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Top copy on Econ Pol July 1980 PM's luncheon at Chequers on Sunday 13 July 1980 for a group of academic economists.

NOTE OF A DISCUSSION AT CHEQUERS: SUNDAY 13 JULY

Present: The Prime Minister
Chancellor of the Exchequer
Chief Secretary
Sir Douglas Wass
Mr. Terry Burns
Professor Matthews
Professor Griffiths
Professor Hague
Professor Minford
Professor Ball
Mr. Christopher Foster

Mr. T.P. Lankester

Professor Minford said that, since last November, the Government had got a grip on the fiscal and monetary environment. The Medium-Term Financial Strategy (MTFS) was the cornerstone of the Government's economic strategy, and it was crucial that people should understand this and be influenced by the targets that had been set. There were signs that the credibility of the strategy was beginning to take hold. But the battle was still to be won. It was essential that the Government should "see it through", and give no sign that it was going to relax. The current method of monetary control was not ideal, but the authorities had to live with it for the time being. Their objective should be to stay well within the monetary target range - and probably at the lower end of it. Only by a progressive reduction in the PSBR and by sticking to the monetary targets would the inflationary psychology be cracked and would there be any prospect of recovery of the real economy.

Professor Matthews said that it was important that the Government should not over-estimate its powers of bringing about recovery. The 1940s, 1950s and 1960s had been years of success; the 1970s had been years of significantly worse performance, and it was far from clear exactly why there had been this deterioration. If Government claimed too much for its ability to change things, there was a real risk of disappointment. He agreed in general terms with the Government's

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strategy. But he was nonetheless concerned that the strategy might fail - with the result that, after much pain, a Leftist government might be returned with a commitment to destroy the market economy as we knew it. In order to reduce the short-term cost of the strategy, he strongly favoured a lower exchange rate. He believed this could be achieved by "talking it down". There was no point in companies getting rid of restrictive practices and improving efficiency if they were still going to collapse or run down because of an excessively high exchange rate. It was all very well to say that companies and employees had to adjust to the 40 per cent loss of competitiveness since 1976 by greater efficiency and more realistic pay bargaining; but the extent of the adjustment that was required was simply too great. On the other hand, he accepted that there was the danger that any announcement designed to get the exchange rate down could all too easily be interpreted as implying that the Government was moving away from the strategy. Professor Matthews also said that it was important not to take too insular a view of Britain's problems. At present, we were disinflating more than other countries. He hoped that in due course we would be able to move more into line with them.

Commenting on the exchange rate point, Professor Minford said that the only sure way of getting the real exchange rate down was for people to price themselves into jobs. If it were possible to get the nominal exchange rate down without shifting away from the medium-term financial strategy (and in his view this was very doubtful), it would only aggravate the problem of inflation. Mr. Burns said that the 40 per cent loss of competitiveness since 1976 exaggerated the extent to which companies had to adjust; for in 1976 the exchange rate had been substantially under-valued. Professor Ball said that the Government could not have an inflation target and an exchange rate target at the same time: the two were mutually incompatible. Unless the authorities felt that the exchange

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rate market was working inefficiently, there was no way they could get the rate down without tampering with the inflation target..

Professor Ball went on to say that, while he supported the MTFS wholeheartedly, he was worried about the absence of a proper industrial policy. With the MTFS securely in place, the Government had reached an important point of transition; and should now be giving more attention to the supply side of the economy. He was concerned that the necessary structural adjustments would not take place through market forces alone, and that a great deal more needed to be done - for example, in the provision of training, energy investment, regional assistance, industrial infrastructure, and the implementation of a more radical housing policy. What the Government had done, and was likely to be able to do, in the field of taxation, would not be sufficient on its own. On the question of training, the problem was largely an institutional one. It had been a great mistake to convert the colleges of advanced technology into universities, and the polytechnics were giving far too much emphasis to the social sciences at the expense of industrial technology. Professor Matthews added that restrictions on entry to apprenticeships was another major problem which needed tackling. Shortage of skilled labour had been a constraint on UK development since the turn of the century, and the apprenticeship system was responsible for a great deal of this.

Mr. Foster said that spending more money on training would not necessarily help. It would be far better to concentrate on trying to improve the working of the market - by tackling the apprenticeship entry problem, improving mobility, and relying on the re-emergence of differentials following the demise of incomes policy. Professor Minford made the same point in relation to regional policy: spending more money on the regions would not work. On Merseyside, the

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Government was actually preventing the market from working properly through its policies on subsidies and transfers.

Professor Griffiths said that he strongly supported the strategy but he hoped the social cost would not be too high. There was a need for certain gestures at least to show that the Government cared about unemployment. He agreed that the strategy was more likely to succeed if the Government could attack restrictive practices generally, but it was also crucial to hold down public spending and borrowing so as not to starve the private sector of resources. Like Professor Ball, he thought that there was an urgent need to look at supply side measures.

As to what the Government might do in the way of gestures, Professor Matthews suggested that they could cut the National Insurance Surcharge. This was particularly inappropriate at the present time since it was a tax on employment. Professor Minford disagreed. The NIS could only be cut at a cost to the PSBR and therefore to interest rates. He went on to say that the trade unions were responsible for causing unemployment, and it would be as well for the Government to attack them for doing so. The Government had to make people understand that they could only get their jobs back by competing - and this meant reducing real labour costs.

