply side" of the economy. A major lesson of recent years has been the ineffectiveness of overall economic policies that have failed to pay sufficient regard to the problem of supply.

10. The pattern of industrial growth to be built on these foundations is not something that governments can or should dictate from the centre. Opportunities for building new industries - services as well as manufacturing - around new products and markets will spring from trends in consumer demands and technological change at home and overseas. What these trends will be is uncertain but they could, for example, spring

from developments in the energy field and in service oriented industries. Smaller scale enterprises will probably have a big role to play: a recent study showed that in the USA 60 per cent of all jobs are generated by firms employing 20 employees or less and a recent study of the Cleveland area in the UK indicated the importance of small firms in providing new jobs as jobs in old-established industries disappeared. It will be necessary to think in completely new ways about what will in future constitute "employment". Trends for employment under the impact of new technology will be discussed at the January meeting of the Council. The economic framework and industrial atmosphere need to create an environment in which new occupations, industries and jobs can flourish and take up resources freed from industries in decline.

Overall economic framework

11. Successive Governments have set themselves the aim of controlling inflation. Continued high inflation undermines consumer confidence and demand and eats into the social fabric through its perverse redistributive effects. It affects not only today's jobs but, by corroding business confidence and reducing investment, ensures that many potential new jobs will be stillborn. There have been repeated attempts, whether of a statutory or non-statutory kind, to restrain inflation by direct control of incomes. The promulgation of a norm for pay increases - for example a fixed percentage - has not been successful. By introducing distortions and hampering the flexible allocation of resources it can be positively harmful and there is now increasingly general agreement that an institutionalised "incomes policy" is not a realistic answer to the problem of inflation. There has at the same time been a growing recognition on all sides of industry that firm monetary control is essential if inflation is to be tackled at its roots.

12. Precisely how that monetary control should be applied is a matter for legitimate discussion and debate. The government

has continued the practice of setting specific targets for monetary growth, and has demonstrated its determination to see that they are observed. Inflation can only be mastered if the money supply is brought under firm control and its rate of growth progressively reduced over the years.

13. But although an appropriate monetary policy is a vital part of the framework, it is also necessary to ensure a proper balance between the resource needs of the public and private sectors. In particular this means that, though there is room for disagreement over particular priorities, the total volume of public spending must be planned on realistic assumptions about economic growth. The evidence is that to allow public spending plans to run ahead of growth of GDP leads to the need for disruptive cut-backs and, except in the very short term, a stifling of the very economic growth that is the only sound basis for improvements in public services. The aim is to see that over the years public spending as a proportion of GDP should decline.

14. Experience has shown that excessive levels of public spending have led to too much government borrowing and to high taxation, which have impeded growth. High levels of borrowing have also prevented proper monetary control and therefore led to inflation and high interest rates, and hence in turn to further disincentives to investment and economic efficiency. And the consequent lack of growth has made it harder to bear the burden already imposed on the economy by rising public expenditure. It is essential to break out of this vicious circle; and proper restraint on public expenditure is clearly a necessary element in achieving this. In present circumstances indeed, it is not possible to plan for any increase in public expenditure over the next few years.

"Supply Side" policies

15. The setting of the right overall framework is an essential requirement for resumption of sustainable growth. But it is

not enough. The challenge of the energy crisis, of new technology and of newly industrialising countries - all of which the Council have discussed - call for much greater flexibility and willingness to adapt within industry and society generally. The response has to come from industry, but the government can help by doing what it can to create an environment favourable to enterprise and innovation. A major need at present, as recognised in papers before the November meeting of the Council, is for a major programme to raise awareness of new technologies throughout industry and to use all opportunities to persuade people of the paramount need for more effective use of industrial resources.

Incentives

16. There has been little doubt that the public has wanted the burden of direct tax reduced. With current levels of public expenditure this has necessarily involved a substantial switch from tax on income to tax on spending. Income tax reductions in the Budget helped to mitigate the disincentive effects of the poverty trap and bring our personal tax rates more in line with those in other countries. The restoration of incentives is an important part of action to remove the contraints on growth imposed by skilled labour shortages, which have tended to persist even when unemployment generally has risen and have acted as a brake on expansion. The TUC paper discussed at the November Council meeting, for example, stressed the importance of securing a proper supply of trained manpower for the micro-electronics industry. Improvements in manpower and training policies are one part of the solution to this problem but tax policy must help in establishing differentials which make it worthwhile to gain and use improved skills.

17. The Government hopes in the years ahead to be able to make further cuts in income tax and to achieve a further real increase in thresholds; and it is also reviewing the systems of company and capital taxation. But the rate of progress in all these areas will be subject to the constraints imposed by the difficult economic prospect and to the need for fiscal policies consistent with responsible monetary control.

18. Change in the economy inevitably involves upheavals for individuals and their families as jobs disappear in one industry and new employment opportunities arise elsewhere. It is an important responsibility of government to ease the passage of change for those who lose their jobs, through manpower and training services and the social services.

Removal of barriers

19. Apart from changes in tax policy, of the kind now implemented, there have been widespread demands for the removal of unnecessary controls and administrative burdens on industry. The government is ready to do what it can. Price, dividend and exchange controls have already been removed, as have Office Development Permits. Changes have been made in the Industrial Development Certificate system, and other planning controls are being modified. Ways of simplifying planning procedures and building regulations are being reviewed with a view to reducing the time taken to complete investment projects. In addition certain changes were made in July to provisions of the Employment Protection Act and consultations have begun on proposals to amend other provisions which many agree have discouraged the formation of new jobs. The aim of all these changes is not change for change's sake but a genuine wish to let firms and their employees concentrate on flexible deployment of resources and reduce the effort which has too often had to be put into observing rules and regulations of only marginal usefulness.

20. Although none of these measures by itself holds the key to getting the "supply side" of the economy right, cumulatively they should help to improve the general climate for industry. But there are other factors of equal importance. In many situations, for example, competition is the best promoter of both industrial efficiency and the interests of the consumer. This is why the Government have introduced the Competition Bill which will permit the Director General of Fair Trading and the Monopolies and Mergers Commission to investigate restrictive practices more selectively - individual firms and bad practices will be liable to investigation - and more expeditiously. The

Bill also provides for the investigation of alleged abuse of monopoly power by, and of the general efficiency of, public sector trading bodies.

21. Within the freer and potentially more rewarding environment that we should like to create, the prime responsibility for improving industrial performance must rest squarely with management and employees at company and plant level. But, when they operate effectively, the tripartite Sector Working Parties (SWPs) also have a valuable role in helping to identify what needs to be done in particular industries and in stimulating the necessary action at company level. In many sectors the problem is one of poor non-price competitiveness (e.g. outdated product design, poor quality and inadequate delivery and after-sales service); in other cases the SWPs have shown that there is considerable scope for improving performance by strengthening co-operation between potential users (including retailers) and potential suppliers, or by curbing the unnecessary proliferation of purchasing standards and requirements. There are other major cross-sectoral issues such as productivity (in its widest sense), the manpower issues such as skill shortages, and technological developments including microelectronics. These are all issues which the SWPs have been tackling and will need to keep to the fore in future work.

General conclusions

22. In the light of this and the other papers before it the Council will wish to consider the general approach to the difficult problems ahead. While there will naturally be different views on particular aspects, some broad conclusions may be thought to emerge.

23. First, although the difficult prospect ahead limits the room for manoeuvre and a painful period of adjustment seems inevitable, the prime aims of economic policy must be to reduce inflation (and thereby restore confidence) by proper monetary control, to get the balance of the economy right and to take every opportunity to encourage growth through encouragement to the "supply side" of the economy.

24. Second, within the above objectives, the prospects for the company sector and the path of unemployment depend heavily on the individual behaviour of those setting pay and prices in industry. The absence of an institutionalised "incomes policy" does not remove the need for a responsible attitude to pay settlements. Indeed the firm restraint of money supply underlines the imperatives that need to be respected by both sides of industry. Excessive increases in pay or prices are bound to cause a deeper recession, more unemployment and slower reduction of inflation.

25. Prosperity and jobs depend crucially upon achieving an effective use of all resources. The economy can only grow if we are industrially competitive. There is widespread agreement about the need to accept new technology; and about the importance of improving consultations and communications between both sides of industry at all levels. The main focus for action must be at company and plant level, and here the Sector Working Parties have an important part to play. It is vital that throughout industry and in government everything possible should be done to help raise industrial performance and to equip the economy to respond and adapt more quickly to a fast-changing world.

(G.H.)

HM TREASURY
Parliament Street

27 November 1979

1. Mr Whitmore [illegible] 22.xi
2. CF..

copied to Community Budget + Master Set

NOTE FOR THE RECORD

c. Mr. Alexander

The Chancellor called on the Prime Minister at 0900 hours this morning.

They discussed briefly the handling of the draft paper which the Treasury had sent over last night on "the Economic Outlook". The Prime Minister agreed that this should be circulated to a small group of Ministers. I have written to the Treasury accordingly, with the names of the Ministers whom the Prime Minister wants to be on this group.

They also discussed the Chancellor's minute of 21 November on our EEC contribution. The Chancellor said that he had pursued his enquiries on the possibilities of reducing or interrupting our contribution rather further than the FCO would have liked; but he felt that all avenues had to be explored. If it was not possible to achieve all that we wanted at the Dublin Council, it might be possible to follow through at the Budget Council meeting shortly thereafter.

The Prime Minister said that there seemed to be plenty of mechanisms for reducing our contribution, given the will. But she wanted to be clearer on precisely what the mechanisms were, and she would like to see more figures. The Chancellor said that the Treasury would be sending over additional material, which should meet the Prime Minister's requirements, by the weekend.

The Prime Minister said that Mr. Scott Hopkins had told her that supplementary estimates of £800 million were likely for this year; of which the UK's share would be £200 million. However, she was not sure that his figures were correct.

Turning to the debate on the EEC budget, the Chancellor explained that it had not been possible to have an FCO Minister speak in the debate. Neither Lord Carrington nor Sir Ian Gilmour were available; and therefore Mr. Peter Rees would be winding-up for the Government. The Prime Minister wondered why Mr. Ridley could not wind-up. The Chancellor explained that he had not had

/ anything

anything to do with EEC budget matters. The Prime Minister then said that she could not understand why Mr. Ridley was not working on economic issues. He was the only FCO Minister who understood economics. She intended to take this up with Lord Carrington (and asked to be reminded to do so).

TL

22 November 1979

PERSONAL AND CONFIDENTIAL

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Tim Lankester
No. 10

These are the figures which informed the Chancellor's recent paper. They are very sensitive: they have not gone (and will not go) outside the Treasury, and the circulation within the Treasury was very narrow and Personal and Confidential. Please treat accordingly.

John [illegible]
23/11

THE MEDIUM TERM PROSPECT

PERSONAL

Introduction

This note briefly summarises the medium term prospect (Case A) and presents some results on an optimistic variant, which has become known as the "better world" (Case B). Case A is an extension over the medium term of the main case in the report on the short term forecast (circulated on October 22 under a covering minute to the Chancellor by Mr Shepherd) and is identical to this for the first two years. The "better world" case has been designed on somewhat different principles to the four variants in the short term forecast, but does have some features in common with these.

2. Both Cases A and B have been constructed (i) with constant indexed tax rates, or (ii) with a declining path for the PSBR, achieved by varying personal taxes. The declining path for the PSBR is as set out in the FST's note to the Chancellor of September 24. An alternative procedure would be to fix an "acceptable" path for interest rates rather than for the PSBR and work out the tax implications of this. At the moment, however, it is computationally simpler to fix the PSBR.

3. It is worth noting that all the cases assume that public expenditure plans for 1981-82 to 1983-84 are as proposed by Treasury ministers and not the higher totals that have been agreed by Cabinet.

4. The tables attached to this note are

Table I	Case A(i)	:	The main case (identical to the short term forecast for 1980 & 1981).
Table II	Case A(ii)	:	as in A(i) with a declining path for the PSBR achieved by varying taxes.
Table III		:	The changes in taxes needed to achieve the PSBR target in Case A(ii).
Table IV	Case B(i)	:	The "better world" case.
Table V	Case B(ii)	:	The "better world" case with the PSBR constrained as in A(ii).

Table VI	:	The changes in taxes needed to achieve the PSBR target in Case B(ii)
Table VII	:	The growth in potential output over the medium term.
Table VIII	:	A summary comparison of Cases A(ii) and B(ii).

The medium term prospect in the main case (Cases A(i) and A(ii))

5. The assumptions on policy and behaviour are essentially the same as those summarised in the report on the short term forecast and are not given in detail again here.

Case A(i)

6. The main features of the prospect in Case A(i) (Table I) are as follows:

(i) The fall in GDP comes to an end in 1982, but the subsequent rise is extremely modest. Manufacturing output falls throughout the period. Unemployment rises steadily through the period.

(ii) The rate of increase of average earnings falls steadily after 1980 to reach 9 per cent in 1983. This gives an idea of the strength of the unemployment effect in the main earnings equation. The rate of increase in the RPI falls more slowly and real take home pay falls in every year.

(iii) The effective exchange rate falls, but only enough to maintain labour cost competitiveness at the extremely unfavourable level reached in 1979.

(iv) The PSBR as a share of GDP at market prices rises until 1981-2 after which it falls. The PSBR path and the assumed target growth for £M3 together imply rises in interest rates until 1981-82 and only modest falls thereafter.

TABLE 4 CASE A(i)

Percentage changes on a year earlier unless otherwise stated.

	1978	1979	1980	1981	1982	1983	Annual average 1978-83
Activity							
GDP	2.6	1.2	-3.3	-1.8	0.1	0.8	-0.6
Manufacturing Output	0.4	0.6	-7.0	-4.2	-1.5	-0.7	-2.6
Unemployment (%) (narrow)	5.6	5.3	6.4	8.4	9.6	10.1	7.6
Prices & Costs							
Average Earnings	13.8	15.0	16.9	13.4	11.5	9.0	13.1
RPI	8.3	13.5	17.8	15.3	12.5	10.6	13.9
Real take-home pay	6.4	3.2	-1.1	-1.7	-0.7	-1.4	-0.4
Balance of Payments & Exchange Rate							
Effective Exchange Rate	63.0	67.5	62.8	60.4	58.3	56.4	61.4
Labour Cost Competitiveness	93.1	106.1	105.2	106.7	107.8	106.8	104.3
Current Balance (£bn)	1.0	-2.9	-2.2	0.9	0.4	-0.4	-0.5
Borrowing Requirement & Financial Forecast (financial years)							
PSBR (£bn)	9.3	8.7	10.3	12.7	12.2	11.2	10.7
as % of GDP at market prices	5.6	4.5	4.7	5.1	4.4	3.6	4.7
£M3	11.5	10.7	9.0	8.5	8.0	7.0	8.7
LA 3 month interest rate (%)	10.7	13.6	14.8	15.4	14.5	13.0	13.7
20 year gilt rate (%)	12.9	12.7	14.6	15.0	14.4	13.0	13.8

TABLE 10 CASE A(ii) PSBR TARGET ACHIEVED THROUGH CHANGES TO PERSONAL TAXES

Percentage changes on a year earlier unless otherwise stated.

	1978	1979	1980	1981	1982	1983	Annual Average 1978-83
Activity							
GDP	2.6	1.2	-3.4	-2.2	0.0	1.1	-0.7
Manufacturing Output	0.4	0.6	-7.1	-4.7	-1.7	-0.3	-2.7
Unemployment (%) (narrow)	5.6	5.3	6.4	8.5	9.9	10.3	7.7
Prices & Costs							
Average Earnings	13.8	15.0	16.9	13.3	11.1	8.5	12.9
RPI	8.2	13.5	17.8	15.0	12.1	10.2	13.7
Real take-home pay	6.4	3.2	-1.1	-1.7	-0.7	-1.4	-0.3
Balance of Payments & Exchange Rate							
Effective Exchange Rate	63.0	67.5	62.7	60.3	58.6	56.7	61.5
Labour Cost Competitiveness	93.1	106.1	104.9	106.3	107.8	106.4	104.1
Current Balance (£bn)	1.0	-2.9	-1.9	2.0	2.2	1.2	0.3
Borrowing Requirement & Financial Forecast (financial years)							
PSBR (£bn)	9.3	8.6	8.8	8.6	8.3	7.7	8.5
as % of GDP at market prices	5.6	4.5	4.1	3.5	3.0	2.5	3.8
£M3	11.5	10.7	9.0	8.5	8.0	7.0	8.7
LA 3 month interest rate (%)	10.7	13.6	14.3	13.8	12.7	11.1	12.7
20 year gilt rate (%)	13.0	12.7	14.1	13.5	12.6	11.1	12.8

TABLE III : TAX CHANGES TO MEET PSBR TARGET IN CASE A(ii)

	PSBR ≠≠≠ RATIO IN CASE A(i)	TARGET PSBR RATIO IN CASE A(ii)	EX ANTE CHANGES IN TAXES TO ACHIEVE TARGET PSBR		
			£m	£m at 1979(4) prices ≠	pence on ≠≠ basic rate
1980/81	4.7	4.0	1501	1311	2.7
1981/82	5.1	3.5	4000	3073	6.4
1982/83	4.4	3.0	3363	2323	4.8
1983/84	3.6	2.5	1968	1242	2.6

≠ Current price tax changes deflated by the consumers' expenditure deflator.

≠≠ Assumes no accompanying changes to either higher rates or bands; these estimates are therefore largely illustrative.

≠≠≠ Ratio of PSBR to GDP at market prices.

Case A(ii)

7. The main features of Case A(ii) are in Table II. The tax increases necessary to achieve the declining path for the PSBR are in Table III.

8. Constraining the PSBR produces a not unacceptable path for interest rates. The increases in the level of taxes from those produced by constant indexed tax rates are considerable. In 1981-82 the increase is equivalent to 6½ pence on the basic rate, though there is some decline thereafter to a level of basic rate still above the present rate.

9. In spite of the substantial increases in personal taxes the effect on growth and inflation are quite small. The explanation for these somewhat paradoxical results are complicated, but they do illustrate the strength of the interest rate effects (in this case a "crowding in" effect) in the Treasury model. Lower interest rates for given money supply produce a lower exchange rate and thus produce better competitiveness and net exports. Lower interest rates have a direct effect on consumers' expenditure and investment and also have a powerful effect on the RPI, which eventually has an effect on the increase in earnings. These interest rate effects in large part offset those of higher personal taxes on earnings, through the 'retention ratio', and on consumers' expenditure, through lower RPDI.

The medium term prospect with a 'better world' : Cases B(i) and B(ii)

10. The purpose of the 'better world' case is to illustrate prospects on the basis of a possible - but not in our opinion central - alternative view of how the economy has worked and/or will work in the future. It is not therefore simply an optimistic variant, and as will be seen has very little effect on output in the early part of the period.

11. The main differences between the main and 'better world' cases are

(a) a stronger effect from interest rates to expenditure;

(b) a stronger short run effect from unemployment to wage inflation (the coefficient is twice the value used in A(i) and (ii));

(c) an allowance for the effect of past and announced future increases in £M3 on price expectations of those involved in wage bargaining;

(d) a gradual increase in the annual rate of growth of underlying productivity (the increase begins in 1981 and is $1\frac{1}{4}$ per cent per annum by 1983);

(e) some improvement, consistent with (d), in non-price competitiveness of traded goods.

The improvement in productivity growth in (d) is large in relation to the historical rate of productivity growth. (Table VII sets out the productivity assumptions.)

12. Changes (a)-(e) on their own produced a sharp reduction in the rate of inflation over the period. Earnings decelerated more than prices and real take home pay fell even more than in the main case. GDP fell more in the early years and rose more quickly at the end of the period. To reduce these effects there are in Case B(i) and (ii) in addition to those changes set out in the previous paragraph,

(f) in 1982 and 1983 some increase in the level of nominal earnings and a small reduction in prices: these improve the prospect for real take home pay and prevent earnings growth (temporarily) falling below monetary growth.

