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From the Private Secretary

13 November 1980

Copied to Master set - Domestic Monetary Policy

Dear John,

As you know, the Prime Minister held a meeting yesterday afternoon with the Chancellor and Sir Douglas Wass to discuss Sir Douglas' paper on policy options for taking the pressure off the corporate sector (your letter of 7 November refers). Sir Robert Armstrong was also present.

The Chancellor said that he had decided that the immediate aim must be to go for option II - i.e. an early, modest reduction in interest rates. He had in mind a reduction in MLR of 2 per cent. To enable this to take place, he would need to be able to demonstrate that the Government was not abandoning the monetary strategy; and he would therefore need to announce in his speech in the Debate on the Address a credible package of measures. His intention was to announce the following: a further extension of granny bonds and probably a restricted indexed gilt, the outcome of the current public expenditure review, the external financing limits for the nationalised industries in 1981/82, an increase in PRT to bring in about £1 billion in 1981/82, and the increase in employee national insurance contribution. He would also have to announce the roll forward of the monetary target and the Government's conclusions on the monetary base control Green Paper. All this would be against the background of the Industry Act forecast which would be published at the same time. Final decisions still had to be taken on most of these matters; but he hoped that - even though the conclusion on public expenditure was likely to be disappointing - the various measures taken together would produce a setting in which a 2 per cent MLR reduction would be defensible. Nonetheless, it had to be recognised that it would involve a considerable element of risk: questions would be raised as to whether the Government was doing enough to get the fiscal balance right, and this might mean that the next budget would have to be even more restrictive; alternatively, it might conceivably be necessary to put MLR up again.

As regards the other options, the Chancellor said that he had concluded that option I - i.e. inflow controls - should not be adopted alongside a reduction in MLR. The two together would give the impression that the Government was moving to an exchange rate objective. But if it turned out towards the end of the month that an MLR reduction was not possible, it would probably be necessary to announce a package of inflow controls to show that the Government was "doing something", even though he did not think that they would have any significant effect. He had rejected the other options in

/Sir Douglas' paper

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Mr Douglas' paper, Option V - i.e. a significant tax switch to the benefit of companies - might be desirable in principle, but it was not possible in terms of cost. Nonetheless, it would be right to lean in the direction of making tax concessions for companies in the next budget.

In discussion the following points were made:-

(i) The proposed 2 per cent reduction in MLR, though desirable on industrial grounds, could very well have a perverse effect on the exchange rate - since it might well result in heavy foreign inflows into gilts. On the other hand, it was argued that a fall in MLR was already being discounted, and that the exchange rate would be just as strong if there was no early reduction. The Prime Minister suggested that, if a 2% reduction were likely to have a perverse effect on the exchange rate, a 2½% reduction might be considered; against this, it was argued that such a figure would look like fine tuning, and would not be understood.

(ii) The public expenditure figures for 1981/82 which the Chancellor would announce following the current review were likely to be £1b or more higher than the figures in the latest public expenditure White Paper; it was therefore crucial for the credibility of the strategy that the Chancellor should announce some of his intentions on tax for 1981/82 at the same time.

(iii) The Prime Minister said she hoped that, even if option I were not adopted, the Treasury would consider switching Bank "customers'" transactions off market again.

(iv) It had been suggested in some quarters that several £b of additional revenue could be raised from PRT rather than the £1b proposed by the Chancellor. But the marginal rate of tax on North Sea fields was already over 90%, and to take out more than an extra £1b could well put at risk the further development of the North Sea. As it was, the reaction of the oil companies was likely to be fairly hostile.

(v) The Prime Minister said she found it difficult to understand the administrative arguments against a fairly radical extension of "Granny Bonds". She hoped that Treasury Ministers would look at the problem, if there was one, imaginatively.

(vi) The Prime Minister said the most disappointing feature of the current PESC review was the deteriorating financial position of the nationalised industries. They had undermined the Government's whole public expenditure strategy. The Chancellor, who reported on a discussion he had had with Sir William Barlow, said that the

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Government's experience with the nationalised industries over the last 18 months reinforced the arguments for denationalisation and removing the nationalised industries' monopoly position wherever possible.

In conclusion, the Prime Minister said she was content for the Chancellor to proceed on the basis he had outlined.

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

Yours ever,

Tim Lankester

A.J. Wiggins, Esq.,
HM Treasury.

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