Mr. Foster said that he thought that a great deal could be accomplished through more radical housing policies. The Housing Bill was, in his view, disappointing. The Government ought to move towards de-restricting rent control altogether. This would surely be very popular. At present the disadvantages of moving, and the advantages of staying at home if one was unemployed, militated against mobility. Professor Matthews said that far too many resources were going into housing in the UK. This required an end to the subsidisation of housing generally - both council houses and owner occupiers. As regards the latter, it would be far better to re-introduce Schedule A than to get rid of the tax relief on mortgage

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interest. The Prime Minister said that neither of these were a starter.

There was then some discussion of the question of what was the appropriate level for the PSBR. Mr. Burns said that, if the recession was deeper than forecast, the PSBR would increase of its own accord. The Government would then have to face the question of whether to cut spending and/or increase taxes to bring the PSBR back. Professor Minford said that it was quite clear that, if the recession turned out to be approximately the same as forecast, and the PSBR was running higher than forecast, then corrective action should be taken. If, on the other hand, the recession was worse than expected, then in principle it might be acceptable to allow for a higher PSBR. But there was a risk that the markets would misunderstand and that interest rates and inflationary expectations would suffer. It would take considerable persuasion to convince the markets that the Government was not going off course. Mr. Foster said that a clear distinction had to be drawn between the case for a higher PSBR described by Professor Minford and the old fashioned argument that we should "spend our way out of recession". The latter was clearly unacceptable. Sir Douglas Wass pointed out that for a given monetary target there was a trade-off between interest rates and the PSBR. A decision not to allow the PSBR to rise would benefit interest rates and thus should help to bring the exchange rate down. In this context, the experience of 1977 was interesting: the Cambridge forecast of unemployment following the IMF package had been completely disproved, and the rapid fall in interest rates was no doubt responsible for this.

Professor Minford raised the issue of Monetary Base Control (MBC). The present system of control was creaky, and the authorities ought to move over to a new system which would allow interest rates to move more flexibly. Mr. Foster,

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who incidentally said that he thought there was a real risk that money supply growth would not moderate over the coming six months and that a rise in interest rates would be necessary, criticised the Green Paper on MBC. Professor Griffiths said that he strongly favoured a move to MBC. MBC was about controlling what could be controlled - namely, the banks' deposits with the Bank of England. The authorities should be prepared to take the interest rate consequences of such a system. The main causes of up-turns in the money supply over the years had been governments' unwillingness to let interest rates rise to appropriate levels. MBC would de-politicise the problem of monetary control. The Bank of England disliked MBC because they wanted to retain control over interest rates. In his view, MBC would not mean large swings in interest rates, but rather, small and continuous fluctuations. The Chancellor said that a move to MBC would involve a major upheaval. There was much disputing the merits and de-merits of such a move, and many of the arguments put forward in favour had been expressed in support of the changeover to Competition and Credit Control. When the Government was trying to achieve so much else, it was a mistake to embark on adventures. He did not necessarily rule out a change to MBC, but the burden of proof had to rest with its proponents. // Mr. Foster then raised the issue of public sector monopolies. In the case of the seven or eight monopolies which were not subject to foreign competition, there was a limit to what could be achieved by references to the Monopolies Commission. With these monopolies, there could well be a case for some kind of regulatory framework. He cited the example of telecommunications, where higher costs could always be passed on in prices under the present arrangements. One possibility would be to set up an independent commission which would supervise monopolies on a continuing basis. The Chancellor said that, in contrast to the USA, the Government stood behind the public utilities; and therefore the result of price regulation could

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all too easily be an increase in Government spending. Sir Douglas Wass said that it was important for the Government to develop better tests of performance, and to insist that management achieved them. This was probably a better approach than setting up a regulatory commission.

CC Econ Pol Pt 2 Public Sector Pay Policy.

Finally, there was some discussion of public sector pay. Mr. Foster said that, if private sector employers saw the public sector standing up to pay demands, they were much more likely to do so themselves. In his view there was a strong case for a public sector pay freeze to help speed the transition to lower inflation. Professor Minford said a freeze would be a disaster. He went on to suggest that cash limits next year should be set within the money supply target range and the Government should try to settle the pay of its employees within this range, too. If the Government expected the private sector to settle within the monetary target range in order to prevent jobs from being lost, it should adopt the same approach with public service employees. The Chief Secretary said that the Government would need to set tough cash limits, but they must also be realistic. Professor Matthews said that there were inherent difficulties in improving the productivity of the public services. There was greater accountability in the public service than in the private sector; public servants had to be more even-handed; and they had to guard against charges of corruption. Each of these factors militated against better productivity. Mr. Foster said that somehow greater financial discipline must be instilled at local government level. The best way would be to reduce the proportion of Government grant to local authority expenditure, and replace it with a widely spread tax at local level. This would make the local authorities more accountable to their electorates. Even with the present arrangements, there was evidence from the recent local authority elections that those authorities which had increased rates the most had performed relatively poorly.

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Professor Minford suggested that, to help set public service rates of pay at appropriate levels, the Government should do more to monitor the supply and demand of particular categories of employees: the Clegg Commission had failed to do this in their reports.

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