(g) some small addition to net exports in 1980 and 1981.

(g) partly lessens one consequence of the 'better world' assumptions, (a)-(e), namely that the cycle generated by a progressive tightening of fiscal and monetary policy is more pronounced than in the main case. Tables IV, V & VI show the economic prospect with all the adjustments ((a)-(g)). The rate of price inflation comes down to 7 per cent in 1983. Growth in GDP is significantly higher than in the main case in 1982 and 1983. To achieve the target PSBR (as in Case B(ii)) the basic rate of tax still has to rise in the early years though by less than in Case A(ii) Only in 1983-84 is the basic rate lower than at present.

13. One feature of a planned reduction in inflation brought about by tighter fiscal and monetary policy is that it works primarily through the labour market. The adjustments in (g) above and the higher exchange rate than in Case A help to reduce the rate of price inflation independently of the path of earnings. In spite of these adjustments earnings

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TABLE IV : CASE B(i) - THE BETTER WORLD

Percentage changes on a year earlier unless otherwise stated.

	1978	1979	1980	1981	1982	1983	Annual Average 1978-83
Activity							
GDP	2.6	1.3	-3.4	-1.7	1.3	3.0	0.1
Manufacturing Output	0.4	0.6	-6.9	-4.2	0.0	2.4	-1.7
Unemployment (%) (narrow)	5.6	5.3	6.4	8.8	10.4	10.7	7.9
Prices & Costs							
Average Earnings	13.8	15.0	16.9	11.1	7.2	5.3	11.0
RPI	8.3	13.5	17.4	13.1	8.8	6.9	11.9
Real take-home pay	6.4	3.2	-0.7	-1.8	-1.1	-1.2	-0.3
Balance of Payments & Exchange Rate							
Effective Exchange Rate	63.0	67.5	63.8	63.4	61.8	61.0	63.4
Labour Cost Competitiveness	93.1	106.1	106.7	108.5	105.0	100.8	103.4
Current Balance (£bn)	1.0	-2.9	-1.3	2.3	2.0	1.6	0.5
Borrowing Requirement & Financial Forecast (financial years)							
PSBR (£bn)	9.3	8.6	10.0	12.1	10.4	6.6	9.5
as % of GDP at market prices	5.6	4.5	4.6	5.0	3.9	2.3	4.3
£M3	11.5	11.0	8.7	8.5	8.0	7.0	8.6
LA 3 month interest rate (%)	10.7	13.6	14.7	14.5	12.8	10.4	12.8
20 year gilt rate (%)	12.9	12.7	14.5	14.2	12.7	10.4	12.9

TABLE V : CASE B(ii) PSBR TARGET ACHIEVED THROUGH CHANGES TO PERSONAL TAXES IN 'BETTER WO[illegible]

Percentage changes on a year earlier unless otherwise stated.

	1978	1979	1980	1981	1982	1983	Annual Average 1978-8[illegible]
Activity							
GDP	2.6	1.3	-3.5	-1.9	1.3	3.5	0.1
Manufacturing Output	0.4	0.6	-7.0	-4.5	-0.1	3.0	-1.6
Unemployment (%) (narrow)	5.6	5.3	6.4	8.9	10.5	10.8	7.9
Prices & Costs							
Average Earnings	13.8	15.0	16.9	11.0	7.0	5.0	10.9
RPI	8.3	13.5	17.4	12.9	8.4	6.7	11.7
Real take-home pay	6.4	3.2	-0.7	-1.8	-1.0	-1.2	-0.3
Balance of Payments & Exchange Rate							
Effective Exchange Rate	63.0	67.5	63.7	63.2	62.1	61.3	63.5
Labour Cost Competitiveness	93.1	106.1	106.5	108.1	105.2	100.7	103.3
Current Balance (£bn)	1.0	-2.9	-1.1	3.1	3.3	2.0	0.9
Borrowing Requirement & Financial Forecast (financial years)							
PSBR (£bn)	9.3	8.6	8.7	8.4	7.9	7.2	8.4
as % of GDP at market prices	5.6	4.4	4.0	3.5	3.0	2.5	3.8
£M3	11.5	11.0	8.7	8.5	8.0	7.0	8.6
LA 3 month interest rate (%)	10.7	13.6	14.3	13.1	11.5	9.7	12.1
20 year gilt rate (%)	12.9	12.7	14.0	12.8	11.4	9.7	12.3

TABLE VI : TAX CHANGES TO MEET PSBR TARGET IN CASE B(ii)

	PSBR ≠≠≠ RATIO IN CASE B(i)	TARGET PSBR RATIO	EX ANTE CHANGES IN TAXES TO ACHIEVE TARGET PSBR		
			£m	£m at 1979(4) prices ≠	pence on the basic rate ≠≠
1980-81	4.6	4.0	1262	1109	2.3
1981-82	5.0	3.5	3574	2827	5.8
1982-83	3.9	3.0	1903	1398	2.9
1983-84	2.3	2.5	-2121	-1470	-3.0

≠ Current price tax changes deflated by the consumers' expenditure deflator.

≠≠ Assumes no accompanying changes to either higher rates or bands; these estimates are therefore largely illustrative.

≠≠≠ Ratio of PSBR to GDP at market prices.

TABLE VII PRODUCTIVITY & PRODUCTIVE POTENTIAL (All figures % pa, rounded to nearest ¼%)

	1975	1976	1977	1978	1979	1980	1981	1982	1983
Recorded output per head									
(1) Manufacturing	- 2½	5¼	¾	1	1½	-	-	-	-
(2) Non-manufacturing	2	½	1¼	¾	- ½	-	-	-	-
(3) Whole economy (excl. N/Sea)	- ¼	3	¾	1½	- ¼	-	-	-	-
Productive Potential									
(i) Labour force	1½	1½	1¾	½	¼	½	1	1	¾
(ii) Underlying productivity ⨍ (adjusted for cyclical effects)									
(1) Manufacturing	3½	2½	1½	1½	1¼	¾-1	¼-1¼	¼-1¾	¼-2½
(2) private non-manufacturing	2½	1½	1	1	¾	¼-½	0-1	0-1½	0-2
(3) Whole economy excl. N/sea oil	2¼	1½	1	1	1	½-¾	0-1	0-1½	¼-2
(iii) Contribution of N/Sea oil and gas	0	½	1	¾	¾	½	½	½	¼
(iv) Productive Potential	2¾	2	2½	2¼	2¼	1½-1¾	1½-2½	1½-3.0	1¼-3

⨍ For the future trend productivity growth is given as a range, reflecting the difference in assumption between Cases A and B.

growth still falls more than price inflation as a result of the powerful employment effect and with price expectations partly based on monetary growth. The prospect for real take home pay is therefore little different from Case A.

14. Unless there is in Case B scope for (i) a much higher exchange rate (and therefore worse competitiveness), which we do not think plausible, (ii) some further downward adjustment to prices (as in (f) above), or (iii) significant cuts in personal taxes, real take home pay is bound to fall. The prospect for taxes depends critically on the growth of GDP. Just assuming a more monetarist economy - as in assumptions (a)-(c) of the 'better world' - is not itself sufficient to generate a better prospect for tax cuts. The most powerful way in which this could be done would be to assume an even better trade performance than is in the 'better world' case.

15. Table VIII summarises the differences between the two PSBR constrained cases, A(ii) and B(ii).

TABLE VIII : A comparison of the main and better world cases with the PSBR constrained (annual growth rates (%) unless specified).

	GDP		RPI		Average earnings		Changes to the existing basic rate of income tax (pence per pound)	
	1978 -1983	1983	1978 -1983	1987	1978 -1983	1983	1980-81 to 1983-4 (average)	1983-4
Main case (A(ii))	-0.7	1.1	13.7	10.2	12.9	8.5	+ 4p	+ 2½p
Better world (B(ii))	0.1	3.5	11.7	6.7	10.9	5.0	+ 2p	- 3p

Maureen

Caroline "thinks"
this is when the
meeting is – but
it probably won't
happen – just file it.

C.

✓
clashes with NEDC mtg.

10 DOWNING STREET

With the compliments of

10 DOWNING STREET

From the Private Secretary

22 November 1979

File for 5 Decembr

9.30.

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859

File

bc: M. Vile, C.O.
Mr Whitmore to see

10 DOWNING STREET

From the Private Secretary

22 November 1979

~~BF 30-11-79 to see if mtg arranged~~

When the Chancellor called on the Prime Minister this morning, they discussed briefly the draft paper on the economic outlook which you sent under cover of your letter of 21 November. The Prime Minister said that she was content for the Chancellor now to circulate the paper for discussion by a small group of Ministers prior to its being circulated to Cabinet. She would like the group to consist of herself, the Chancellor, the Chief Secretary, the Secretaries of State for Industry, Trade, Energy, Employment and Social Services and the Home Secretary. Perhaps you could get in touch with Caroline Stephens to arrange a suitable time for the meeting of this group of Ministers. The Chancellor mentioned to the Prime Minister that he was also proposing to circulate to the group a paper on public expenditure.

T. P. LANKESTER

overtaken

Set up meeting for 16.00 on Thursday 6th December. J. Hattersley can only attend for ½. ✓

[S. of S. will be publishing White Paper on Industrial legislation that day]

A. M. W. Battishill, Esq.,
H. M. Treasury.

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MT/ W.W./
G.H./ J.P.
J.B./ P.J.
K.J./
J.N./
~~GP~~
D.H

PRIME MINISTER

Meeting with the Chancellor at 0900 hours,
on Thursday, 22 November, 1979

The Chancellor will be sending over later tonight a draft (- now enclosed) of the paper on Economic Strategy which you agreed he should, at some stage, circulate to Cabinet. You also agreed with him that the draft should be considered by a small group of senior Ministers before it is finalised for Cabinet. The Chancellor will no doubt want your clearance of the paper for this more limited discussion. You will have to decide which Ministers should be invited. Earlier, you said that Lord Soames, Mr. Prior, Mr. Whitelaw and Mr. Jenkin should be included. You would presumably want Sir Keith Joseph and Mr. Nott as well.

There is nothing else which - as far as I know - the Chancellor wishes to raise with you. However, I think you might ask him about progress on possible measures to assist small firms.

This was discussed at E Committee on 23 October, and the hope was expressed then that a tax package could be announced in advance of the Budget (even though the actual changes could not come into effect until the Budget). It seems to me that there is now added urgency to this work. Even though the monetary package was inevitable if we were to keep the money supply under control, industry - and particularly small firms - are taking it very badly. I think it would do a lot for industrial confidence if we could now announce something positive.

PM said "push them" T. 21/11

The Chancellor will be receiving a submission in the next week or so; until he receives it, it would probably be unfair to question him on the possibilities. But you might like to urge him to move fast, and if necessary, to override the Revenue if they are stone-walling. (For your own information, the CPRS have got in a tax lawyer who - they hope - will cut through some of the Revenue's objections).

/The best

The best two ideas so far to come forward are:

(a) Tax relief for investment by individuals in new companies. Although minimising the risk of tax avoidance causes lots of technical problems, this would be a radical and easily understood measure aimed at encouraging the foundation of new companies. It has been very crudely estimated to cost around £100 million per year in tax foregone. Of course, if it stimulated new economic activity, this would be offset.

(b) Tax relief for capital losses incurred by an individual investing in an unquoted company. At first sight this sounds a little less politically attractive because it is associated with losses. The aim, of course, is to alter the risk/reward ratio, inducing people with capital to consider putting it into companies (which is risky) rather than, say, property. It would probably cost £10-25 million a year in foregone revenue.

R.

21 November 1979

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cc Hoskyns

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

21 November, 1979

Dear Tim,

When she saw the Chancellor on 5th November to discuss the Bray forecast, the Prime Minister agreed that it would be useful to have a discussion on economic strategy in Cabinet and precede this with a discussion in a smaller group of Ministers.

... I enclose a copy of a paper on the economic outlook which has been prepared as the basis for this discussion which the Chancellor, with the Prime Minister's agreement, would like to circulate to the small Group. The paper mentions (in paragraph 12) a separate paper which considers the possible timing and method of re-opening the public expenditure plans. The Chancellor and the Chief Secretary have set work in hand on this and will let the Prime Minister see it as soon as it is completed.

You may like to suggest to the Prime Minister that the enclosed paper is added to the agenda when she sees the Chancellor at 9 a.m. to-morrow morning.

Yours ever,

Tony Battishill

A.M.W.BATTISHILL

T. P. Lankester, Esq.,

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THE ECONOMIC OUTLOOK

Memorandum by the Chancellor of the Exchequer

Introduction

I have been taking stock of the economic situation in the light of the most recent developments. We knew when we took office that we had interited an extremely difficult situation; and I have no doubt that our general strategy for tackling it remains the right one. But it is now clear that the difficulties we face - both domestic and international - are greater than we had any reason to expect, and I think the time is ripe to re-examine our specific approach in the future.

Recent Developments

2. I would single out three particular developments of concern:-

(i) with strong wage inflationary pressures, poor trading, productivity and competitiveness performance and the unpromising outlook for world trade following the further large increases in oil prices, the economy is moving into a recession from which there could well be only a slow recovery;

(ii) in particular, despite the action I took in the Budget, the recent figures have shown that underlying monetary growth is much higher than we had expected (£M3 has grown at an annual rate of over 14% in the last 4 months - higher than at the time of the Budget);

(iii) although I believe that the message has got through that we shall stick to our monetary strategy, inflationary expectations, and hence pay pressures, are remaining high and intractable.

3. This more sombre outlook was reflected in the Industry Act forecast that I published [earlier this week]. This brought out in

particular the deteriorating prospects for output and for reducing the rate of inflation in the coming year. I would not wish to attach too much weight to the specific figures in the forecast; but the general direction in which the economy is now moving is clear and agreed by most outside forecasters.

Action so far

4. Given the timing of the election we made a good start in dealing with our dismal inheritance in the Budget. The combination of direct measures on the monetary side (including the increase in MLR to 14%) and reductions in public expenditure in the current year established our credibility from the start and signalled our resolve to maintain strict monetary control backed by fiscal policies consistent with it. And the measures I announced on 15 November demonstrated our determination to maintain those policies in the face of the disappointing deterioration in the underlying monetary and PSBR situation that had come to light. The markets have so far responded favourably and I believe that the action I announced should enable us to finance the PSBR within our monetary target for the rest of the current year without even higher interest rates than the already very high ones that we have no alternative now but to accept.

Future Action

5. But I fear that, faced with the sombre prospects referred to above, the action we have recently taken may only provide a temporary respite. I remain convinced that, if we are to master inflation as a necessary condition of resumed and sustainable growth, the progressive reduction of the money supply must continue to have overriding emphasis. It is, in any case, a policy over which we have little choice in a world of floating exchange rates, as the experience of the previous Government has shown. But it is increasingly clear that we shall not be able to achieve this - at any rate in the lifetime of this Parliament - unless we are prepared to modify at least one of our other intentions or objectives.

6. To put this more explicitly, our declared policies at present embrace the following:

(i) An overriding commitment to deceleration in the rate of growth of the money supply at tolerable interest rates;

(ii) an objective of further reductions in the burden of personal taxation, with the long-term aim of reducing the basic rate of income tax to 25%;

(iii) substantial reductions in the inherited public expenditure plans and in the size and role of the public sector generally.

7. In my view no compromise is possible on (i). Otherwise the credibility of our whole economic strategy would be destroyed. And, although I have made it clear publicly that the room for manoeuvre in next year's Budget is very restricted, I believe there is only limited scope for modifying our longer-term tax objective at (ii). At the very least - and this really falls far short of what we have set out to achieve - there must be no <u>increase</u> in the real burden of taxation. But, given the worsening of our economic prospects, I have to confirm that I see no way in which the above objectives can be attained on the basis of the public expenditure plans agreed by the Cabinet in July for 1980-81 and more recently for the later years of the Public Expenditure Survey period.

8. It is now clear that a measure of disappointment with the public expenditure plans for 1980-81 announced in the recent White Paper (which fell some £2 billion short of the target the Chief Secretary and I had set) was an important element in the unsettled market conditions that forced me to take further action on 15 November. The markets were expecting a reduction in the volume of expenditure, and the PSBR in 1980-81 and these expectations were disappointed. For the period after 1980-81 I fear that a similar situation is in prospect. The Chief Secretary and I warned the Cabinet in September that even with the expenditure reductions we were proposing for the later years it would be hard to hold the borrowing requirement to around its present proportion of GDP without some real increase in taxation. In the event the plans agreed by the Cabinet look like being more than £1 billion higher for most of the years concerned; and the economic prospect generally has worsened. On any prudent assessment, therefore, of the outlook for the economy over the next year the present public expenditure plans seem incompatible with achieving a slower growth of the money supply without even higher interest rates or higher taxes.

9. This conclusion is derived from the recent medium-term work on the economy in the Treasury. But the conflicts are likely to be at their most acute in the next 2 years. Again, as with the short-term prospect, I should not wish to place too much weight on specific figures. There are very large uncertainties and margins of error. But to allow for these I have had further work done on more optimistic assumptions. This shows that, for example, to get money supply growth down to 7% by 1983 (2 percentage points below the middle of the present target range) and the PSBR to about 2½% of GDP (which should allow interest rates to fall) would, on the expenditure plans approved by the Cabinet, imply increases equivalent to around 5p on the basic rate of income tax by 1981-82. And even on this optimistic view of the economy's performance in later years there would be no prospect of a basic rate of below 30% until 1983.

Conclusions

10. For the reasons outlined above the path to low inflation and resumed and sustainable growth will be harder than we had earlier hoped or foreseen. It would be wrong to exaggerate this; but disastrous not to face up to it. In my view two key conclusions now emerge from recent developments. First, however difficult and unpopular the path in the short-term, the centre piece of our strategy against inflation - progressive reduction in monetary growth - remains the only feasible one. But second, unless we are prepared to scale down our spending plans we shall not be able to adhere to this without serious damage to our taxation objectives and the risk of even higher interest rates than the high rates that have proved necessary so far. I believe that this is also becoming increasingly clear to the financial markets and that unless we reduce our spending plans so that they are consistent with our other objectives we shall be confronted by a series of tensions in the financial markets, of which that earlier this month was only a first example.

11. I should be grateful for my colleagues views. As a help to discussion the Chief Secretary and I have set out in a separate paper some ideas on the possible timing and method of re-opening the public expenditure plans. Subject to our discussion of these two papers I

should like to consider when and on what basis we should consider re-examining the present public expenditure plans with the Cabinet, bearing in mind that the Cabinet noted that there was a case for so doing in their discussion on 15 November.

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Econ Pol. DSG

10 DOWNING STREET

From the Private Secretary

19 November 1979

The Prime Minister has seen your letter of 18 November and the draft which you enclosed on Economic Prospects for 1980 which it is intended to publish later this week.

The Prime Minister is content with the substance of the draft, but - as I told you on the telephone - she hopes that Treasury Ministers will consider further the drafting with a view particularly to political sensitivities.

I am sending a copy of this letter to Stephen Locke (Financial Secretary's Office).

T. P. LANKESTER

M. A. Hall, Esq., M.V.O.,
H.M. Treasury.

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H.M. Treasury,
Parliament Street,
London. S.W.1.

18 November 1979

Dear Tim,

The Chancellor of the Exchequer has asked me to let you have the enclosed draft of the forecast which he proposes to publish this week in order to meet the Government's obligations under the Industry Act. He was particularly concerned that the Prime Minister see it today, and I have therefore asked the Duty Clerk to bring it urgently to her attention.

The forecast will appear as a supplement to the Treasury's Economic Progress Report. In view of the comments and questions which have already arisen it is very desirable to publish this week. Moreover, a rigorous interpretation of the Industry Act probably implies publication by 20 November. We therefore need to finalise the text on Tuesday, and should be grateful for any comments the Prime Minister may have as soon as possible. I regret the urgency; this arises from the conflicting pressures of the statutory deadline and the need to take account of last week's measures.

