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Mr Middleton
Mr Bridgeman
Mr Riley
Mr Odling-Smee
Mr Ridley
Mr Cropper
Mr Cardona

A MEDIUM TERM FINANCIAL PLAN

1. Mr Ridley's minute of 6 September suggested that you might be interested on Ministers' views on this important topic. In setting out my own views in the following paragraphs - and I apologise for the length of this minute - I have been assisted by the meeting I had with officials on 17 September, which helped to clarify the issues.

2. I have argued the case for having a medium term financial plan on previous occasions. This minute is concerned with what the plan should contain.

3. I do not think there can be any doubt that the heart of the plan must be a series of declining figures for the growth of the money supply, as defined by £M3. It should be noted, however, that in his minute of 11 September on Assumptions for the Autumn Forecast, Sir Douglas Wass suggests that, in the context of the MTA, only the terminal figure should be specified (he suggests a target range of 5-9% for 1983/84), with the intervening years merely characterised by the injunction that at no time would monetary growth exceed the target for the previous year.

4. This may be good enough for the MTA, but it is not good enough for the Financial Plan. In the first place, as soon as a terminal figure is published, commentators will work out (and publish) the straight line path from here to there, with the result that we shall be judged by precisely the same yardstick as if we had published that path ourselves, but without the beneficial effects on confidence (and hence expectations) from having taken the initiative. Second, the market has become increasingly cynical of Governments pledging themselves to tread the path of virtue - but not yet. You will recall the regular pattern of the not-so-distant past, when Governments attempted to justify an inordinate rise in public expenditure by pointing to a flattening out in the shadowy later years, and claiming that this demonstrated an acceptable rate of growth over the quinquennium as a whole.

5. What, then, should the precise numbers be? Sir Douglas Wass's suggestion of a central target of 7% for 1983-84 is cautious, but I would not quarrel with that. I am less happy with his suggestion that the central target for next year - 1980-81-should remain at the 9% we announced for the post-Budget ten months of the present year. It seems to me it will be very ill received, and get the financial plan off to an unfortunate start, if we do not at least wind the target down a further half-point to 8½%. This is particularly so since, in the cirsumstances likely to prevail, even 8½% in 1980-81 will be an easier target to achieve (and also less contractionary) than the 9% target you set in the Budget for the period June 1979-April 1980.

6. This would imply the following sequence of figures:

	1980-81	1981-82	1982-83	1983-84	
£M3	8½%	8%	7½%	7%	(central targets)

However, I take it that for each year we will in fact be specifying a target range, of which the above figures are the mid-points. Hitherto, the rage has been plus or minus 2%; but this was originally decided in the context of the celebrated 9-13% target - ie a central target of 11%. With lower money supply targets a narrower range is clea..y indicated; and for the peiod we are now discussing I would recommend plus or minus $1\frac{1}{2}$%. This narrowing of the range would, I believe, to some extent counteract any disappointment that might be felt at the slowness of the proposed decelartion in monetary growth. If this is accepted, the target range for 1980-81 would be announced at 7-10% (and the 1983-84 figure would become $5\frac{1}{2}$-$8\frac{1}{2}$%).

7. There is less agreement over what else, if anything at all, should accompany the money supply figures to comprise the financial plan. In your Budget Statement you made two specific commitments: that there would be a steady reduction in the growth of the money supply and that there would be a steady reduction in the PSBR. I believe that, in line with this, there should be a PSBR path in the financial plan - but there should be no further components of the plan.

8. Broadly speaking, there are four main arguments for including the PSBR in the plan:

i. it formed part of your basic economic strategy as enunciated in your Budget Statement, and its absence will give rise to adverse comment and misinterpretation;

ii. its presence will add credibility to the money supply targets, and thus to the plan as a whole;

iii. it will demonstrate that the money supply targets are to be achieved without an undue reliance on interest rates, which is important for confidence in the private sector; and

iv. it will assist you in your crucial task of persuading colleagues to curb public spending - since, once the PSBR is given, the level of public spending determines the level of taxation.