The draft is however very much on the lines which the Chancellor discussed with the Prime Minister on 5 November. There are perhaps three features of particular note.

1. Inflation

The RPI forecast of 14% (for the first quarter of 1980 compared with the year previously) is the figure already agreed between the Chancellor and the Prime Minister. It now looks on the optimistic side in the light of the recent level of pay settlements and the rise in interest rates, which is likely to affect the RPI through the mortgage rate. Nevertheless, this figure may be the best compromise between a higher figure which could adversely affect expectations and a lower figure which would be greeted with incredulity.

2. The PSBR

Since the precedent has been to include the PSBR in the next financial year in the autumn forecasts the Chancellor has concluded that simply to exclude it would create the suspicion that prospects were much worse than the Government actually thought. Equally, however, it is most undesirable to offer a precise figure which can so easily get turned into an inescapable requirement. The draft compromises by emphasising the large margins of error and the arbitrary policy assumptions involved; and by referring to the PSBR only as a percentage of GDP and not as a sum of money. In fact, it is necessary to say only that the percentage is much the same as the forecast we have given in 1979/80.

3. The Recession

The forecast shows quite a severe recession - a 2% fall in GDP volume between 1979 and 1980. This is a somewhat sharper fall than most other forecasters have predicted so far, though rather less than the internal Treasury forecast. However, the outside users of the Treasury model have come up with

/ bigger falls

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bigger falls in GDP, and although there is no necessary relationship between the model and the forecast, too big a gap would prompt questions. Although the Chancellor does not want to exaggerate the gloom it may not be unhelpful to indicate that present inflationary trends are bound to have adverse consequences; and to make it clear that the Government is fully prepared for a difficult period in carrying through its policy of bringing down inflation by firm control of the money supply.

Yours ever,

MH

M.A. Hall,
Private Secretary

T.P. Lankester, Esq.,
10 Downing Street.

cc ADingmid

ECONOMIC PROSPECTS FOR 1980

This supplement reviews economic developments so far this year and presents revised Government forecasts, now extended to the end of 1980.

Summary

2 In difficult world conditions and with a recent history of excessive inflation the UK economy is likely to experience some decline in economic activity in 1980. The priority in economic policy will be to counteract inflation by adherence to a declining path of monetary growth combined with the necessary fiscal restraint. The recent trend to accelerating inflation should be reversed in 1980, but the growth of the RPI during the year is still likely to be of the order of 14%. During the period of adjustment to a lower rate of inflation some adverse effects on international competitiveness, profitability and personal real incomes are almost inevitable. Any quantitative assessment of prospects is subject in present circumstances to very large uncertainties: the figures put forward should not be interpreted as indicating anything more precise than that the rate of inflation next year - though declining - is likely to remain in double figures and that there will probably be some fall in real GDP.

Recent developments

3 The higher rate of inflation over the past twelve months has reflected both high pay settlements and rises in oil and other commodity prices. Prices of materials and fuel used by manufacturing industry rose by some 20% in the year to October, indicating the significant non-wage element in inflationary pressure, even though this was greatly mitigated by the strength of sterling, for which the effective rate appreciated by ~~over~~ nearly 10% in the same period. The domestic rate of inflation, as measured either by retail prices or the wholesale price of (non-food) manufactures stood at about 17% over the twelve month period. The TPI, which takes account of direct as well as indirect taxation had risen by a little under 15%. Taken in conjunction with pay increases of some 15-16% on an underlying basis the real value of earnings was still increasing, though the improvement was considerably smaller than it had been in the early months of the year and in 1978, when the trend of commodity prices had been much more favourable. The combination of an appreciating exchange rate and a relatively high rate of domestic inflation has led to a sharp loss of international competitiveness in terms of both prices and costs.

4 The rate of monetary growth in the past twelve months has been over 13%. In banking October, the latest month for which figures are available, sterling M3 grew by 2% taking the annual rate of growth since the beginning of the Government's target period in mid-June to just over 14%. This rapid growth occurred in spite of the rise in MLR from 12% to 14% at the time of the Budget and the fact that recorded growth of sterling M3 has increasingly tended to understate underlying monetary growth. This recent rapid growth reflects in part the high PSBR in the first half of the financial year. The measures announced in the Budget which increase the PSBR, such as the income tax reductions, were expected to come through faster than those which reduce it, such as higher VAT and sales of public sector assets. Also, borrowing by local authorities and public corporations was higher than expected, partly as a result of industrial action at the Post Office which substantially delayed payment of telephone bills. In addition bank lending has been growing extremely rapidly since the turn of the year, to some extent reflecting an unexpectedly buoyant rate of stockbuilding.

4a After the Budget interest rates remained remarkably stable - at about 14% at the short end and about 12½% at the long end - for around four months. But in October interest rates rose further, reflecting both increases in overseas rates, including those in the US, and fears about the continuing rapid rate of monetary growth. On 15 November an increase in MLR from 14% to 17% was announced, and at the same time the Government announced a rolling forward of the 7-11% target range for a further six months. The target now relates to monetary growth at an annual rate in the sixteen month period from mid-June 1979 to mid-October 1980. In addition it was announced that the Supplementary Special Deposits scheme was to be extended for a further six months, with the permitted rate of growth of interest bearing eligible liabilities remaining at 1% per month.

5 The weak recovery from the 1974/75 recession was checked in the autumn of 1978 and followed by a fall in activity in the early months of 1979, largely because production was disrupted by bad weather and industrial disputes. These was a marked rebound in output in the second quarter, but there has probably been a further drop in the third quarter partly as a result of the engineering industry dispute and the trend of activity over the past twelve months has probably been fairly flat. The manufacturing sector has reflected a broadly similar pattern to GDP in total. Despite the lack of output growth employment in undustry has declined only marginally and unemployment was on a downward trend until the summer of 1979, though this appears to have been checked in recent months.

6 Personal consumption has added to demand but there appears to have been little change in public sector demand or in private sector investment. An increasing share of consumption has been met by growth of imports rather than by domestic production.

7 The growth of personal consumption reflected brisk growth in real personal disposable incomes in the period up to mid-1979. The precise timing of both income and consumption movements are complicated by the short-term effects of Budget changes. Taking the first nine months of 1979 the level of personal consumption rose by some 4½% compared with a year previously; this was probably a little below the growth in real incomes over the same period. The fall in consumption in the third quarter of 1979 partly reflected the effect of the Budget which had brought forward expenditure into the second quarter; in view of the trend in prices and real incomes the strong upward movement in consumption has probably now ceased.

8 Private sector investment in distributive and service industries was on a strong upward trend until mid year, but manufacturing investment appeared to have passed a cyclical peak and private sector housing investment had declined sharply. Stockbuilding has remained at a fairly high level so far this year albeit with erratic quarterly fluctuations. Public sector expenditure on goods and services has remained roughly constant.

9 The quarterly path of overseas trade has been greatly obscured and damaged by industrial disputes. It may be best to compare the first ten months of 1979 with the equivalent period of 1978. In this period export volumes (excluding fuel) rose only marginally (¼%) while import volumes (excluding fuel) rose by 14% with a substantially larger growth in imports of manufactures. These movements reflected strong consumer demand and worsening competitiveness while some exports are likely to have been permanently lost as a result of indistrial disputes. Despite favourable terms of trade (reflecting the strong exchange rate) and continuing improvement in the balance of trade in oil the visible balance deteriorated and over the first ten months of 1979 was in deficit by some £3 billion. The invisible surplus, on provisional figures, has also deteriorated. This reflects an estimated worsening of the services balance as well as rising North Sea oil profits accruing to foreign owned companies and some further increase in UK net contributions to the EEC. Over the first ten months of 1979 the current account is provisionally estimated to have been in deficit by some £2½ billion. It remains highly uncertain to what extent this deficit reflects temporary disturbances.

PROSPECTS FOR 1980

Policy assumptions

10 The forecast takes account of the measures announced on November 15 and assumes that monetary growth is held within the new target range. Public expenditure plans for 1980-81 are as set out in the recent White Paper (Cmnd 7746). For the purpose of this forecast tax receipts are projected on the conventional assumption that allowances, /threshholds and specific tax rates are uprated in line with the RPI growth during the previous calendar year.

Inflation

11 Prices in the UK are currently rising at or a little above 1% per month. In the current quarter, the retail price index is likely to be some 17% higher than a year earlier (consistent with the Budget forecast), a rate which includes the once-and-for-all effects of the rise in VAT. Prospects for 1980 depend mainly on rises in domestic costs and in import prices. The effective exchange rate is assumed to remain close to its present level in 1980, so that rises in import prices reflect rises in world prices: although the long-awaited recession in industrial countries may limit any rise in commodity prices, some of the effects of higher import prices that have occurred so far this year will still be feeding through into domestic prices in the early part of next year. The growth of domestic costs depends, essentially, on the climate of pay negotiations. This forecast allows for a progressive reduction in the rate of settlement over the coming year in response to the Government's fiscal and monetary policies. It leads to a forecast reduction in the rate of RPI inflation (over a twelve month period) to 14% in the fourth quarter of 1980. With the share of profits being adversely affected by the continued rise in labour costs and by the fall in economic activity, a significant fall in the rate of inflation must occur in the first instance through a slower growth of costs: there would seem little scope for reduction in the already exceptionally low level of profit margins.

Demand, trade, and activity

12 Taking account both of the weakness of activity and the large prospective pay increases in the public services a small fall in real personal incomes is likely in 1980. However, consumer confidence

should be helped by the decline in the rate of price inflation, and the savings ratio is likely to fall. This leads to a forecast of a small rise in consumers' expenditure next year.

13 Industrial and commercial companies are likely to encounter difficult trading conditions next year, reflecting weak world demand and unfavourable UK competitiveness. The adverse effects on output and profitability, combined with tight monetary conditions, may lead to a downturn in private investment and stockbuilding, both of which appear, in any case, to be close to cyclical peaks. The forecast of private sector investment is strongly influenced by the latest surveys of firms' investment intentions undertaken by the Department of Industry and CBI. Private manufacturing investment is expected to show little change this year and then fall by about 7% next year, rather less than in some previous downturns. Little change is forecast for other private investment in 1980. Stockbuilding was unexpectedly high in the first half of 1979. A turning point is forecast around the end of this year as companies react to the falling away in demand and to financial pressure. The forecast is for destocking on a significant scale during 1980, implying a large turnaround (some 2% of GDP) between 1979 and 1980.

14 The forecast is for little change in the volume of general Government expenditure on goods and services in 1980. This is consistent with the plans in the White Paper on public expenditure in 1980-81 (Cmnd 7746).

15 The US is expected to enter a period of recession and growth in the other industrial countries is expected to slow down, but without coming to a halt altogether. Many governments are tightening policies in order to contain the inflationary impact of higher oil prices, with the result that inflation may be better contained than after the 1973-74 oil price rises. In common with most of the international economic organisations, a slowdown in world economic activity is expected next year. Economic growth in the main industrial countries is forecast to drop from 4% in 1978, to under 3% in 1979 and to around 1% in 1980. The growth in the volume of world

trade is expected to be very slow but the growth of UK markets should be less affected as the imports of smaller OECD countries and OPEC - relatively more important to the UK - are expected to grow faster than trade in general. UK-weighted trade in manufactures, estimated to have risen 5-6% in 1979, may rise a further 4% in 1980. The implication of the forecast for UK inflation combined with the assumption of a constant effective exchange rate, is that the UK's cost and price competitiveness does not change greatly from its recent level.

16 After a period of stability, the share of UK exports of manufactures in world trade appears to have fallen in 1979, with the disruptions caused by industrial disputes in the UK, and probably some effects of worsening competitiveness, adding to the longer-term tendency of the UK to lose share in world markets. In 1980, world trade growth is liable to be weaker and the lagged effects of changes in competitiveness more strongly unfavourable, so that there may be little change in the volume of manufacturing exports.

17 For both import and export volumes this forecast gives some weight to the views of outside forecasters but it is still less optimistic than most on short-term trends in trade volumes. The import propensity has moved upwards in recent years, and fluctuates cyclically though erratically from year to year. With the fall in demand forecast for 1980, the volume of imports should decline. There is particular uncertainty about the forecast for imports of manufactures.

18 Although, largely for cyclical reasons, there may be no further growth next year in the share of demand met from overseas the fall in the main categories of domestic demand - with exports substantially unchanged - indicates some fall in economic activity next year: the forecast, subject of course to a large margin of error, is for a fall in GDP of the order of 2%.

The current account

19 The terms of trade improved between 1977 and 1979 by about 7%. With little change assumed in the exchange rate and with commodity prices rising only slowly, some further improvement in the terms of trade may take place in 1980. On invisibles, the outturn so far this year is, on very provisional figures liable to substantial revision, a good deal less favourable than in 1978, partly as a result of higher payments to the EEC, higher profits earned by foreign companies operating in the North Sea, and higher interest rates in the UK. While there should be an improving trend in the balance of services, higher North Sea profits will continue to reduce the net balance on interests, profits and dividends. There could be some further deterioration in the total balance on invisibles next year.

20 In total, the current account of the balance of payments seems likely to be in substantial deficit this year, perhaps by some £2½ billion. The figure has been affected to a substantial but incalculable extent by the effects of major industrial disputes such as those in the road haulage and engineering industry. Continuing poor performance by the motor industry has also been an important factor. In the absence of disputes on a comparable scale next year, the fall in demand for imports will probably be sufficient to bring about some improvement in the current account, though a significant deficit - possibly of the order of £2 billion - is still forecast.

Public Sector Borrowing

21 In the first six months of the current financial year the PSBR is provisionally estimated at £6½ billion. This is high in relation to the Budget forecast of £8¼ billion for the year as a whole and reflects, in particular, higher than expected borrowing by local authorities and public corporations. There are, however, strong reasons for expecting a big reduction in the PSBR in the second half of the year: receipts from the higher rate of VAT and from the planned £1 billion of asset sales will be almost entirely in the second half of the year and the loss arising from the delays to telephone bills should be partially recovered, though the forecast assumes that £400 million is still outstanding at the end of the financial year. With great uncertainty still remaining the likely outcome now seems to be in the region of £9 billion before taking account of the acceleration of PRT payments announced on November 15. Allowing for the PRT change the forecast reverts to the Budget figure of £8¼ billion (4¼% of market price GDP).

22 For 1980-81 the prospect is inevitably affected both by large prospective increases in public service pay and by the poor outlook for economic activity. There are, however, some favourable factors such as a full year's receipts of VAT at the higher rate, the build-up of revenue from North Sea taxation and the recovery of the remaining backlog of Post Office receipts. On assumptions adopted for this forecast the prospect - subject of course to a very high margin of error - is for little change from the 1979-80 level in the PSBR as a percentage of GDP. In the absence of a fall in economic activity the prospect - given the same policy assumptions - would, of course, be more favourable. If, for example, stronger private sector activity led to no change in real GDP next year rather than the forecast 2% fall, the PSBR would be likely to fall by at least ½% of GDP. With rising GDP the PSBR would be reduced still further. It should also be noted that any projection of the PSBR at this stage reflects not only very high margins of error (past experience would suggest an <u>average</u> margin of error in either direction of some 2% of market price GDP) but also involves necessarily arbitrary or conventional assumptions about future policy decisions. Actual policies for the PSBR in 1980-81 will be determined at the time of the Budget in the light of developments in the economy and, above all, of the requirements for meeting the Government's monetary target.

Margins of error

23 At present any assessment involves unusually large uncertainties. In particular, there is no reliable way of using past experience to assess the pace at which inflation responds to the new emphasis of monetary and fiscal policy. This applies particularly to the effects of policy on expectations, both insofar as they influence pay settlements directly and insofar as they influence financial markets and hence, in turn, the exchange rate, domestic prices and pay settlements. Similarly, because of the loss of trading competitiveness, which has occurred and is assumed not to be corrected, the forecast is particularly sensitive to fallible estimates of cost and price elasticities. Given a pronounced cycle the response of investment and stockbuilding to movements in output, profitability and financial conditions is also important.

24 In the circumstances it is not sufficient to use margins of error based on the record of past forecasts and the assessment of uncertainty has to be fairly subjective. Nevertheless, the final column of table 1 shows the average errors obtained from past forecasts with a time horizon comparable to the present forecast for 1980. In addition to the arguments for believing that margins of error are bigger in present circumstances it should be emphasised that these are average errors which, by definition, have frequently been exceeded.

25 Given these qualifications the forecast should not be interpreted as suggesting much more than that retail price inflation is likely to slow down but to remain in double figures next year and that there will probably be some fall in real GDP.

Table 1: Economic Prospects to end 1980

	1978 to 1979	1979 to 1980	Margins of error in 1980*
A. Output and expenditure at constant 1975 prices	percentage changes		per cent
Gross Domestic Product (at factor cost)	1	-2	1½
Consumers' Expenditure	4	½	1½
General Government Expenditure on Goods and Services	½	0	1½/
Public Corporations fixed investment	-4½	-4½	6½
Private sector investment	-2	-1	4
Exports of Goods and Services	1½	0	3½
Stockbuilding (as per cent of GDP)	¼	-2	¾
Imports of goods and services	11½	-2½	2½
	1979	1980	
B. Balance of payments on current account	£ billion		£ billion
	-2½	-2	2
	percentage changes		per cent
C. Retail Price Index	4th Quarter 1978 to 4th Quarter 1979	4th Quarter 1979 to 4th Quarter 1980	
	17½	14	4

/This margin applies to General Government consumption.

*The errors relate to the average differences (on either side of the central figure) between forecast and outturn. The method of calculating these errors has been explained in earlier publications on Government forecasts, notably in November 1978.(See Economic Progress Report Supplement or Economic Trends No 301, November 1978.) The errors are after adjustment for the effects of major changes, where excluded from the forecasts, in fiscal policy and hire purchase terms controls. Quarterly forecasts are grouped so as to be comparable with the changes between calendar years as shown. For a forecast made in quarter 0 the errors (both for the constant price magnitudes and for the current account) relate to the forecast changes between the "base year" (quarters -1 to -4) and the forecast period (quarters 1 to 4). The strict comparison with the present calendar year forecast would, of course, involve a base year comprising quarters 0 to -3. For the retail price index the margin relates to the percentage change between quarter 0 and quarter 4.

Although roughly appropriate in respect of time horizon and period covered these figures are likely to understate the true margins of error for the general reasons indicated in the concluding paragraphs of the text.

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Table 2. Forecasts of expenditure, imports and gross domestic product

£ million at 1975 prices, seasonally adjusted

	Consumers' expenditure	General Government expenditure on goods and services: Final consumption	Fixed investment	Total	Other fixed investment	Exports of goods and services	Stockbuilding	Total final expenditure	less Imports of goods and services	less Adjustment to factor cost	Statistical adjustment	Gross domestic product at factor cost	GDP index 1975=100
1977	63350	23250	3950	27200	16200	31700	1250	139700	30400	10850	-200	98250	105.1
1978	66700	23650	3350	27000	17150	32350	1100	144300	31600	11850	0	100850	107.9
1979	69300	23900	3200	27100	16650	32850	1450	147350	35300	12300	1550	101900	109.1
1980	69600	24150	3050	27200	16400	32800	-450	145550	34400	12250	500	100150	107.0
1978 First half	32950	11750	1750	13500	8650	15900	600	71600	15700	5900	-50	49950	106.9
Second half	33750	11900	1600	13500	8500	16450	500	72700	15900	5950	50	50900	108.9
1979 First half	34900	11850	1650	13500	8200	15950	800	73350	17600	6200	1050	50900	108.9
Second half	34400	12050	1550	13600	8450	16900	650	74000	17700	6100	500	51000	109.2
1980 First half	35000	12100	1500	13600	8300	16500	-50	73350	17300	6150	250	50450	107.9
Second half	34850	12050	1500	13550	8100	16300	-400	72400	17150	6100	250	49700	106.4
Percentage changes													
1977 to 1978	5½	1½	-15	-1	6	2		3½	4	9½		2½	
1978 to 1979	4	1	-4	½	-3	1½		2	11½	3½		1	
1979 to 1980	½	1	-7	0	-1½	0		-1	-2½	0		2	

Because of rounding half-year totals do not always sum exactly to the annual figures or the components of expenditure to total final expenditure.