9. A paper by Mr Odling-Smee, sent to you under cover of a note from Sir Douglas Wass on 11 September, in effect argues against the inclusion of a path for the PSBR, essentially on the grounds (a) that the PSBR has a life of its own, and is only haphazardly linked to

the rate of monetary growth and (b) that the PSBR should follow a cyclical path (expanding in a recession and contracting in a boom). So far as (a) is concerned, a more objective analysis can be found in the paper Monetary Targets and the Public Sector Borrowing Requirement, written by Mr Middleton, Mr Odling-Smee and others for a City University Conference earlier this year, and shortly to be published. In it the authors found that, using the Treasury Model, "With a floating rate, the simulations suggest that a similar change in fiscal policy and the PSBR is needed to keep to the monetary target"; and that, while different methods of changing the PSBR have slightly different impacts on the demand for money, "under a floating rate ... the orders of magnitude per unit of PSBR are not all that different". So far as (b) is concerned, it is equally important not to exaggerate the significance of the cyclical factor. During the decade 1963-64 to 1972-73 inclusive the PSBR averaged 2.4% of GDP at current market prices; over the six subsequent years (1973-74 to 1978-79) it has averaged 6.8% of GDP. This is a massive secular rise, and it is this secular rise that must be reversed.

10. Insofar as there is a case for superimposing some sensitivity to cyclical conditions on the much-needed secular decline in the PSBR, this can best be achieved by incorporating the concept of a range in the PSBR line of the financial plan, as well as the £M3 line. Thus the PSBR line might look as follows:

	1980-81	1981-82	1982-83	1983-84
PSBR (% of GDP)	4%	3½%	3%	2½%

It would, however, be made clear that these were central figures of a range bounded by plus or minus ½% (of GDP). Thus the 1980-81 figure would represent a range of 3½-4½% of GDP. Unlike the case with the money supply target, however, the actual PSBR for the coming year would not necessarily be set at the mid-point of the published target range, but would merely be somewhere within that range. (There would, of course, be no question of base drift, whatever the figure actually chosen: this is crucial.) This procedure should allow ample scope for any cyclical adjustment that is felt to be required. The proposed total margin (of 1% of GDP) for 1980-81 amounts, after all, to very nearly £2,000 m: I find it hard to imagine that most of us will be further apart than that in our judgment as to the appropriate 1980-81 PSBR. But that does not mean the PSBR line becomes valueless in psychological and expectationsl terms: on the contrary, publication of a numbered commitment to a steady return to pre-1973 levels of PSBR would I believe be most valuable. (For purposes of comparison, incidentally, the official forecast for the current - 1979-80 - PSBR is 4½% of GDP.) What it also means is that it would be possible - should circumstances justify it - to allow a slight increase in the PSBR from one year to the next at some stage, an increase not merely in money terms but also in terms of % of GDP, without departing from the financial plan and thus without the adverse market consequences that would otherwise arise. This is yet another illustration of the general point that a medium term financial plan, while curbing irresponsibility, actually enhances responsible flexibility.

11. Paragraph 9 above takes it for granted that the PSBR line in a financial plan should be expressed as a percentage of GDP rather than (a) in money terms, (b) in money terms at constant prices, or (c) in constant emplyment terms (somehow or other). As for (c), the importation of this quasi-metaphysical concept would clearly convey no information whatever to the market and would secure none of the benefits of publishing a PSBR line in the first place. As to (a), this would imply forecasting the rate of inflation over the period in question, which would be foolish. A far stronger theoretical case can be made for (b): the only real reason for measuring the PSBR as a % of GDP - rather than in constant price terms - is to facilitate international comparisons, which is at best peripherally relevant to the question at issue here, and it is clearly paradoxical that a definition

(% o. GDP) should be used which suggests that it is appropriate for the PSBR to fall in a recession and rise in a boom. However, in practice the rate of inflation (and danges in that rate) is so much bigger than the rate of real growth (and changes in that rate) that there is little difference between the trend of the PSBR in real terms and its trend as a % of GDP, and there are obvious presentational reasons for preferring the latter formulation.

12. Finally, it may be argued - and implicitly is argued by Mr Odling-Smee - that if, in effect, there is to be a second line to the financial plan, it should be the General Government Financial Deficit rather than the PSBR, since variations in this are more closely linked to variations in monetary growth. However, what the market looks at, and what it will continue to look at, is the PSBR; and this alone is sufficient reason for our sticking to this both in our general public pronouncements and in the presentation of the financial plan - quite apart from our inevitable preoccupation with the PSBR since it is this, and not the GGFD (let alone the constant employment budget deficit/surplus), which we have to finance. Nevertheless, there remains some attraction in the fact that, unless I am much mistaken, a PSBR of 2½% of GDP, as projected for 1983-84, would be compatible with a GGFD of zero: in other words, our fiscal target would be a balanced budget - in GGFD terms.

13. To sum up, my suggested medium term financial plan wuld look like this:

	1980-81	1981-82	1982-83	1983-84
Rate of growth of money supply (£M3: + or - 1½%)	8½%	8%	7½%	7%
PSBR (as % of GDP: + or - ½%)	4 %	3½%	3 %	2½%

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NIGEL LAWSON
24 September 1979