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cc Gen Pol (Pub Ex) Pt 6 CONFIDENTIAL Econ Pol PM B Econ Pol

cc Wolfson
Vile (CO)

10 DOWNING STREET

From the Private Secretary 5 November 1979

KRB

The Chancellor of the Exchequer called on the Prime Minister at 1730 hours today to discuss his proposals for the Bray forecast and for the economic assumptions to be given to the Government Actuary. (These proposals were set out in his minute of 2 November.)

They agreed on the following forecasts/assumptions:

(i) RPI per cent increase 4th quarter of 1980 on 4th quarter of 1979 (or for the Actuary's report, November 1980 on November 1979) - 14%.

(ii) Average earnings increase financial year 1980/81 on 1979/80 - 14%.

(iii) Average number wholly unemployed (Great Britain) financial year 1980/81 - 1.6 million.

(iv) Average number wholly unemployed (Great Britain) financial year 1979/80 - 1.25 million.

The Chancellor and the Prime Minister agreed that the Treasury forecast should not be circulated ~~widely~~ in Whitehall.

The Chancellor raised the question of whether there should be an economic strategy discussion in Cabinet. He said that he would find it helpful to have such a discussion in order to persuade more Cabinet colleagues

CONFIDENTIAL / of the rightness

of the rightness of the overall strategy. He suggested that, before putting a paper to Cabinet, a draft might be considered by a small group of senior Ministers. The Prime Minister agreed that a strategy discussion in Cabinet would be useful, and that this should be preceded by a smaller meeting. Ministers for this smaller meeting should include the Secretary of State for Employment, the Lord President, the Home Secretary and the Secretary of State for Social Services. The Chancellor should aim for this initial discussion within the next few weeks.

The Chancellor reported that Treasury officials were examining the options for the presentation of the figures in the Public Expenditure White Paper for the later years of the P.E.S.C. period. He was hoping to have a meeting with Treasury Ministers to consider a paper by officials in the near future, and would then be ready to discuss the question with the Prime Minister.

T. P. LANKESTER

A. M. W. Battishill, Esq.,
H.M. Treasury.

cc Pub Expend Pt 6

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Econ Pol. 3

NOTE FOR THE RECORD

My letter of today's date to Battishill records the conclusions of the Prime Minister's meeting with the Chancellor this afternoon. The following additional points came up in discussion.

(i) The Prime Minister noted that the monetary prospect was now a great deal worse - as recorded in the Chancellor's minute of today's date, and that it might be necessary to raise MLR either this Thursday or next. The Chancellor said that the reasons for the deterioration in banking October were far from clear except that VAT receipts were coming in much more slowly than had been expected. Added to this, sales of gilts had been negligible. A further fiscal package was unthinkable (the Prime Minister agreed) and therefore the only option for bringing the money supply back within the target seemed likely to be a further increase in MLR. The Prime Minister said that she was most disturbed by this, and said that she was not sure that a further MLR increase would do the trick. So much depended upon psychology, and it was not clear to her that increasing MLR again would have the necessary effect. The Chancellor said that he and the Governor might need to see the Prime Minister on Wednesday to reach a decision on whether or not MLR should be moved this week; if not this week, it would almost certainly have to be considered very seriously next. Hearing that the Governor was planning a trip to China starting on 15 November, the Prime Minister said that - if MLR were to be increased - he ought to cancel this visit. The Chancellor pointed out that if the monetary prospect did not improve in the next month or two it might well be necessary to consider a further "cut" in next year's public spending plans.

(ii) On the issue of what figure to publish for the RPI forecast, the Chancellor pointed out that Phillips and Drew were forecasting a figure of 15% for the coming year in their latest report. This was higher than the forecast published in the FSBR at the time of the Budget because energy prices had increased and because the earnings out-turn for 1978/79

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/ and also

and also earnings assumptions for the current year were higher than then assumed. He had decided to shade the Treasury forecast down to 14 or 15%, but he did not believe it was possible to go lower than this. To do so simply would not be credible - and it would also make it difficult to justify an increase in the National Insurance contribution rates which was needed to help finance the PSBR. The Prime Minister said that she was most unhappy to find that the Treasury were still assuming that inflation would be in the mid-teens at the end of 1980. How could this be so if the Government were pursuing a tight monetary policy and when the underlying rate of inflation at present was only 12-13%? She thought that insufficient emphasis was being given to the beneficial effect of the monetarist approach. The Chancellor replied that, in the short term, the crucial factors determining inflation were the earnings assumption and the exchange rate. Monetary stringency would no doubt influence earnings in due course, but the short term effect would be primarily on output. If earnings continued to grow, as seemed likely, over the next 12 months, by 14% plus, then it was hard to see how inflation could be lower than 14%. The Prime Minister reluctantly agreed that 14% should be used for the Bray forecast and the Government Actuary's Report.

(iii) The Chancellor raised the question again of Mr. Christopher Macmahon's appointment as Deputy Governor of the Bank of England. He had a solid international reputation, and would - in his view - make an excellent appointment. The Prime Minister said that she was still not happy with this proposal. The Chancellor then said that the Governor would want to go back to her on it.

(iv) The Chancellor said that he was disappointed that the Government strategy was not being adequately put across by Ministers. He felt that he was carrying too much of the burden himself. The Paymaster General had circulated some good material in September, but Ministers were not making enough use of it. This material also needed to be up-dated continuously. The

Paymaster General had had it in mind to appoint an Assistant Secretary from the Department of Industry to expedite this work; so far no-one had been appointed. (After the meeting the Chancellor told me that he did not wish this to be minuted between No. 10 and Departments; I undertook to take the matter up with Sir Douglas Wass and then with the Paymaster General himself.)

R.

5 November 1979

Distribution: Sir Robert Armstrong, Cabinet Office.
Mr. David Wolfson, No. 10

SECRET

ce Econ Pol July 79
Public Attitudes to Pay

2

PRIME MINISTER

MEETING WITH THE CHANCELLOR AT 1730 ON MONDAY 5 NOVEMBER

The main purpose of this meeting is to reach decisions on the forecast which has to be published by 20 November, and which is needed very soon for the Government Actuary's report. The assumptions in this report provide the basis for the new contribution tables which have to be prepared and distributed to industry in good time in the New Year, and this in turn requires that the Contributions Order be laid by the end of November.

The main issue for discussion is the RPI forecast. The Chancellor offers the option of 15 per cent or 14 per cent for the 12 months ahead. Although there are risks of credibility in choosing the lower figure, I am sure that on confidence and more general political grounds it would be the right choice. The arguments against going for a lower figure still are:

(i) It would not be credible against the background of higher energy prices and a worse earnings outcome for 1979 than was predicted earlier. The forecast published at the time of the Budget is at Flag B - this shows an RPI forecast for 1980 of 13½-14 per cent. Phillips and Drew will be publishing their forecast on Monday showing 15 per cent for next year.

(ii) Any figure lower than 14 per cent will make it hard for Mr. Jenkin to justify to Parliament any increase in the contribution rate. Although the National Insurance Fund is in sizeable surplus at the moment, he will need an increase for it to remain in balance next year (unless we are very lucky on the inflation front).

I understand the Chancellor will also wish to discuss the point which you raised last week - that Cabinet might have an economic strategy discussion before too long. You suggested a session at Chequers after Christmas; the Chancellor, I understand, is

/inclined to

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inclined to ask for a discussion before Christmas with a view to lining up more of your colleagues behind the strategy - or at any rate, to elicit more explicit support from some of the waverers or from those who say little in Cabinet.

I think the idea of a general discussion is an excellent one, but it obviously needs careful handling if you are to get the right result. One possibility would be for the Chancellor to circulate a paper to an "inner group" - say, Sir Keith Joseph, Mr. Nott, Mr. Whitelaw and possibly Lord Soames (the latter two might be counted upon to raise some of the arguments of those who are less sympathetic to the strategy and this could be useful as a "trial run").

The other question is whether such a discussion should be linked to any particular decision. One major decision which has to be taken in the next few weeks is whether to announce a medium-term financial plan. Putting together a credible plan raises big questions about the consistency of the Government's fiscal and monetary policies, and there might be advantage in securing the explicit support of colleagues for it. On the otherhand, if this issue is to be specifically put to Cabinet, there will be demands that future decisions on monetary matters should go to Cabinet. I am sure that monetary decisions on a month-to-month basis must be taken by the Chancellor, in consultation with you as necessary.

Finally, the Chancellor may raise the question of publicity. I understand he is unhappy with the lack of progress which is being made with the campaigns to influence public attitudes on pay determination, etc. A good deal of work was done on these in the summer, and Ministers were asked to use speaking material provided by the Paymaster General. But not much has come of this in terms of Ministerial speeches. The Chancellor, I know, feels that he is being left to carry too much of the burden and the general "message" is not getting across sufficiently.

T.P.L.

2 November 1979

cc: Messrs. Wolfson and Ingham

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changes in the Budget itself may tend to increase margins of error. The forecasts are largely based on economic relationships fitted to the historical data of the last 10 or 15 years. Although the economy is modelled in such a way as to take account insofar as possible of the effects of policy changes, it remains a possibility that large changes in policy will affect the economy in ways which are not foreseen. It is particularly difficult to take account of possible changes in confidence and expectations or, for the slightly longer term, of the effect of incentives on supply side relationships.

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TABLE 3. ECONOMIC PROSPECTS TO 1980

	Main forecast	Lower savings variant	Margin of error(1) (plus or minus)
A. *Output and expenditure at constant 1975 prices*			
First half 1979 to first half 1980; per cent change:			
Gross domestic product (at factor cost)	−1	+½	2
Consumers' expenditure	−1	+1	2
General Government expenditure on goods and services ...	−2½	−2½	2(2)
Public corporations' fixed investment	−4½	−4½	8
Private sector investment	−½	+1	5
Exports of goods and services	5½	6½	4
Stockbuilding (as per cent of GDP)	−½	0	1
Imports of goods and services	1	3	3½
Manufacturing production	−2½	−½	5
B. *Balance of Payments on current account*			
£ billion:			
1979 First half	−¾	−¾	..
Second half	0	−½	½
1980 First half	0	−¾	1¼
C. *Public Sector Borrowing Requirement*			
£ billion; in brackets percentage of GDP at market prices:			
Financial year 1978–79	9¼ (5½%)	9¼ (5½%)	..
Financial year 1979–80	8¼ (4½%)	7½ (4%)	2¾
D. *Retail Price Index*			
Per cent change:			
Third quarter 1978 to third quarter 1979	16	16	1
Third quarter 1979 to third quarter 1980	13½	14	5
E. *Money Supply (Sterling M3)*			
Per cent change:			
Mid-June 1979 to mid-April 1980 (at annual rate) ...	9	9	..

(1) The errors relate to average and not maximum errors (on either side of the central figure) experienced in the past. They have been calculated in much the same way (and in many cases are identically the same figures) as those published in the previous Industry Act forecast (Treasury Economic Progress Report Supplement, November 1978, Table 3). The figures for the current account and PSBR were standardised as percentages of GDP and the figures quoted in £ billion therefore reflect the general increase in current price magnitudes. In Section A, however, the errors are likely to be under-estimates of the true margin of uncertainty in the forecast changes shown. This is because the errors relate to changes between the relevant forecast period and a "base period" spanning the four quarters prior to the completion of the forecast. Errors in forecast changes over a period starting with a relatively short "base" (in this case the first half of 1979) which is itself highly uncertain are liable to be greater. The errors in Section A (apart from manufacturing output) are based on forecasts between June 1965 and November 1976. Sections B and D plus manufacturing output use forecasts between June 1970 and November 1976. Section C uses PSBR forecasts made at the time of the Budget in the years 1967–76. Apart from manufacturing output the errors have been adjusted for subsequent major changes in fiscal policy.

(2) Margin applies to General Government Consumption.

Mr Lankester - PERSONAL

Your Ref

with compliments

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CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Minister of State (C)
Minister of State (L)
Sir Douglas Wass
Sir Lawrence Airey
Sir Fred Atkinson
Sir Kenneth Couzens
Sir Anthony Rawlinson
Mr Bailey
Mr Byatt
Mr Cassell
Mr Kemp
Mr Middleton
Mr Shepherd
Mr Davies
Mr Folger
Mr Ridley

MEETING WITH THE PRIME MINISTER ON MONDAY 5 NOVEMBER

You are meeting the Prime Minister for a discussion at 5.30 pm on 5 November. This brief covers topics that are likely to come up.

Industry Act Forecast

2. One of the main purposes of the meeting is to discuss your minute of 2 November to the Prime Minister on the Industry Act forecast and related questions. You are familiar with the background and underlying issues. I assume that your discussion will start from the premise that a forecast will have to be published later this month. It may be possible to repeal the Bray amendment in due course (Mr Folger's note of 1 November discusses this); but this could not be in time for this month's statutory obligation.

3. Your minute focuses on the inflation issue, which seems likely to be of most concern to the Prime Minister. In crude terms, the question is how far the Government could plausibly push down the main case forecast of 17% in Q4 1980. At our meeting the other day you decided on the figure of 14%. This assumes both a constant exchance rate and constant interest rates and an even more optimistic view of the outcome on earnings in the present pay round than the (optimistic) 14% the forecasters have already assumed. Your minute deliberately presents the Prime Minister with the option of 15% or 14%. This was in order to give her a choice and, frankly, to reduce the chances of being pressed to go below 14%. !!

4. As you know, many of us feel that 14% is itself straining credibility and that 15% (which would still show substantial deceleration from the peak earlier next year) would be more prudent. (You may have seen that the latest Phillips and Drew forecast - to be published on Monday - now forecasts inflation at 15% for the end of next year.) A fortiori we think there would be serious risks in going below 14%. It would strain credibility further; and it could pose practical problems in relation to cash limits.

5. We hope it will be possible for you to reach agreement with the Prime Minister on Monday on the inflation point. I imagine that she will not want to see the other numbers (for GDP etc) in detail. As you know, the forecasters are working on a further variant case in the light of the discussion with you on Tuesday. Your minute to the Prime Minister (last paragraph) is also designed to discourage her from asking for the full forecast report. But a copy could obviously be provided if she wants it. !!

6. Related to this latter point is the question of circulating the forecast in Whitehall. You decided in July that your normal practice would be to circulate it to the Prime Minister and to 5 of your Cabinet colleagues; and a number of officials in other Departments (who in some cases have helped in the preparation of the forecast) would also expect to receive copies on a personal basis.

7. There seem to be two main options. The first is to circulate the present full report as it stands as a purely internal document with suitable caveats on its sensitivity. The second is to delay circulation for the time being and then circulate on the above basis the "Bray version" on which the forecasters are now working. If the latter option is chosen some officials in other Departments who have been concerned in the preparation of the main forecast will be aware of what has happened. But this would not be disastrous and the important thing seems to be to clear your intentions with the Prime Minister.

Government Actuary's Report

8. I assume that the Prime Minister will not now query whether the Actuary has to publish assumptions on unemployment and inflation. It

is highly inconvenient to have to do so; but it is inescapable and the Chief Secretary's minute to the Prime Minister of 30 October explained why.

9. The important point now, as your own minute points out, is to reach an early decision on the assumptions. The reason for this is that, if new contribution tables are to be prepared and distributed to industry in good time in the new year (and many firms, particularly those who are computerised, need lengthy advance notice), the Contributions Order must be laid by about 28 November and debated before Christmas. Working backwards, and taking into account the work necessary by the Actuary and by the DHSS before Mr Jenkin can put proposals to you, this means that a decision (by normal Actuary/DHSS standards) is already overdue and any further significant delay could jeopardise the changes of processing the Order before Christmas. We very much hope, therefore, that you will be able to secure the Prime Minister's agreement to the assumptions set out in paragraph 8 of your minute.

10. So far as the assumptions themselves go, while they must be consistent with those to be used and published elsewhere, they must also be such as not to jeopardise policy in respect of the National Insurance Fund itself. Your policy objective, agreed at Tuesday's meeting, is to ensure that contribution rates can be raised a ¼% a side so as to secure income of about £400 million in 1980-81 which would benefit the PSBR and which, if contribution rates are not put up would be lost, thus further restricting your room for manoeuvre in the Budget.

11. We estimate that the assumptions set out in paragraph 8 of your minute (14% or 15% prices Q4 1980, 14% earnings average 1980-81 on average 1979-80, and 1.6m unemployed average for 1980-81) would provide a forecast position on the Fund which would enable Mr Jenkin to justify to Parliament (and more specifically to individuals and to industry) a ¼% a side increase. They should show a small surplus on the Fund after allowing for some £400m increase. To alter the assumptions so that a larger surplus was shown could make it difficult to secure this, given that the Fund's balance stands at around £4 billion and there are those who say it should not be allowed to increase further. (You may like to know that the Prime Minister her-

self has become acquainted, through a constituency case, with the large balance and has asked why in this situation a small improvement in certain benefit conditions could not be given.)

12. The arithmetic is such that an increase in prices or unemployment reduces the forecast balance while an increase of earnings increases it. In terms of the policy objective on the Fund and PSBR, therefore, you will want to resist any proposals that the prices or unemployment assumptions should be decreased. The Prime Minister may in particular jib at the unemployment assumption of 1.6 million, but you should oppose any reduction in it. As you know, the Chief Secretary revealed the White Paper assumption of 1.65m (based on an earlier forecast) in the House yesterday.

Economic Prospects

13. You have discussed with Sir Douglas Wass the possibility of stimulating a discussion with some or all of your senior Ministerial colleagues on economic prospects and strategy generally. I understand also that at your talk with her yesterday the Prime Minister volunteered the idea that there might be a session at Chequers after Christmas to discuss both economic and manpower strategy.

14. You may want to raise with the Prime Minister the possible advantage of arranging an economic discussion before Christmas. The main object of this would be to secure greater understanding and support among your Cabinet colleagues (particularly the uncommitted and influential) for your present strategy, particularly given the many important decisions that still remain to be taken (and the unattractive nature of some of the indicators and figures that seem bound to emerge over the coming months). Such support would not only help you and the Prime Minister at Cabinet and other Ministerial discussions in carrying forward your present economic strategy; it might even induce some of your more reticent colleagues to give you greater support in the public campaign of getting the economic message over.

15. There are many possible ways of doing this if you thought the idea worth floating on this occasion. One would be to have a "trial

run" by holding a discussion first with a smaller "inner group" of Ministers. You will best judge whom this might contain; but obviously you would want to involve some influential non economic Ministers like Mr Whitelaw. Such a meeting could be the prelude to a wider discussion in the full Cabinet and would probably better be regarded as an ad hoc arrangement rather than as a regular 'standing' discussion group. An other option would be to go straight to the full Cabinet, with or without a Treasury paper in the first instance. Clearly the Prime Minister's views on how best to handle this would be critical. She has not so far been disposed to open out the economic discussion and there can be advantages to you in this; but on the other hand the road ahead may prove increasingly difficult to travel- particularly in so far as public expenditure is concerned - unless more collective Ministerial support is forthcoming.

No

16. A further question is whether any discussion should be linked to specific operational issues. The obvious one would be any proposals for a medium term financial plan which would in any case be linked with the second Public Expenditure White Paper. I imagine that you would not want to have to seek specific collective approval for the details of a financial plan. But since the compilation of a credible plan raises fundamental questions of the consistency of the Government's fiscal and monetary policies there might be advantage in exhibiting the general problems and seeking to secure the support of your colleagues in principle in advance. This would be particularly so if you judged that it might be necessary at any stage to reopen major policy questions with the colleagues eg on public expenditure.

17. Finally, the logistics of any such discussion or discussions would also be for consideration. Chequers always comes to mind; but past experience suggests that there could be disadvantages in this unless the time allowed were pretty severely disciplined.

Summary

18. In sum, you will want to use this meeting to:-

(i) Secure agreement on Monday to your proposals for the presentation (and Whitehall circulation) of the Industry Act forecast, and in particular the prices figure for Q4 1980;

(ii) Secure agreement on Monday to the inflation and unemployment assumptions you have proposed for the Government Actuary, and in particular to avoid lower assumptions that would make it difficult to justify a ¼% increase in contributions;

(iii) float with the Prime Minister the possibility of a discussion on general economic strategy before Christmas.

J B UNWIN
2 November 1979

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

ECONOMIC PROSPECTS

Flag A

I minuted you on 12 October on the preliminary results of the Treasury's autumn short-term forecasting exercise and indicated that I had asked for further work to be done. I have now reviewed the outcome with officials and should very much welcome the opportunity of a discussion with you.

2. I fear that we are in some difficulty. This is because, although I should prefer not to, under the terms of the Industry Act we are statutorily obliged to publish a forecast by the end of November (technically by 20 November, though some slippage is possible). And by convention the published material includes a forecast for the RPI (on this occasion it would be for the fourth quarter of 1980) which it would be difficult to omit or conceal since a prices assumption for broadly the same period will have to appear in the Government Actuary's statutory report on the National Insurance contributions review published at about the same time. Our expectations on prices will in any case also be apparent from the announced decisions on cash limits.

3. The problem on the RPI arises from the figure of 17 per cent which emerges in the forecast. To publish this would be disastrous for expectations and, as you yourself have pointed out, carry self-fulfilling risks. I am clear that we cannot publish this and I regard it in any case as being unnecessarily pessimistic.

4. I have had a long discussion with officials to explore what alternative lower figure could be justified on a different view of the key underlying assumptions. If we were to take a more optimistic view of the course of the exchange rate and interest rates - in effect assuming a constant exchange rate and constant interest rates, including the mortgage rate - the forecast figure would come down to about 15 per cent. This would be a plausible (but less than satisfactory) figure to publish. To go below this - say, to 14 per cent - would entail taking a optimistic view of the outcome on earnings in the present pay round; the forecasters have assumed 14 per cent in the private sector, excluding the effects of overtime etc, which already looks rather optimistic.

Flag B

5. 15 per cent would, I suppose, be "defensible". It is worse than the figure in the Budget forecast (13½ per cent with a variant of 14 per cent) but this is explicable in terms of the further oil price increases since June and the higher than expected level of pay settlements. But, although there is some risk of straining credibility and creating problems when we set the remaining public service and central Government cash limits, 14 per cent could be considered if you thought the expectational arguments should be given greater weight.

6. I do not, however, think we could go below 14 per cent. Apart from the general question of credibility, the cash limits problems would be more acute. A lower figure might at the same time make our decisions on the RSG cash limit look lax and also present us with severe problems on the cash limits yet to be set. We want them to be tight; but not so unreasonably tight as to make breaches inevitable, with damaging consequences for cash limits as a whole.

7. For the rest, the Industry Act forecast will need to show figures for GDP and its main components and the balance of payments. These will be substantially worse than in the Budget forecast, but this is inescapable and in line with other recent forecasts. By convention a PSBR forecast has also been given (on this occasion it would be for 1980-81), but, provided we have reached a decision on whether to publish a medium-term financial plan, I see no reason to include it. It seems unnecessary to forecast so far in advance a figure subject to such large margins of uncertainty; and if we can announce that we shall in due course be publishing a financial plan, I see no reason to expect adverse market reaction.

The Chancellor will be coming forward separately on this. TL

8. I referred above to the Government Actuary's report.
Flag C
John Biffen has minuted you separately on your query on whether the figures have to be published at all and on the unemployment assumption underlying the 1980-81 Public Expenditure White Paper. If previous practice on publication is followed, the figures the Government Actuary uses (which are attributed to the Government) must be broadly consistent with the Industry Act forecast and those used for other purposes (eg cash limits). On this basis, and subject to our decision on the RPI

figure on the forecast, I propose that the Government Actuary should be instructed to use the following assumptions:-

RPI per cent increase November 1980 on November 1979	-	14 per cent or 15 per cent
Average earnings increase financial year 1980-81 on 1979-80	-	14 per cent
Average number wholly unemployed (Great Britain) financial year 1980-81	-	1.6m
Average number wholly unemployed (great Britain) financial year 1979-80	-	1.25m

9. The unemployment assumption would be a little lower than that (1.65m) underlying the Public Expenditure White Paper. But it reflects a more up to date assessment and no unemployment figure will be included in the published Industry Act forecast. The Actuary's Report does not normally attract much attention; but we obviously cannot bank on this.

10. It would be very helpful to be able to discuss these issues with you early next week. I am particularly anxious to settle the assumptions for the Actuary so that the National Insurance review can go forward. In the meantime if you should wish to see the full (and rather lengthy) Treasury report on the forecast, I will arrange to let you have a copy. But since it is largely written round assumptions which I find unduly pessimistic I doubt if you need bother with it.

Yes please

G. H.

(G.H.)
2 November 1979

CONFIDENITAL

Econ Pol

c/ Mr Hoskyns

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

2nd November 1979

Dear Mike,

INCENTIVES FOR THE LOWER PAID AND ALLIED MATTERS

E Committee last Tuesday commissioned certain work by officials under Treasury chairmanship concerning incentives for the lower paid and allied matters. At Cabinet on Thursday it was further agreed, in the context of discussion on the Earnings Related Supplement, that the Chancellor should arrange for a complete and confidential review by officials of the whole complex of redundancy payments, earnings related, sickness and unemployment benefit and taxation of benefits, and of their affect on incentives, and should report back to the appropriate Cabinet Committee in due course.

As you will appreciate, although the wording varies, in fact these two remits are very similar, and in practice will involve officials from the same departments covering very much the same ground. The Chancellor proposes, therefore, that they should be treated as one. The combined remit should cover the points recorded as lying behind both the E Committee and Cabinet decisions, and might be summarised as being a study of the factors affecting work incentives especially for the lower paid, with particular reference to effects of social security and other benefits, and direct taxation, on net income in and out of work.

The Chancellor will ask his officials to get in touch with officials in interested departments with a view to putting the necessary work in hand, with the aim in the first place of producing the quick interim report which E Committee Commissioned.

M. Vile Esq.
Cabinet Office
Whitehall
SW1A 2AS

CONFIDENTIAL

I am copying this letter to Private Secretaries of members of the Cabinet.

Yours ever,

MA

M.A. HALL

cc Cabinet Business. Masters.

NOTE FOR THE RECORD

c.c. Mr. Whitmore
Mr. Wolfson
Mr. Alexander

At the Chancellor's meeting with the Prime Minister this morning, the Prime Minister mentioned in passing that she would like to have an all-day session for the Cabinet at Chequers after Christmas to discuss the Government's economic strategy, and possibly strategy on manpower and foreign policy.

This was, of course, before the Cabinet discussion on Civil Service staff, which I think the Prime Minister had anticipated would go rather less well than it actually did. There still has to be a further discussion on Civil Service staff cuts to pick up various loose ends from this morning's meeting; but I am not sure the Prime Minister will still want a strategy discussion on manpower.

The Chancellor did not react to the suggestion. But I understand that he will be considering the idea of a Cabinet discussion of economic strategy over the weekend, and will want to discuss ~~them~~ it with the Prime Minister when he meets her on Monday afternoon. There may be a case for an economic strategy discussion rather earlier than Christmas. It could be linked to the decisions which are needed towards the end of November if the Government is to promulgate a medium-term financial plan. On the other hand, a discussion soon after Christmas could be a "scene setter" for the Chancellor's budget deliberations.

R.

1 November 1979

H M Treasury

Parliament Street London SW1P 3AG

Direct Line 01-233 3016
Switchboard 01-233 3000

TL 5/11

J B Unwin
Under Secretary

Mr T Lankester
10 Downing Street

26 October 1979

PERSONAL & CONFIDENTIAL

Dear Tim,

I enclose the papers I mentioned to you which relate to the whole series of decisions required between now and the end of the year and in particular (in Douglas Wass' minute) to the presentation of the Industry Act Forecast. I should be grateful if, for obvious reasons, you would keep these to yourself for the time-being.

Yours Ever,

J B UNWIN

747|10

CHANCELLOR OF THE EXCHEQUER MR. J. B. UNWIN,

cc Chief Secretary
Financial Secretary
Minister of State (C)
Minister of State (L)
PCC
MEG
Mr Ridley
Mr Cropper
Mr Cardona

DECISIONS ON TARGETS, FORECASTS AND ASSUMPTIONS: AUTUMN 1979

I mentioned to you the other day that I was concerned that you and your Ministerial colleagues should be fully seized of the nature of the decisions, and their timing, that would be required of you if we were to carry out the plans you have provisionally made to publish in the next few months the economic forecast, the financial plan and the Public Expenditure White Papers (Marks I and II). Besides these publications we have a time-table to meet in publishing the cash limits for the RSG and for the nationalised industries and in providing the Government Actuary with the economic assumptions he needs to cost the social security programmes for the Contributions Review.

2. These exercises are to a greater or lesser extent all inter-related and it would be unbusinesslike to proceed in piecemeal fashion. Indeed if we do we could find awkward inconsistencies arising. The attached note describes the relationships and puts forward a sequence according to which decisions might be taken.

3. The first and most urgent decision required is what we should publish in the way of a short-term forecast under the terms of the Industry Act towards the end of November. Mr Shepherd has just put forward the full report of the forecasters, which deals with the variant cases you wished to have explored, and this will form the basis for your consideration.

4. As I see it, there is a range of choices as to what the published forecast might contain. These include:-

(i) The main forecast as submitted. Subject to all the uncertainties and margins of error, this reflects the forecasting team's best judgment about the likely outcome. But there are obvious difficulties in presenting this as the Government's central view, not least in the risk that the inflation forecast would affect expectations and become to some degree self fulfilling. I imagine that even if you thought it right to publish this as one case, you would wish to display others also.

(ii) Three or four separate cases. These could embrace, but need not be the same as, those reported on in Mr Shepherd's submission. Unless you wished to identify one as the most likely case, they would not strictly be variants but possible views of equal status. There would be no technical objection to this, but I suspect it would lead to a good deal of confusion, and both Ministers and officials (eg in the House and in the Treasury Committee) would be pressed very hard to reveal which of the alternatives - to the extent that they were credible - was the 'central' one. It would in any case be difficult to repeat this device in the Budget forecast next Spring when it will be published alongside the public sector accounts and the Government will be obliged to commit itself to a specific inflation forecast (eg for the November 1980 social security uprating).

(iii) A single case - not necessarily one of the four explored but perhaps containing a blend of some of the elements in them - reflecting the most favourable prospect that it seemed realistic to publish. If, as I imagine you would wish, this embodied a better outlook on inflation, it would be necessary to make it explicitly clear that the reduction in inflation through 1980 postulated, in accordance with Government policies and expectations, a deceleration in earnings during the current pay round. It would also be made clear that to the extent that earnings did not so respond, the outlook for inflation and output would be correspondingly poorer.

5. The choice between these is not easy. The advantage of course (i) is that, on our reckoning, the main case is more likely to be validated than any other. This is the one therefore that should be used as the basis for fixing cash limits (subject to any volume squeeze which as an act of policy it is desired to secure). It is the one which the forecasters would like to publish, not least because their professional reputation is at stake. I recognise the difficulties however and would not press you to adopt this course if your judgment was that it would undermine Government policy. If you regard the effective choice as being between (ii) and (iii), you may see attractions in the former in that it does not give a simple figure to be shot at. As a course it depends critically on our being able somehow to be neutral with respect to the four cases. Course (iii) is attractive in the short run, but the credibility of the case might not survive for long.

6. Whatever course you choose, there would, I think, be great advantage in switching the emphasis in the presentation of the forecast from the figures to the prose. I do not think we can omit a table similar to those produced in the past, but it should be possible to bring out more emphatically than hitherto the uncertainties, judgments and margins of error to which the bare figures are subject.

7. Since, as the attached note shows, a number of other decisions hang on the forecast, it would be most helpful if a decision on the scope of the publication could be reached very soon. You may think that a meeting would be helpful in achieving this. You will also, I expect, want to secure the Prime Minister's agreement to the course of action you favour.

8. Finally, we have been giving further thought to your suggestion for a discussion with outside forecasters. I think this would be helpful, but frankly I doubt whether it would be feasible in relation to the immediate forecast. What I should like to do is to think in terms of arranging a seminar towards the end of the year after this forecast has been published and before we start the next forecasting round, and, if you agree, I will bring further proposals forward on this.

DW.

DOUGLAS WASS
25 October 1979

DECISIONS ON TARGETS, FORECASTS AND ASSUMPTIONS: AUTUMN 1979

Note by the Central Unit

Introduction

The purpose of this note and Annex is to distinguish and discuss the principal occasions up to January 1980 on which the Government will be obliged to release or publish specific forecasts, targets or assumptions about the future course of key variables such as unemployment, the RPI and average earnings, the PSBR and £M3. (It covers also occasions - such as publication of the RSG cash limits - on which figures for key variables are not given directly but underlie published figures for other quantities.) The note comments briefly on the problems of securing consistency and is intended as a background to the separate submissions that will be coming forward on the substance of individual issues.

2. The main issues of substance (eg the possible need for fiscal adjustments to secure PSBR figures compatible, at ~~un~~acceptable interest rates, with declining target £M3 growth) are likely to arise in connection with the putative medium-term financial plan (MTFP). It is assumed that such a plan would be published with, though not necessarily in the same document as, the second Public Expenditure White Paper (PEWP II). Preparation of such a plan supported by consistent medium-term revenue and expenditure projections would involve a great deal of detailed work for which adequate preparatory time would be vital. If publication were next January, decisions about the form of the plan would need to be taken by mid-November at the latest. Final decisions on public expenditure programmes for 1981-82 to 1983-84 would need to be taken by then and the economic assumptions for the programme figures in PEWP II and the MTFP would need to be decided by the end of the first week in November.

The events

3. The various events that need to be considered are set out in rough chronological order in the Annex. For each entry this shows the decision deadline, release or publication date, and a brief

summary of the kind of information to be provided. Omitted are:

(i) Various EEC and OECD occasions on which UK officials will have to discuss the outlook and provide forecasts. We cannot exclude the possibility of leaks but there have been none recently.

(ii) The possibility of a Government paper for the 4 December meeting of NEDC. For immediate purposes it can be assumed that such a paper would be written round whatever figures had already been released in other contexts.

<u>Inter-relationships</u>

4. There are some complex interactions between the 9 events listed at Annex A. However there are two fixed points conditioning the approach to the rest:

<u>item 1 1980-81 RSG cash limit</u>: Treasury Ministers have put proposals to colleagues (Chief Secretary's paper to MISC 21) for a cash limit providing for local authority cost increases of around 13%. This represents a shading-down of pay and price assumptions (equivalent to an annual rate of 14.6%) consistent with the short-term forecast submitted on 8 October.

<u>item 2 PEWP I</u>: The 1980-81 programme figures will be based on the same economic assumptions (for 1980-81 unemployment, price and earnings increases) as were used in the 1979 Survey. It is also planned to give the unemployment assumption of 1.65m for 1980-81 in the text of the White Paper.

5. Examination of the commitments set out in the Annex suggests there are two main groups of items within which it is <u>essential</u> to maintain broad consistency.

<u>November Announcements</u>

6. The first is the late November clutch of announcements. This

comprises the RSG cash limit and Scottish housing subsidies (for both of which local authorities are the main audience), the assumptions for the Government Actuary (GAD) (on which final decisions should be taken by end October), the Industry Act forecast and the nationalised industry cash limits.

7. The nationalised industry cash limits will be set after discussion with each industry of its own assessment of the cost increases it will be facing, and the price increases it can make. The figures agreed for the nationalised industries and the provision for local authorities' cost increases will need to be broadly consistent with the picture of the economy in the Industry Act forecast; but some variation can be defended on the basis that the provision in cash limits takes account of the particular circumstances of each case. At the same time the cash limits will need to make sufficiently realistic allowances for cost and price increases to avoid a situation in which they are exceeded. Similarly reasonable consistency between the short term forecast and the assumptions for the GAD and Scottish housing subsidies is needed to avoid problems of substance. And they should also be consistent with the published Industry Act forecast, although the incorporation of variants in the forecast might ease (though not eliminate) this problem to some degree.

8. The above suggests that early decisions on the Industry Act forecast are necessary so that sets of assumptions for the GAD, housing subsidies and the nationalised industry cash limits can be fixed to be consistent with it. (The GAD needs final figures by the end of October if the normal timetable for the Ministerial review of National Insurance contributions is to be met.) Otherwise as time passes what can be published as the Industry Act forecast will have become progressively more prejudiced by the need for consistency with earlier ad-hoc decisions on assumptions to be provided (and in most cases published) in these other cases.

9. However, the possibility of inconsistency between the (post Budget) economic assumptions underlying the figures in the first public expenditure White Paper (PEWP I) and the figures to be given in various contexts at the end of November, seems unavoidable. There is thus a case for making clear in briefing when PEWP I is published

that the economic assumptions date from/the early summer; that the autumn forecasting round is not yet complete and that the assumptions (and certain of the programme figures) may need revision later; but that whatever happens, the PSBR will be restrained as necessary to ensure that the Government's £M3 targets are met.

Later Announcements (including January 1980)

10. The second group of announcements within which consistency would seem essential comprises PEWP II and a MTFP and the November roll-forward statement about the ceiling on monetary growth for the 6 months beyond April 1980. The need for consistency between the first two is obvious and referred to in paragraph 2 above; if, however, the Industry Act forecast published in November incorporated a range of variants, then this might to some extent ease the difficulty of publishing in a MTFP/PEWP II, if it appeared necessary, a projection for 1980-81 differing from any central case in the Industry Act forecast.

11. The overriding importance of a clear and consistent message on monetary targets based on realistic underlying assumptions, means that the target rate of monetary growth to be announced in November for the period to October 1980 should be consistent with what might be envisaged for a MTFP without prejudicing subsequent decisions on such a plan. Advice on the November roll forward will come forward separately in due course.

Conclusions

12. The discussion in this note suggests the following main conclusions:

(a) a very early decision is now required on the numbers to be published in the Industry Act forecast;

(b) decisions on the economic assumptions to be supplied to the Government Actuary, and to be used for calculation of Scottish housing subsidies, should be taken only after figures for the Industry Act forecast have themselves been settled (assumptions for the Actuary are needed urgently, which reinforces conclusion (a));

(c) If a medium term financial plan is to be published next January, decisions will be needed by mid-November on the form of any such plan, so that there is adequate time in which to prepare consistent sets of revenue and expenditure projections and to deal with any problems of substance which might arise. This in turn requires decisions on public expenditure programmes for 1981-82 to 1982-83 by the same time, and decisions on the economic assumptions underlying the programme figures by the end of the first week in November.

Central Unit
H M Treasury
22 October 1979

decisions needed by	publication date	event	details	comments
25 Oct (Cabinet)	16/20 Nov	Cabinet decision on 1980-81 RSG cash limit. (Meeting with local authorities' Consultative Council on 26 October. Public announcements on 16 Nov (Scotland) and 20 Nov (England & Wales).	Decisions needed on assumptions for earnings increases for local authority employees (as a result of Clegg and other comparability awards, 1979-80 pay round and part of 1980-81 pay round) and RPI Nov 1979 to average 1980-81. Individual assumptions are not published and public presentation will only give allowance made for overall costs. Local authorities may be able to guess at underlying assumptions.	Treasury Ministers are recommending 13% on local authority costs. This is a rounding down, allowing for hoped-for productivity increases, of the 14.6% figure resulting from assumptions of: 14% for settlements in the 1979-80 pay round, 12½% for the 1980-81 round and 14½% for the RPI increase from November 1979 to average 1980-81. In addition 6% has been allowed for the effect of Clegg awards. The assumptions are consistent with the autumn forecast.
end Oct	20 Nov	Economic assumptions for the Government Actuary's Report to permit Ministers to review of National Insurance contribution rates for 1980-81.	Assumptions on: i. RPI % increase Nov 79 to Nov 80 ii. % increases average earnings 1979-80 on 1978-79 and 1980-81 on 1979-80 iii. average level of unemployment in 1979-80 and 1980-81.	a. Buoyancy of the fund if assumption for increase in average earnings proves to be on the low side means there is some leeway in choosing assumptions which in the event will probably not affect the PSBR. b. Legislative and administrative procedures to be completed before Christmas would make it difficult to delay a decision on assumptions much beyond the end of October.

decisions needed by	publication date	event	details	comments
-	1 November	Publication of PEWPI on 1980-81	Public expenditure figures by programmes but only a minimum of economic cladding. No specific forecasts or targets for economic variables but it is intended to give the unemployment assumption of 1.65m for 1980-81.	Chancellor has agreed (meeting on 9 October 1979) that the unemployment and other assumptions should be left unchanged from those used in the Survey. The 1980-81 unemployment assumption (1.65m) underlying the social security figure is included in the draft White Paper going to Cabinet and has already appeared in the press following a leak. PEWPII assumptions for 1980-81 (and programme figures as necessary) may differ from PEWPI in the light of the Industry Act forecasts to be published in late November.
early Nov*	Nov*	Nationalised industry cash limits for 1980-81	Limits are set after discussion of cost increases likely to face each industry. The industries have a view on how these cost increases relate to general inflation. The pay and price assumptions underlying the cash limits are not published.	a. The cash limits need to be consistent with the picture of the economy presented in the Industry Act forecast. They also need to make realistic allowance for cost and price increases. b. Whenever the limits are published there could well be strong pressure (eg from SCT) for the pay and price assumptions to be released.

*the NCB cash limit may need to be decided and published rather sooner

decisions needed by	publication date	event	details	comments
mid Nov	mid Nov	Roll-forward of £M3 target	Budget undertaking to roll forward 6 months beyond April 1980 "in the autumn", implying publication of a target range for £M3 growth October 1979 to October 1980	a. Strong arguments for an announcement of some kind on (but not before) 15 November when October £M3 figures are published. b. Strong arguments also for announcing a decision in principle on a medium term financial plan. Markets would expect something to be said. c. The figure for the roll-forward target should be consistent with what might be envisaged for a medium term financial plan, without prejudicing decisions on it.
	NOTE ALSO	Future of SSD "corset" scheme	If SSD were to continue then ceiling in IBELs growth beyond December 1979 would need to be announced. If SSD were to be scrapped then mid-November announcement required to give the banks adequate notice for operational purposes.	Desirable to declare policy on SSD simultaneously, with figures for £M3 foll-forward.
As soon as possible given the other decisions (GAD, n.i. cash limits etc) which hinge on it.	late Nov	Publication of Industry Act forecast	Publication of forecasts "as to such matters as appear [to the Treasury] to be appropriate" Precedent suggests, for each of several variants: i. % growth in GDP and conponents to second half 1980 ii. RPI increase to Q4 1980 iii. current account of b.o.p. for 1979 and 1980 iv. PSBR, nominal and as a % of GDP, for 1980-81	a. Legislative commitment is normally interpreted to require publication of forecast on or before 20 November. Some slippage probably tolerable but could cause Parliamentary embarrassment. b. Unemployment and £M3 projections are not published as part of the Industry Act forecast. But the former can be guessed from the GDP growth rates.

decision needed by	publication date	event	details	comments
				c. Problems would arise if economic projections in PEWPII and/or a MTFP were inconsistent with the Industry Act forecast. Difficulty is not only with 1980 itself but also with medium term projections for later years: PEWPII/MTFP cannot show a totally implausible discontinuity between 1980 and 1981
mid Nov	end Nov	Statutory Instrument on Scottish Housing subsidies for 1980-81 to be laid	Figures given to local authorities for increases in average earnings and cpi, 1980-81 on 1979-80. Also for projected "pool" interest rate for all l.a. outstanding debt). Figures for projected expenditure on these assumptions are published in an Order.	a. Did not attract great attention in 1978, the first year of a new system. b. In 1978 the assumptions used and published were those contained in the Survey. LD would propose to do the same this year but the Scottish Office may press for up to date figures. c. Assumption on course of interest rates in 1980-81 is neatly obscured by use of "pool" rate.
early Nov	Jan	PEWPII, 1980-81 to 1983-84	publication of i. public expenditure figures by programme ii. possibly, economic projections over the period on at least two cases iii. "broad working assumptions" on numbers of unemployed iv. PSBR and revenue projections	Item iv could possibly be published in the MTFP if that were to be published separately.

decisions needed by	publication date	event	details	comments
as soon as possible for form of any plan.	Jan	medium term financial plan	No final decisions yet taken on whether to have a "Plan" and if so what it should contain. But it seems likely that it would give for the 5 years 1979-80 to 1983-84, £M3 targets year by year and sufficient supporting detail to demonstrate their credibility, especially in relation to planned public expenditure.	a. Plan, if agreed, will be centrepiece of government's medium term strategy and fiscal policies. b. MTFP could be incorporated in PEWPII or published separately (in which case some of the revenue projections etc given in CMND 7439 could be omitted from PEWPII)

PERSONAL AND CONFIDENTIAL

Econ Pol

CF.

P.a.

TL

Mr. T. Lankester
No. 10 Downing Street.

I attach two papers:

(a) The PSBR, Interest Rates and Money Supply. This is basically a less technical version of a paper which we gave at a City University conference in May. It argues that the relationship between the PSBR and £M3 operates mainly on the demand for money, and is therefore not straight-forward and certainly not one-for-one.

(b) The PSBR. This is rather more general, and it includes the points in (a) (in paras. 13-15).

I am at the moment writing a paper on the other subject we discussed — the possible conflict in the medium term between objectives for monetary growth, public expenditure, taxation and interest rates. I shall try to slip you a copy when it is completed.

Please do not indicate that you have seen these.

John O.S.

23.10.79

RESTRICTED

CHANCELLOR OF THE EXCHEQUER

c.c. Chief Secretary
Financial Secretary
Sir D. Wass, o.r.
Mr. Littler
Mr. Bridgeman
Mr. Byatt, o.r.
Mr. Cassell
Mr. Middleton
Mr. Shepherd
Mr. Odling-Smee
Mr. Riley
Mr. Powell
Mr. S. Bell
Mr. Wilkinson
Mr. Ridley

THE PSBR, INTEREST RATES AND MONEY SUPPLY

I think you will be interested in the paper below prepared by Mr. Odling-Smee under cover of his minute of 11th September, supplemented by another of 19th September.

2. The subject of the PSBR and its effect on money supply and interest rates is clearly of first importance but unfortunately it is not an easy one to grasp. The whole thing is far more complex than one would suppose from thinking of the PSBR as one element making for creation of money. The fact is that the growth of the money stock depends on the demand for money as well as on the supply, and changes in the PSBR affect the demand as well as the supply. Also, the <u>nature</u> of the change in the PSBR makes quite a difference.

3. If I may attempt to simplify Mr. Odling-Smee's paper further, no doubt very crudely, I would bring out the following main points:-

(i) The quantity of money is determined by the interaction of demand and supply. It is not determined simply by the monetary authorities through a reserve ratio control.

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(ii) A change in the PSBR affects both the supply of and the demand for money in a number of different ways.

(iii) A change in the PSBR has different effects on the monetary position according to whether it comes about from varying this or that kind of tax and this or that kind of expenditure.

(iv) Estimates can be made of the effects of changing the PSBR on the stock of money or interest rates. These effects, in the second year after the change, are of the order of 1 to 2½ per cent fall in the stock of money per £1 billion fall in the PSBR. In terms of interest rates, assuming no change in the stock of money, a fall of £1 billion in the PSBR might cut interest rates by ½ to 1 per cent in the second year; by rather less in the first year. Such an effect on interest rates could of course easily be offset or intensified by some other factor - interest rates depend on many things besides the PSBR.

FJA

(F. J. ATKINSON)

20th September, 1979.

THE PUBLIC SECTOR BORROWING REQUIREMENT

Introduction and conclusion

The aim of this paper is to consider what meaning can be attached to the PSBR, and in particular whether it is useful as a target for policy. There are sections on recent trends, fiscal stance, financial implications, the control and monitoring of the PSBR, and public sector indebtedness. The conclusion is that neither the level of nor changes in the PSBR throw much light on what is happening to the economy unless they are interpreted in the context of all the other developments that are taking place. Since the PSBR is also difficult to forecast and monitor, it is inappropriate as an intermediate objective for monetary or fiscal policy.

Recent Trends

2. The table below shows the PSBR in £ millions and as a proportion of GDP at current market prices from 1963-64 to 1978-79. The effect of inflation on the absolute size of the PSBR can easily be seen. For this reason it is best to concentrate on its size in relation to market price GDP, since that allows for the effect of general inflation although not for the effect of changes in relative prices between the public and private sectors or for fiscal drag.

3. The table can be split into three quite distinct five-year periods. The first, from 1963-64 to 1967-68, saw an average ratio of the PSBR to GDP of 3.4 per cent. In the second period, from 1968-69 to 1972-73, the proportion fell by more than half to 1.4%, largely as a consequence of the restraint on public expenditure and high taxation in the late 1960's and early 1970's. These policies were reversed in 1971-72, and this, followed by the oil and commodity price rises of 1973-74 and the ensuing world

and domestic recession, gave rise to the relatively high PSBRs of 1973-74 to 1978-79 - an average of 6.8% of GDP. The PSBR as a proportion of GDP is also shown in the graph.

TABLE 1

	PSBR £ millions	As a % of GDP at current market prices
1963-64	1084	3.5
1964-65	880	2.7
1965-66	995	2.8
1966-67	1215	3.2
1967-68	1980	4.9
1968-69	452	1.0
1969-70	-525	-1.1
1970-71	803	1.5
1971-72	1014	1.7
1972-73	2502	3.8
1973-74	4427	6.0
1974-75	7947	9.1
1975-76	10588	9.8
1976-77	8500	6.7
1977-78	5555	3.8
1978-79	9227	5.6

4. This pattern of increase in public sector borrowing to the mid-1970's is common to other countries. The table below shows the PSBR as a percentage of current price GNP (GDP in the case of the UK) in a number of countries:

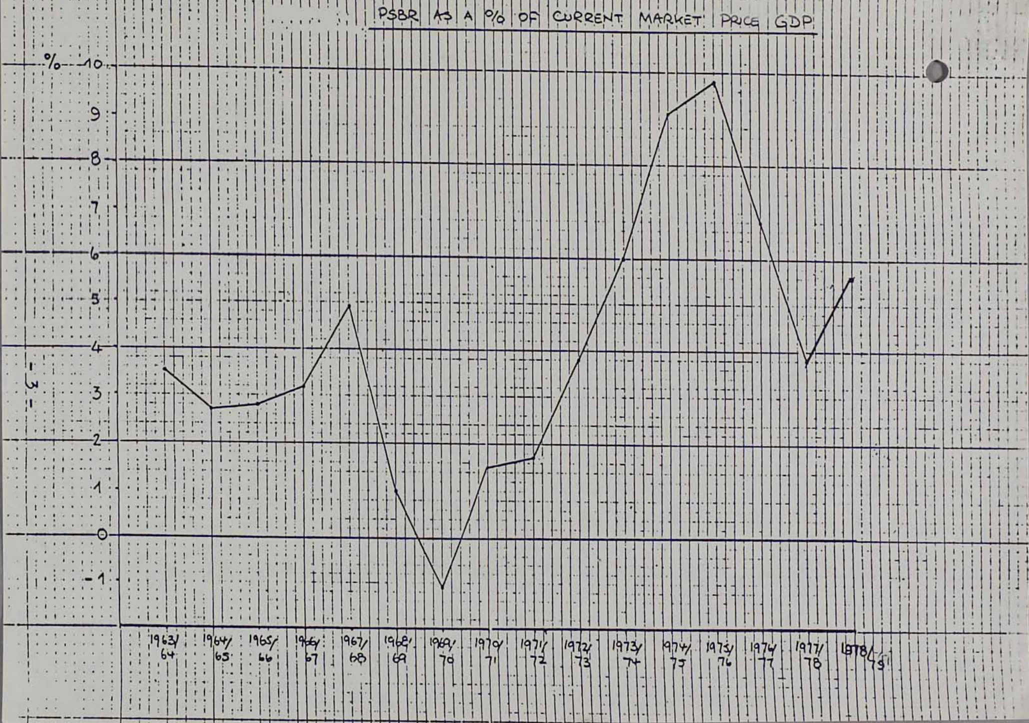
TABLE 2

	US	Japan**	Germany	UK
Average 1960-69	2.1	5.5	1.4	3.0*
1970	2.7	6.2	1.3	-0.1
1971	4.4	7.4	1.8	2.8
1972	2.9	10.9	1.8	3.7
1973	1.9	5.1	1.7	6.6
1974	2.3	6.6	2.4	8.7
1975	6.9	9.4	6.3	11.3
1976	5.9	10.4	4.2	8.4
1977	4.9	10.4	3.1	4.8

Source: OECD Economic Outlook Dec. 1978

* Average 1963-69

** There is a break in the series in 1973


PSBR AS A % OF CURRENT MARKET PRICE GDP
%
10
9
8
7
6
5
4
3
2
1
0
-1
1963/64
1964/65
1965/66
1966/67
1967/68
1968/69
1969/70
1970/71
1971/72
1972/73
1973/74
1974/75
1975/76
1976/77
1977/78
1978/79

- 3 -

International comparisons of the size of the PSBR in relation to GNP are difficult because:

i. there are wide variations between countries in the definition of the public sector. The definition in the UK, for instance, is unusually wide; it is almost alone among industrial countries in including public enterprises in the coverage of public sector accounts. In principle, these differences in coverage can be allowed for (see paragraph 6 below);

ii. countries differ in the extent to which the provision of services such as health care or education is divided between the public and private sectors; there is little that can be done to overcome this problem since it is a matter not just of accounting practice but of widely differing institutional structures.

5. No importance should therfore be attached to differences in the ratio of the PSBR to GNP between countries in the table above. It is interesting, however, that the PSBR ratio rose in all these countries after 1973 to reach unprecedented postwar levels in 1975; and that in the US, Germany and the UK it subsequently fell in 1976 and 1977.

6. The difficulty of the exclusion of public enterprises from the definition of the public sector in many countries can in principle be tackled by using a standardised statistical concept such as 'general government'. This comprises central, state, provincial and local government, social security institutions and other non-profit-making government-controlled bodies. The following table provides statistically consistent estimates of the financial balance of the general government sector as a percentage of GDP for some countries since the mid-1960's. (The financial balance is smaller than the borrowing requirement of the general government sector in that it excludes on-lending to public

enterprises and other sectors). The earlier conclusion that the recent rise in the financial deficit of the public sector does not look out of line with developments in other countries is endorsed by these estimates.

TABLE 3

Estimates of financial surplus(+) or deficit(-) of general government as a percentage of GDP at market prices.

	1964-69	1970-73	1974	1975	1976	1977	1978*
United States	0	0	+½	-3½	-1½	-¼	+¼
Japan	-2¾	+1	+½	-2¾	-3½	-4	-4¾
Germany	-¼	+¼	-1½	-5¾	-3½	-2½	-2¾
France	+½	+¾	+½	-2¼	-½	-1¼	-2½
Italy	-2¾	-5½	-6	-11¾	-9	-8	-10½
Canada	+¾	+½	+2	-2½	-2	-2½	-3½
United Kingdom	-1	-¾	-4	-4¾	-5	-2¼	-4

*Provisional

Source: OECD Economic Outlook July 1979

Fiscal Stance

7. Since the PSBR is essentially a measure of the imbalance between tax revenue on the one hand and public expenditure on the other, it is natural that it should be seen as a measure of the public sector's demand for real resources. Another way of putting this is to say that the PSBR is a measure of the impact of fiscal policy on output, and hence an indicator of the stance of fiscal policy (eg. expansionary or contractionary).

8. The first point to note is that any measurement of the level of net demand made by the public sector is conceptually difficult, since it involves an implicit comparison with a situation in which there is no public sector. It would obviously be impossible to say what would happen if there were no public sector. The world would be so different as to make comparisons ridiculous.

9. The best that can be hoped for is that changes in the PSBR reflect changes in net demand by the public sector over time. But changes in the PSBR need not be the result of changes in the stance of fiscal policy in the narrow sense of the settings of

nominal tax rates or planned public expenditure. A fall in investment or exports, for example, will raise the PSBR both by decreasing tax revenues and by raising expenditure on unemployment benefit. This effect is a consequence of the operation of automatic stabilisers, which bring about an increase in public sector demand when private sector demand falls. As such it reflects fiscal policy in the broad sense, although there is no change in the more narrowly defined stance of fiscal policy. The latter is sometimes referred to as discretionary fiscal policy to distinguish it from the operation of automatic stabilisers. Changes in variables other than the level of activity eg. interest rates or the level of prices, would have the same effect. For instance, a tighter monetary policy, as a result perhaps of a change in the way the PSBR was financed, would increase interest rates and tend to raise the actual PSBR, suggesting a change in fiscal policy which had not occurred.

10. Because the PSBR is partly dependent on exogenous factors, changes in it cannot be used to measure the impact of changes in fiscal policy instruments on output in the economy. Some kind of constant employment budget balance might be better for this. But most of the measures that have been produced do not allow for the effects on output of changes in the mix of taxes and public expenditure and in the way in which the actual budget deficit is financed. The most realistic measure of the impact of changes in fiscal policy instruments would take these into account, and it could also distinguish between time periods. This is, of course, a long way from changes in the PSBR.

11. Some writers, such as Neild and Ward, have argued not only that the constant employment budget balance (CEBB) is a helpful measure of the fiscal stance, but also that it should provide a target for policy. The justification for this lies partly in a distrust of 'fine tuning' of demand management, partly in the assumed long term relationship between the public sector deficit and the current balance, and partly in the assumed association between a constant CEBB and stability of monetary growth. Not all economists would accept these arguments.

Many would argue that fiscal and monetary policy can and should be directed at targets for final objectives, such as output and prices and that this does not necessarily imply that the CEBB would have to be constant.

Financial Implications

12. The increasing emphasis placed on the PSBR in recent years owes less to a concern for the direct demand effects of the public sector and more to the realisation that the financial effects can be substantial. Part of this is due to the acknowledgement that wealth effects are important in the determination of private expenditure and that a PSBR involves increasing public sector indebtedness and, consequently, increasing private sector net wealth. Part is due to the greater emphasis on monetary policy and the control of monetary aggregates.

13. A change in the PSBR will affect interest rates, the stock of money or both. The extent to which it affects one rather than another depends on government policy. The government can allow a change in the PSBR to come through entirely on the money supply, by holding interest rates at the levels they would have been at, or entirely on interest rates by holding the money stock on the path it would otherwise have followed. Assuming that the money stock responds in a fairly stable manner to interest rate changes, the broad financial impact of a change in the PSBR can be analysed in terms of either extreme case (interest rates unchanged or money stock unchanged). In what follows it is assumed that interest rates are held at the levels they would otherwise have been at, and changes in the PSBR alter the money stock. If the interest rate changes required to offset the resultant change in money stock were known, the implications for the other extreme case could be worked out.

14. The stock of £M3 does not change one-for-one in response to changes in the PSBR with unchanged interest rates. In terms of the traditional accounting identity,[1] this is because nearly all the factors which change the PSBR also change other items on the right hand side of the identity. For example, if the PSBR is reduced by cutting public expenditure on goods and services, prices and activity will be reduced and hence the amount of bank lending to the private sector. There will also be a reduction in private sector wealth and thus sales of public sector debt to the non-banks, and changes in the external (balance of payments) adjustments.

15. Not only is the relationship between £M3 and the PSBR not one-for-one, it is not even stable. It varies according to the particular factor which brought about the initial change in the PSBR. The explanation for this lies in the nature of the demand for £M3, which depends on private sector financial wealth, real incomes, prices and interest rates. Factors which alter the PSBR also alter these determinants of the demand for £M3, but with differing emphases. Thus an increase in indirect taxation raises prices while a reduction in public expenditure reduces them. The former also reduces real GDP by more than the latter for the same reduction in the PSBR. The net effect of these mechanisms and of changes in financial wealth is that the reduction in £M3 following an increase in indirect taxation is less for any given reduction in the PSBR than when public expenditure is cut. Estimates from simulations of the Treasury model suggest that with a floating exchange rate an increase in VAT will reduce £M3 by only about a half of the reduction bought about by the equivalent (in PSBR terms) cut in government procurement expenditure, and that with a fixed exchange rate it will actually raise £M3.

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(1) Change in £M3= PSBR + (Change in bank lending to the private sector)- (sales of government debt to the non banks) + (External adjustments) - (Change in banks' non-deposit liabilities)

16. The relationship between the PSBR and £M3 differs again when the change in the PSBR is brought about by exogenous changes in economic activity. In a recession, for example, the automatic rise in the PSBR is not necessarily accompanied by an increase in monetary growth. This is because when the private sector's demand for funds is weak it is relatively easy to finance the PSBR outside the banking system. The money supply grows relatively slowly (or interest rates hardly rise), even though the PSBR might be large as a proportion of GDP.

17. Even when the level of activity is high, and the competition for funds between public and private sectors pushes up interest rates, an increase in the PSBR will not necessarily reduce private expenditure to the same extent. In the short and medium-term there is no presumption that a higher PSBR will fully displace or "crowd-out" private expenditure, unless there are physical constraints on further economic expansion.

The control and monitoring of the PSBR

18. The PSBR thus appears to be an unsatisfactory measure of the effects of fiscal policy on output and on monetary developments and interest rates. As a control variable it suffers further disadvantages. For instance, it is difficult to forecast accurately. A post-mortem of the Treasury's forecasts made at the time of the Budget over the past 10 years shows a mean absolute error (the average error, irrespective of sign) of 1.9% of GDP in the PSBR forecast over the year ahead. This would be equivalent in 1979-80 to an error of about £3 billion.

19. Part of this large error can be explained by the difficulty of forecasting taxes and expenditure, and hence the PSBR, in 1974-75 when inflation was accelerating and when the economy was moving into deep recession. But this is just a reflection, admittedly a rather dramatic one, of the difficulty of forecasting the balance between two large aggregates with any accuracy. Errors in one of these aggregates can lead to proportionately much larger errors in the PSBR itself.

The stability or predictability of private sector behaviour is important in this context. Part of the difficulty of forecasting the PSBR in 1974-75 was a direct result of the unexpected rise in the saving ratio at the time and of the implications of this for the level of economic activity.

20. Monitoring the movement of the PSBR through the year is made difficult by the time it takes to compile statistics for borrowing by local authorities and the nationalised industries and other public corporations. Complete estimates are compiled only quarterly and, as a result, the PSBR figures are first published some 8 weeks after the period to which they relate. This obviously makes the use of the PSBR as a control variable somewhat difficult.

The PSBR and public sector indebtedness

21. Up to this point, public sector borrowing has been discussed as if it were a single transaction with no implications for the economy except at the time when it is undertaken. But a positive PSBR implies rising public sector indebtedness which leaves a legacy of interest to be paid in perpetuity (or at least until it is reduced by net repayments of debt in subsequent periods). The rise in the PSBR since the early 1970's has meant that debt interest is now a large component of public expenditure. In turn, the rising flow of debt interest has contributed significantly to the rise in the PSBR.

22. However, part of public sector debt interest really represents compensation to lenders for capital losses suffered on debt fixed in nominal terms as a result of inflation. Interest payments can typically be thought of as comprising two elements: repayment of capital (ie. compensation for inflation) and a true interest payment. Conventional national accounts statistics, by treating interest payments solely as income (to the lender) and as expenditure (by the borrower), distort the 'true' pattern of income and saving in a time of inflation. If a part of interest payments sufficient to maintain the real value of the original debt were to be regarded as capital repayment rather than income,

then the income and saving of borrowers (typically the public sector) will be higher and that of lenders (typically the private sector) will be lower than conventionally measured. Even where monetary assets bear no interest, however, it is clear that in times of inflation the borrower makes a capital gain and the lender a loss. The table below shows how adjusting income and saving to allow for these effects alters the net financial position of the public and private sectors in the period since 1967. The public sector turns from a persistent net borrower into a net lender and conversely for the private sector. The switch is most noticeable in the period since 1971, when inflation rapidly eroded the capital values of assets fixed in nominal terms.

TABLE 4

Net Acquisition of Financial Assets by Public and Private Sectors Before and After Adjustment for Capital Gains or Losses on Net Monetary Assets

£ billion (per cent of national income)

Public Sector	Before Adjustment	After Adjustment
1967-70 average	-0.4 (-0.7)	1.6 (3.8)
1971-74 "	-2.4 (-3.8)	2.7 (4.3)
1975-77 "	-7.3 (-6.7)	3.1 (2.7)
Private Sector		
1967-70 average	0.6 (1.2)	-1.1 (-2.9)
1971-74 "	1.0 (1.6)	-3.8 (-6.0)
1975-77 "	5.5 (5.0)	-3.9 (-3.5)

The effect of inflation on the public sector's liabilities means that, despite the historically high borrowing requirements of the 1970's, the public sector's balance sheet has actually improved. The major assets - the productive capital of the nationalised industries - have risen in price more or less in line with inflation whereas liabilities are fixed in nominal terms.

22. There is another reason why the total PSBR provides at best only a rough guide to the future burden of debt obligations. Any lending or investment by the public sector which will itself generate a stream of income sufficient to cover future interest payments should in principle be deducted. On these grounds one might exclude much fixed investment by the nationalised industries, much public sector housing investment as well as those items described in the accounts as net lending by the public sector. The current presentation of debt interest in the Public Expenditure White Paper recognises this by including only those interest payments which have to be met either out of taxation or fresh borrowing. It can also be argued that some current expenditure, for example on health or education, is an investment in the future from a social point of view. Although it does not provide a cash return to the public sector, it provides a welfare return to society as a whole for which it is appropriate to incur debt.

23. Debt interest payments in excess of receipts from income-earning activities, are, of course, only a transfer of income within the economy (interest paid abroad can be ignored in this context if it is assumed that the current account, excluding interest debits on UK government stock, is in equilibrium from now on). But this does not mean that it is entirely costless to society as a whole. Eventually taxes have to rise to service the accumulated debt. This could be delayed, either by meeting interest payments by further borrowing, which brings the risk of loss of confidence in markets, or by reducing the PSBR. In either case, the burden of debt interest acts as a constraint on monetary and fiscal policy in the long run.

Conclusions

24. The government will always wish to consider the implications of their policies in terms of their ultimate objectives for the economy. But though this is essential it is also very complicated. Intermediate objectives help the government to give direction to their economic policy and provide the public with a necessary yardstick

There are, however, severe limitations to the usefulness of the PSBR as an intermediate objective . Changes in the PSBR do not necessarily reflect changes in the public sector's demand for real resources or changes in monetary developments and interest rates. The difficulties involved in forecasting and monitoring the PSBR make its use as a control variable hazardous. If a single intermediate objective is required the growth of the money supply is much better than the PSBR, looked at on its own.

SIR FRED ATKINSON

cc Mr Byatt o.r.
Mr Cassell
Mr Middleton
Mr Shepherd
Mr Riley
Mr Powell
Mr Mowl
Mr S Bell
Mr Wilkinson

THE PSBR, INTEREST RATES AND MONEY SUPPLY

You asked what reduction in interest rates might be possible if the monetary effects of a fiscal contraction were allowed to come through onto interest rates instead of money supply. The reduction in both long and short interest rates associated with the same three policy instruments considered in the paper attached to my minute of 11 September, scaled as before to produce a reduction in the PSBR of £1000 million in 1979/80 are estimated from ready reckoners to be:

	Income tax	VAT	Procurement expenditure
	(absolute change in interest rates, in percentage points)		
Year 1	-0.5	-0.3	-0.7
Year 2	-0.8	-0.5	-0.9
Year 3	-1.1	-0.6	-1.4

As in the earlier paper, the exchange rate is assumed to be floating.

2. The ranking of the three policy instruments by the size of their effects on interest rates with fixed money supply is, of course, the same as the ranking by their effects on money supply with fixed interest rates.

3. The estimates are unrealistic for three reasons:

(a) they assume that interest rates move in steps at the beginning of each financial year, and then remain at the new level until the end of the financial year. Allowing interest rates to adjust smoothly would not, however, alter the broad picture;

(b) in practice the authorities do not take steps to ensure that all interest rates move together. Policy operates mainly on short interest rates, and market forces alter long rates. While the latter might be expected to come down eventually in response to a reduction in the PSBR and short rates they might take some time to do so. In the meantime, the reduction in short term rates might have to be very large to hold the money supply up in the face of a fiscal contraction. (The responsiveness of £M3 to changes in the short rate is much less than that to changes in long rates in the model.) It was because of this point that we did not put figures of this kind in the text;

(c) they assume no change in expectations in the gilts market. In practice a change in the PSBR might be expected to have some effect on expectations, but it is difficult to estimate what it will be. A justification for the no change assumption is that the market was expecting the change in the PSBR to take place. The long run change in interest rates would anyway be the same either way.

Joh OS

J ODLING-SMEE
19 September 1979

Cop, for Stephen. 557

CHANCELLOR OF THE EXCHEQUER

THE PSBR

In the run-up to your decision whether to incorporate in the medium term financial plan a target path for the PSBR, you may be interested to read the attached paper written by Mr Odling-Smee and endorsed by those of us who have considered it. It provides a useful survey of the trend of the PSBR home and abroad in recent years and discusses its usefulness as a measure of the of fiscal policy on monetary developments. It also considers the case for the PSBR as a control variable (which in a sense it would become if it were made the subject of a medium term plan). It also bears on the issue raised recently by Greenwells and by the LBS, viz the proper posture of the PSBR in a recession.

The paper does not argue the case for or against the incorporation of the PSBR in a publicly stated plan. It does not for instance consider the psychological effects of a commitment to a substantially smaller PSBR - something to which its proponents like Professor Minford would attach very high importance. But it does contain material pertinent to the whole debate, and as such is worth reading.

DW.

DOUGLAS WASS
11 September 1979

cc Chief Secretary
Financial Secretary
Minister of State (C)
Minister of State (L)
Sir Lawrence Airey
Sir Fred Atkinson
Sir Kenneth Couzens
Mr Byatt
Mr Shepherd
Mr Cassell
Miss Brown
Mr Bridgeman
Mr Hancock
Mr Middleton
Mr Unwin
Mr Odling-Smee
Mr Riley
Mrs Lomax

SIR FRED ATKINSON

cc Mr Byatt
Mr Cassell
Mr Middleton
Mr Shepherd
Mr Riley
Mr Powell
Mr S Bell
Mr Wilkinson

THE PSBR, INTEREST RATES AND MONEY SUPPLY

Before you went on leave you asked me to prepare a paper on the relationship between reductions in the PSBR on the one hand and monetary growth and interest rates on the other. I attach a draft, an earlier version of which was discussed with Messrs. Cassell, Middleton, Riley, Powell, Bell and Wilkinson. They have not seen the present version and may wish to comment.

2. The paper contains a potted version of the arguments in the City University paper. Ministers were sent this at the end of July, and there has not been much reaction so far. However, the Financial Secretary intends to hold a meeting quite soon to discuss it. You might like to wait to see how this meeting goes before deciding how to handle the attached paper. The relationship between the PSBR and £M3 also crops up in the paper on medium term financial targets, which Ministers have seen.

JoL OS.

J ODLING-SMEE
11 September 1979

Encl.

THE PSBR, INTEREST RATES AND MONEY SUPPLY

Introduction

Central to the Government's medium term strategy is a progressive reduction in the rate of inflation achieved by a progressive reduction in the rate of growth of the money supply (£M3). Another key element in this strategy is to change the balance between monetary and fiscal policy so that the reduction in monetary growth is obtained more by fiscal contraction and less by high interest rates. In other words the Government wishes to see both lower monetary growth and lower interest rates. Such a policy is likely to involve fiscal contraction: reducing public expenditure and/or increasing taxation.

2. The fiscal contraction will reduce the PSBR below what it would otherwise have been. If the contraction is sufficient to lower monetary growth and/or interest rates over the long term, the PSBR as a ratio of GDP will eventually fall. But year to year movements in the PSBR ratio will not always be downwards, because cycles in economic activity will cause it to fluctuate about the downward trend. It is quite possible that economic activity in some years will fall to a sufficiently great extent to cause the PSBR ratio to rise, despite the decline in monetary growth and interest rates and the general downward trend in the PSBR ratio itself.

3. This paper is not, however, concerned with the path over time of the PSBR, interest rates and the money supply. Its purpose is to explain why and how fiscal policy-induced reductions in the PSBR reduce interest rates and/or monetary growth. It draws on the analysis in a paper on "Monetary Targets and the PSBR" presented by four Treasury economists to a conference at the City University in May 1979.

4. The first step is to consider, in the next section, what determines the stock of money. Then there are two sections on how changes in the PSBR may affect the determinants of the money stock and interest rates. The following section attempts a rough quantification of the relationship between the PSBR and the money stock.

Determination Of The Money Stock

5. The market for £M3 is like most other markets in which the observed quantity and its price are determined at the same time by the interaction of demand and supply. (All general references to the quantity of money will be in terms of the stock. The word supply will be used only in the sense of supply as opposed to demand.) An essential feature of the money market is that there is virtually never any rationing. The 'price' of money moves relatively quickly to equate demand and supply or the banks and the public sector supply whatever quantity is demanded at the going 'price'. In the case of £M3 the 'price' is the opportunity cost of holding £M3 rather than some other asset. In other words, it is the difference between the average rate of interest on £M3 and the average rate of interest on other financial assets such as gilts. Since only part of £M3 is interest-bearing (time deposit accounts, wholesale deposits and certificates of depsoit) the average rate of interest on £M3 is influenced by the level of interest rates as well as by the structure, which is more obviously relevant to the difference between the average interest rates on £M3 and other assets.

6. The main factors in addition to interest rates which influence the demand for money by the non-bank private sector are real income, the price level, and financial wealth. Real incomes and the price level are the major determinants of the transactions demand for money. Financial wealth, itself affected by real incomes and prices, is important because a large proportion of it can be held in the form of money. This is the asset demand for money.

7. Banks supply all the components of £M3 except notes and coin which are supplied by the public sector on demand. The components of £M3 supplied by banks range from sight deposits, which are also supplied on demand, to certificates of deposit (CD's) whose supply depends on the banks' balance sheet position and interest rates. Between the two extremes are retail time deposits (deposit accounts) and wholesale deposits other than CD's. In these cases banks supply however much is demanded at the ruling interest rates, but they change the interest rate and hence quantity supplied in response to changes in market rates and their balance sheets. The existence of quantitative controls, for example on bank lending or eligible liabilities, affects banks' supply of some components of £M3 (and also determinants of the demand for £M3).

Theories of the PSBR and Money Stock

8. As the money stock is determined by the interaction of demand and supply, it is necessary to consider all the channels through which changes in the PSBR can influence the determinants of demand and supply. Some theories, however, neglect the demand side. By making rather extreme behavioural assumptions they conclude that there is a simple, unique arithmetic relationship between the PSBR and the actual quantity of money.

9. This view may derive partly from the mechanics of the way changes in the PSBR affect the money supply in the first instance. The immediate impact of, say, a cut in public expenditure on goods will usually be to reduce the bank deposits of the private company supplying the goods compared with what they would otherwise have been. From the banks' point of view the counterpart to this fall in deposit liabilities is a fall in lending to the Government (typically in the form of Treasury Bills) since the banks are likely in general to be the Government's residual source of finance. This fall in the money stock is only the impact effect, however, and ignores subsequent changes in the money stock

resulting from the response of the private sector and banks to the change in expenditure and associated financial changes. These subsequent reactions may follow very quickly. For example, the company losing the cash flow from the Government may need to increase its overdraft with its bank,

10. The simple textbook theory of the money supply takes the process further by examining the second-round reactions of the banks. It relates the outstanding stock of bank deposits to the quantity of reserve assets available to the banking system and the required reserve ratio. Provided that the banks' desired reserve asset holdings are no higher than the required minimum, so that banks hold no more than the required minimum, a reduction in the supply of reserve assets to the banks will reduce the supply of bank deposits by a constant multiple equal to the reciprocal of the reserve ratio. If reserve assets are the residual source of finance for the government, their supply is given by the PSBR minus the supply of other forms of public sector debt. A money supply function can be derived therefore in terms of the PSBR, the required or conventional reserve ratio, the supply of public sector debt which does not qualify as a reserve asset and the supply of cash. This function is often used as the basis of the assertion that there is a direct and unique relationship between the PSBR and quantity of money.

11. This simple textbook model has been heavily criticised as being too mechanistic. To begin with, the demand for money plays no part. Moreover it does not describe the UK banking system. In the UK the public sector does not have a monopoly on the supply of reserve assets. For example, the discount market can create reserve assets with no change in public sector debt supplies. Reserve assets can also be created by intervention in the foreign exchange markets. More generally, banks hold reserve assets in excess of the required minimum and to a degree that varies over time. Non-banks exchange reserve assets with banks in response to movements in interest rate differentials. Given these institutional arrangements a simple linear model of money stock determination is clearly inappropriate.

The PSBR and Money Supply and Demand

12. Once the demand for money is brought into the analysis, the relationship between the PSBR and the money stock and interest rates becomes more complex. This can be illustrated in terms of the familiar accounting identity used to present and analyse monetary statistics:

Change in £M3 =	Public Sector Borrowing Requirement	+	Change in Bank Lending	–	Sales of Government Debt to the Non Banks	
	+ External Factors	–	Change in Non-Deposit Liabilities			

This identity gives the impression that there is a simple relationship between the PSBR and changes in the money supply, since the PSBR appears on the right hand side. However, as Ministers are aware from papers on Monetary Base Control, this is not so because nearly all the changes which affect the PSBR also affect other items on the right hand side. For example if the PSBR is reduced by cutting public expenditure on goods and services this will reduce prices and activity and thus the amount of bank lending by the private sector. It will reduce private sector financial wealth and thus sales of public sector debt to the non-banks.* There will also be changes in the external (balance of payments) factors, even if the exchange

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* Since sectoral deficits and surpluses must in aggregate be zero, the PSBR (or, more strictly, the public sector financial deficit) and the current account surplus together measure changes in private sector financial net wealth according to the following identity:

$$\text{Change in private sector financial net wealth} = \text{PSBR} + \text{Current account surplus} + \text{asset revaluation effects}$$

But this is an identity, not a behavioural relationship. The PSBR and the current account surplus do not determine the net financial wealth of the private sector. Rather, all three are affected by the same factors such as fiscal policy or world trade. Asset revaluations directly affect net wealth but not necessarily one-for-one, since they may also be associated with changes in the other two items on the right hand side of the identity.

rate is freely floating. Initially the current account of the balance of payments will improve and if the rate is floating matching capital outflows will be generated. Only if the capital outflows are all from the private sector and none are from the banks or public sector debt will there be no effect on the money stock.

13. The example in the previous paragraph illustrates the proposition that the relationship between the PSBR and the money stock is complex. The exact relationship also depends on what alters the PSBR in the first place. This can be seen from a comparison of the cut in public expenditure on goods and services with an increase in indirect taxes designed to have the same effect ex post on the PSBR. The indirect tax increase will reduce the level of domestic activity as does the cut in expenditure, though not necessarily by the same amount, but it will increase, not reduce, the price level at least in the short run. Thus whereas in the public expenditure case nominal incomes and expenditure will certainly fall, in the indirect tax case they will probably rise, and bank lending, which is primarily determined by the level of nominal incomes and expenditures, will move in opposite directions in the two cases. There are reasons for thinking that the response of sales of public sector debt and the external adjustments will also differ. For example the import content of public expenditure is generally lower than that of consumers' expenditure, on which the indirect tax increase primarily falls, and so the improvement in the current account will differ.

14. This discussion can be summed up as follows. The money stock is determined as much by demand as supply. Generally whenever the PSBR changes there will be effects on some or all of the factors which influence the demand for money, such as real expenditure, the price level, private sector financial wealth, interest rates etc. These effects will differ according to the source of the change as also will the change in the actual stock of money.

15. So far little has been said about one of the main determinants of the demand for money, interest rates. This is partly because the traditional accounting identity does not lend itself very easily to a discussion of interest rate responses. The way in which both interest rates and the money stock respond will depend on government policy. If the Government is following a policy of reducing the size of the PSBR it can allow the effect to come through entirely on the money supply or entirely on interest rates, or it could allow both the money stock and interest rates to adjust. A larger reduction in the PSBR is required to reduce both money stock and interest rates than to reduce only one of them to the same extent.

Simulation Results

16. The Treasury model helps us to trace through these complex effects and interactions. Simulations of three fiscal policy changes designed to reduce the PSBR by £1 billion were carried out on the Treasury model. However for analytical convenience it was assumed that interest rates remain unchanged. It was also assumed that there were no quantitative controls on bank lending in force eg. through the 'corset'. The results should be regarded as indicating only the broad orders of magnitude. The model is continually being updated. Exact estimates will therefore differ according to which version of the model is being used for simulations. But there is no reason to think that the relativities between the different sources of change will be greatly affected.

17. All the simulations assume a floating exchange rate and that there is no change in expectations in the gilt-edged market following the reduction in the PSBR. The results would have been somewhat different if the exchange rate had been assumed to be fixed. Although we recognise that there can be important expectation effects in financial markets, these are essentially relevant to the short run. They can ignored in the type of longer run analysis under consideration here. The three fiscal policy changes are an increase in personal income tax, an increase in standard rate VAT, and a reduction in general government expenditure on procurement.

Effects Per £1b Reduction in PSBR in 1979/80 (% changes)

	Real GDP	Prices	Nominal GDP	Financial Wealth+	£M3+
Income Tax					
Year 1	-0.3	0.1	-0.2	-1.4	-1.0
Year 2	-0.6	0.4	-0.2	-2.5	-2.5
Year 3	-0.8	0.6	-0.2	-3.4	-2.5
Year 4	-0.9	0.5	-0.4	-4.3	-2.9
VAT					
Year 1	-1.0	1.9	0.9	-1.4	-0.5
Year 2	-1.6	2.7	1.0	-2.1	-1.2
Year 3	-1.9	3.0	1.1	-2.4	-1.4
Year 4	-2.0	3.0	1.0	-3.0	-1.7
Procurement Expenditure					
Year 1	-0.8	-	-0.8	-0.8	-1.3
Year 2	-1.0	-0.5	-1.5	-1.3	-2.1
Year 3	-1.1	-1.1	-2.2	-2.2	-2.9
Year 4	-1.0	-1.8	-2.8	-3.4	-3.8

+End-year figures

18. The table shows that the effects on £M3 vary significantly according to the source of the PSBR change. The biggest reduction in monetary growth, about 1 per cent a year in the early years, comes from cutting procurement expenditure, and the smallest, about half of this, from raising VAT. Increasing income tax is intermediate. The different monetary effects are primarily the result of the different impact on prices and hence on the demand for various financial assets, including £M3: expenditure cuts reduce prices, while tax increases raise them, especially VAT increases. There are also some differences between the impact of the three policy changes on real GDP and financial wealth, but they are much less important.

19. If the financial effects of the fiscal policy changes were allowed to reduce interest rates rather than monetary growth, the effects of the different policies would be ranked in the same way as their monetary effects:procurement cuts would reduce interest rates most, followed by income tax increases, then VAT increases. The exact magnitude of the reduction in interest rates depends on whether all interest rates fall to the same extent.

20. Changes in different types of public expenditure will have significantly different effects on the PSBR per pound of expenditure because of differences in their effects on output and prices: changes in expenditure on public service employment, for example, have a small effect on the PSBR in the short-term compared with public procurement because of substantial off-setting changes in social security payments and taxation revenue (in the medium-term the differences are much less marked). Even if the cuts are scaled to have the same effect on the PSBR, the effect on the money stock will be different. For example, cuts in expenditure on public service employment per unit of PSBR will lead to larger falls in £M3 than cuts in transfers which have larger effects again than cuts in procurement. But per unit of <u>ex ante</u> public expenditure saving, cuts in procurement will have a bigger effect pound-for-pound on £M3 than cuts in employment. From a monetary point of view, sales of public sector assets are in many ways just a means of satisfying a given government financing requirement and have rather different financial implications. There are substantial offsets to gilt sales and some increase of bank lending and consequently only rather modest reductions in £M3.

Conclusions

21. A reduction in the PSBR (expressed as apercentage of nominal GDP) in the long run is a necessary condition for achievement of the Government's twin objectives of a progressive reduction in the rate of monetary growth and a fall in interest rates from current high levels. The main mechanism linking a reduction in the PSBR in the medium term to lower monetary growth and interest rates is the influence of fiscal policy changes on the demand for £M3.

The demand for £M3 is affected because real incomes, net financial wealth and prices change. There is however no simple, unique relationship, especially in the short run, between changes in the PSBR on the one hand and interest rates and the money stock on the other. The extent to which a given reduction in the PSBR leads to lower interest rates and money stock depends on how it is achieved. In some cases fairly large reductions in the PSBR may lead to only modest changes in the money stock and interest rates. Public expenditure on procurement has a bigger impact per pound of PSBR on the money stock (and by implication interest rates) than increasing income tax or VAT. Other types of expenditure change may not be so efficient however. Asset sales for example will have little effect on the money stock or interest rates.

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PRIME MINISTER

Strategy Proposals

The Cabinet Office brief is below. I would like to add one general, and one specific, point.

The various proposals under discussion, taken together, could do a lot to improve the working of the market economy. As such, they are potentially the Government's answer to the criticism that we are doing nothing to "get the economy moving". But to be successful, speed is of the essence. Although a lot of work has clearly been done, there is a risk - as with all exercises of this kind - that there will be bureaucratic delays, especially where a number of Departments are involved. I know that the C.P.R.S. and some of the more positive people in DOI would welcome a strong push from you to move the work along.

I think the study of "Biases against Investment in Productive Assets" needs a special push (this is Item 4 of the Chancellor's paper). On past form, the Revenue will be a stumbling block. It is very important, in my view, that they come up with serious proposals for tax relief on investment in equities.

TL

22 October 1979

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Ref. A0469

PRIME MINISTER

Priority Strategy Proposals

(E(79) 42) (in Pt 3)

BACKGROUND

Earlier this year, you asked a number of Ministers to send in specific proposals for desirable initiatives in economic strategy. The CPRS produced a marshalled list of the suggestions in E(79) 24, and Mr. Hoskyns suggested a way forward in E(79) 28, by identifying certain items for "priority" treatment. These were the items on which quick action was possible, not necessarily the most important items, though naturally the priority list included some of these.

2. E Committee considered the two papers on 24th July (E(79) 6th Meeting, Item 4) and invited the lead Department for each priority item to press on with work on it and to report back to a steering committee (MISC 14) to be chaired by the Chancellor of the Exchequer.

3. MISC 14 considered the Departmental reports in September. The Chancellor of the Exchequer circulated his report to E Committee on 24th September, but pressure of more urgent business has delayed its consideration until now.

4. In his paper, the Chancellor of the Exchequer reports progress on all the priority items; invites E Committee to endorse a number of decisions provisionally taken by MISC 14; and invites E Committee's decisions on two major issues on which MISC 14 have agreed recommendations, but did not feel able to authorise further work before they had been considered by E Committee. Finally, the paper suggests a possible timetable for new initiatives arising from the proposals and their consideration.

HANDLING

5. You will want the Chancellor of the Exchequer to introduce his paper. Then I suggest that you take the Committee through the conclusions on pages 10 and 11.

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Conclusion 1: Take note of work in progress

6. I suggest that you invite the Committee to do no more than take note. At some stage you may want to organise a general discussion of progress towards strategic objectives but you would want a different sort of paper for that purpose. If Ministers have points on particular items of work in progress, other than those which fall to be discussed under other heads below, you might invite them to discuss them directly with the Minister in the lead for that item, and the Chancellor of the Exchequer as Chairman of MISC 14. If there are several such points it might be appropriate for the Chancellor to hold a further meeting of MISC 14, with appropriate invitees, to discuss them.

Conclusion 2: Endorse MISC 14's decisions to commission further work on five subjects

7. You might take the Committee quickly through the list. In each case, MISC 14 felt that the decision to commission further work would be uncontroversial and it will be surprising if E Committee does not fairly readily endorse MISC 14's decisions. But Ministers may want to make points on individual projects on which a brief discussion would be useful.

(a) Planning procedures (Item 11). Work is well in hand at official level and there will be a report back, probably to E(EA) in due course.

(b) Goods Vehicle Licensing (Item 14a). A good deal of work has been done on this recently, and it casts doubt on the allegation, reported in the Chancellor's paper, that different practices in different regions impose heavy costs on operators. However, I imagine that the Committee will want to confirm the remit to officials, if only to bring the facts of the case before Ministers collectively.

(c) Different approaches to reducing restrictive labour practices (Item 21). This is with the CPRS, in consultation with the Departments concerned. You might check whether the Secretary of State for Employment wishes to comment, but I imagine that the Committee will want the review to go ahead.

(d) Reducing nationalised industry monopolies (Item 25). The Chancellor of the Exchequer's paper reports that with two exceptions, Departments have not come forward with firm proposals on this subject. MISC 14 has therefore asked officials to try again, and in particular has asked them to put forward to Ministers all the possibilities they have considered, even if the proposals do not have the support of the sponsoring Department. This last request is particularly important if we are trying to get radical ideas put forward for collective Ministerial discussion, and you might like to ask for the Committee's specific endorsement of it.

(e) Contracting out of public sector services (Item 6). Some Ministers may want to ask about the scope of the review, since it could affect their Departments and they will not have seen the MISC 14 papers. You might ask the Chancellor of the Exchequer to field any such questions. As with the previous item, you might like to get E Committee's agreement that radical suggestions should come forward for Ministerial discussion even if they are not endorsed by the Department directly concerned.

Conclusion 3: Agree that officials should be asked to produce interim reports on two subjects

8. You will want to check that the Committee agree. This proposal has been included for completeness rather than because objections were foreseen, and I imagine that it will go through on the nod.

Conclusion 4: Take decisions on two issues

9. You will want to take the two issues in turn.

10. The first is whether an interdepartmental group of officials should be set up under Treasury chairmanship to review various issues affecting incentives for the lower paid. I imagine that the Committee will agree fairly readily to this but they should not underestimate the size of the task. The review will take a lot of work by officials, and I think it is this aspect which has led the Chancellor of the Exchequer to seek E Committee's views first

rather than commission the work subject to E Committee's endorsement. If the Committee agree that the review should go ahead, you might ask the Chancellor of the Exchequer to report, either at the meeting or soon after it, on how long he expects the review to take.

11. The second issue is whether the CPRS should examine the implementation of policies concerning health and safety at work and if so, whether their examination should extend to the institutional framework within which the policies are applied. MISC 14 were convinced that a review was needed, but they could hardly authorise it themselves without consulting the Secretary of State for Employment. You might start by seeing what he thinks. If he objects, you might turn to other members of the Committee - there will probably be very strong support for a review.

12. If the Committee agree on a review, they will need to decide whether it should take the existing institutional framework for granted, or - as MISC 14 recommend - should look at the institutional framework as well. There was some feeling at MISC 14 that the existing framework is wrong. In theory, the Health and Safety Commission should balance employers' and employees' interests, containing as it does representatives from the CBI and the TUC. But it may be that the representatives on both sides are safety conscious rather than money-conscious, so that the Commission becomes part of the Health and Safety lobby.

13. The Secretary of State for Employment may argue that there is no need to look at the institutional framework, since it will be reviewed anyway in the Pliatzky review of quangos. But this misses the point. Pliatzky will ask whether a quango is needed. The answer may well be yes. In that case he will not ask what sort of quango is needed, and it is precisely this point that MISC 14 want to get at. You might guide the Committee to agree that the CPRS should be free to look at the institutional framework in this sense.

Conclusion 5: Endorse the target timetable for initiatives

14. Pages 8 and 9 of the Chancellor of the Exchequer's paper give a very provisional timetable stretching from the Party Conference to next summer. It is naturally beginning to be overtaken by events. I doubt if the Committee need

to discuss it in detail - they might simply endorse it as a general guide to the timing of various initiatives. The underlying point which they will no doubt all agree is that the pressure should be kept up but that initiatives should come forward in a steady flow rather than all at once.

CONCLUSIONS

15. You will want to record the Committee's decisions on Conclusions 1-5 of the Chancellor of the Exchequer's paper as set out above.

JH

(John Hunt)

22nd October, 1979

SECRET

Prime Minister

Econ Pol

Ref. A0408

MR. LANKESTER

The Economic Forecasts

When the Chancellor sees the Prime Minister at lunch on Sunday he is likely to raise the subject of the medium and short-term forecasts. The outcome of the latest forecasting round was shown to Treasury Ministers this week and they were unready to accept the depth of the gloom which the forecasts presented. They asked the forecasters to try some alternative assumptions - particularly on the likely earnings increase next year. Treasury Ministers are likely to look again at the new alternatives some time in the middle of next week.

Several issues (particularly over timing) arise on this and the Prime Minister might like to get the Chancellor to talk on them. They are -

I. Publishing the forecasts - perhaps the easiest issue.

II. Discussing the forecasts among colleagues.

III. The forecasts and cash limits - the most immediately important issue.

I. Publishing the Forecasts

Under the Industry Act (the Bray amendment) the Government must publish a short-term forecast - strictly speaking by 20th November, but the Chancellor believes this date can be allowed to slip a little.

His idea now is to publish the Bray forecast after the 1980-81 Public Expenditure White Paper which can go ahead on its own and be taken by Cabinet on 25th October, or perhaps even cleared in correspondence. The political difficulties of publishing a Bray forecast which was rather more gloomy than that published at the time of the last Budget ("the Government's policies not working") might be contained by publishing forecasts on more than one wage/price assumption to signify that the Government believes that the effects of its policies was genuinely unknowable yet. All this seems sensible.

II. Discussion among Colleagues

The Cabinet is not going to have an easy time with public expenditure programmes 1981-82 - 1983-84 (Cabinets of 18th October and 1st November). The Chief Secretary is still well short on a number of vital programmes and there are

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Separate in box on this TL

looming demands for more money for the nationalised industries: British Leyland, Rolls-Royce, etc. Nevertheless I doubt whether a general discussion of the medium-term forecast in E or in Cabinet before they take public expenditure 1981-84 would help (we need all the cuts we can get regardless of the forecast) and it might only muddy the waters and delay decisions. But the Prime Minister could, if necessary, offer the Cabinet a later discussion of medium-term economic strategy.

III. The Short-term Forecast and Cash Limits

This is the most immediate and most difficult issue. Ministers may well believe that no forecast of wages and prices in 1980 is worth anything because no-one can forecast the speed and extent of the public's reaction to the Government's radically new policies. But some forecast has to be adopted (and adopted very soon indeed) for calculating next year's cash limits for local government, NHS, nationalised industries, etc.

It has been agreed that the wage and price assumptions used in calculating the cash limits shall be "realistic but not extravagant". It has been agreed that the objective is to make cash limits a real discipline by regarding them as "immutable", i.e. not to be revised upwards if pay and prices increase by more than the amount allowed. But that still leaves two questions -

(a) What figures are "realistic but not extravagant"?

(b) What happens, particularly in central government cases, if pay and prices outturn is different to the allowance? For example, in cases referred to Clegg does the Government bind itself to accept the outcome and provide the necessary extra money? Or does it reserve the right to reduce a Clegg award and/or increase the volume squeeze over and above the volume squeeze already agreed by Ministers?

Ministers are considering this in MISC 21 for report to Cabinet on 25th October. That date should not slip or we will have to postpone the statutory Rate Support Grant meeting with local authorities on 20th November and they in turn will be in difficulties with wage negotiations and settlements due for end-November.

Ministers in MISC 21 can work next week on problems other than the actual pay and prices figures to be used in calculating cash limits. But MISC 21 will need them for their meeting on Monday, 22nd October, if they are to comment on them for Cabinet on 25th October.

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The question then for the Chancellor is will Treasury Ministers come to conclusions on the forecasts by Wednesday or Thursday of next week so that they can be included in the RSG proposals put to MISC 21 for discussion on 22nd October. (If not, they have either to be put straight to Cabinet on 25th October or the RSG timetable would have to slip.)

John

JOHN HUNT

12th October, 1979

Mr faxed to Chequers

and seen by PM

CONFIDENTIAL

Prime Minister,
The Chancellor would like to speak with you about this tomorrow.
Duty Clerk. 13 Oct.

Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

PRIME MINISTER

ECONOMIC PROSPECTS

I have received a preliminary summary from officials of the results of their autumn forecasting exercise and I thought that you would find it helpful to have a brief indication of this and of the further work that is in hand.

2. The general picture is, I fear, a gloomy one and more pessimistic than the forecast we published at the time of the Budget and those of most outside commentators. GDP, after modest growth this year, is expected to fall substantially next year and the rate of price inflation to decelerate more slowly next year than had previously been expected. The inflation prospect for next year has worsened mainly because of higher prices for oil and other imported materials and because earnings in the year ending last July were higher than expected.

3. With price inflation worse but with the rise in earnings moderating because of our tight monetary policy and some prospective rise in unemployment, consumer spending is likely to be lower. Moreover the higher levels of the exchange rate and earnings this year has led to worsening competitiveness which, together with the unfavourable performance so far this year in trade volumes, makes the prospect for trade worse than in the budget forecast. These factors, together with a smaller

/ increase in

increase in world demand for our exports, explain the more pessimistic view on output. Despite lower activity in general, poor trading performance and the virtual disappearance of the usual invisibles surplus lead to substantial current account deficits this year and next.

4. The PSBR prospect for both this financial year and 1980-81 is, however, broadly in line with the previous forecast, remaining at around a constant 4½ per cent of market price GDP. This is, of course, subject to major uncertainties, but I see no case at present for any further policy changes on this account, and I was interested to note that in the seminar I held here with a number of outside economists last Friday on medium term financial plans there was general agreement that it was right to view the PSBR in real terms.

5. I think that the preliminary results of the forecast are a plausible guide to the general direction of the main economic developments in the short-term. But they are, of course, subject to very large margins of error and critically dependant on a number of key judgements. I am not satisfied that these are entirely plausible or acceptable, and I have therefore asked officials to do further work on a number of variants and I hope to have the results of this available within the next few days.

6. We shall need to consider in the light of the further work the form in which we publish the forecast under the requirements of the Industry Act. Although I had previously envisaged that it would be convenient to combine this at the end of this month with the first Public Expenditure White Paper

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containing our plans for 1980-81, I now think that the best course would be to separate them and publish the Industry Act forecast later. This could be delayed until the end of November without our statutory obligations under the Industry Act becoming a serious embarrassment, and would give us more time in which to get the presentation right.

7. Subject to your own views, therefore, I think we should go ahead with publication of the 1980-81 White Paper on its own at the end of this month as previously decided, and I have instructed my officials to plan to this effect.

(G.H.)

12th October, 1979

CONFIDENTIAL

Prime Minister,
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Duty Clerk
13 Oct

Treasury Chambers, Parliament Street, SWIP 3AG
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(G.H.)

12th October, 1979

PART 3 ends:-

E(79)47 of 2 Oct 1979

PART 4 begins:-

Chan tx to PM 12 Oct 79