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FINANCIAL SECRETARY TO THE TREASURY

Mrs Lomax
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CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Minister of State (C)
Minister of State (L)
Sir D Wass
Sir L Airey
Sir F Atkinson
Sir K Couzens
Sir A Rawlinson
Mr Unwin
PCC
MEG
Mr Robson
Mr Rayner
Mr Ridley
Mr Cropper
Mr Cardona

c Mr Bell
Mr Grice

ECONOMIC AND FINANCIAL SITUATION REPORT

I have read with interest your note of 9 August to the Prime Minister. Since I was on holiday when you carried out your general stocktaking, I would like to comment on some of the very important matters touched on, taking your headings seriatim.

2. Pay

I am inclined to agree with a recent minute from John Nott to the effect that the Government as an employer, is showing signs of a tendency towards appeasement. Quite apart from anything else, (not least public expenditure), this sort of behaviour risks undermining the campaign (to which you refer) 'to make clear the consequences of excessive wage settlements'.

3. Company liquidity

From fairly extensive soundings since I returned from holiday, it seems clear that the long-expected company liquidity squeeze is now beginning to be felt; but it is also clear that - as you state - nothing in the nature of a financial crisis is in the offing, and the situation (in general, and leaving aside the inevitable individual exceptions) is not remotely like 1974 - partly because most firms have learned the lesson, and are far less exposed than they were then.

I would not favour taking any action on this front now - and any weakening of our monetary and fiscal policy would of course be disastrous. Clearly, however, we must continue to watch this carefully, and - within the context of our tight monetary and fiscal policy - bear in mind the possibility that we may wish to do something in the 1980 Budget. If we do, I am satisfied that the only sensible option would be some mitigation of the employers' national insurance contribution/surcharge - which could also be represented, if need be, as a response to the then prevailing level of unemployment. Subject to the figures adding up, I would incline (if we do anything at all) to favour the temporary abolition of the 0.2% of liable earnings that employers currently contribute to the Redundancy Fund. This would seem to me to have two special advantages:

(i) unlike a reduction in the National Insurance surcharge, it would be obviously a temporary move to deal with a specific situation, and would thus be readily reversible later on, and

(ii) it would have the incidental effect of running down the vast surplus in the Redundancy Fund, about which the CBI and employers generally have a legitimate gripe.

4. Monetary developments

I entirely agree that there is no need to alter our policies - indeed there is every need not to do so. This is perhaps an appropriate point at which to make a comment on the commentators. They are all - even the most sophisticated ones - in the business of criticism: that is what they are paid for. Now that the (100 day?) honeymoon is over, and at least until the fruits of our policies show up (which will not be for some time yet), they will attack us whatever we do: for 'primitive monetarism' if we continue on our present course and for weakness, U-turns, and general Heath/Barber recidivism if we do not. There is no way in which we can avoid being attacked, whatever we do; we must be guided by the reflection that it is better to be attacked for the right policies than the wrong ones, and concentrate on getting our own message across - for which purpose, incidentally, 'primitive' language is essential: nothing else will be understood. (I return to the question of the 'message' in my final paragraph.)

5. The exchange rate

So far from wishing to do anything to lower the exchange rate, I believe that the strong £ is the biggest thing we have going for us. A rapidly and inexorably rising £ would be another matter, but that is neither the reality nor the prospect. Not only is a strong £ an integral part of our anti-inflation policy, but any attempt to weaken it would quickly lead to a very serious loss of confidence in our resolve to stick to that policy. We must have expectations working for us and not against us: this is fundamental. Thus it is even, I believe, unwise to hint that we are unhappy at the strength of the £. (It is, incidentally, worth noting that, other things being equal, a higher £ implies a lower rate of inflation, and that this, coupled with a given rate of monetary growth, implies a less contractionary monetary policy.) There are only two things I believe we should consider doing which might exercise a downward pressure on the exchange rate (and the emphasis is very much on the 'might'); but if we do do them it would be on their own merits, rather than for that reason. The first, which I am satisfied we should do, and about which I will be making a considered proposal to you in due course, is to have a bonfire of most (if not all) of the remaining exchange controls this autumn. The second, for which a strong case can be made, but which I am not yet satisfied we should do, wouldbe to implement, without delay, a radical change in North Sea oil depletion policy. Again, I hope to let you have a note about this shortly. One other point about the exchange rate, in the context of monetary policy: I was very surprised and unhappy to see the extent to which the Bank intervened in the foreign exchange market (as a seller of sterling) in the latter part of July. This seemed to me to exceed the 'smoothing ... out only' policy you had quite rightly laid down. I attach to this minute a copy of the conclusions of a paper on 'Intervention and the Money Supply' done at my request by Mrs Lomax, under the aegis of Mr Middleton, shortly after the Budget. I entirely agree with these conclusions, and very much hope that the Bank's future intervention policy will conform to them.

6. PSBR and public expenditure

So far as the 1979-80 PSBR is concerned, I am very worried by the way the disposals exercise has so far gone. In order to achieve the £1,000m to which you committed yourself (and to which, needless to say, the doctrine of collective Cabinet responsibility fully applies , we have to achieve two things:

(i) a substantial sale of BNOC/BGC assets and

(ii) a substantial sale of BP shares (to which you also, of course, specifically committed yourself, with the approval of colleagues).

As to (i) we originally asked David Howell for £500m this year at a bilateral meeting at the Treasury on 24 May, and he undertook to do his best to meet this figure. This was eventually, after much argument, transmuted into an edict from E, chaired by the Prime Minister, that he must find £400m this year. Yet though three of the 10 remaining months of the financial year have now passed, we are today no nearer getting the £400m than we were to getting the £500m on 24 May. And as to (ii), we are if anything further from getting the green light now than we were three months ago. It is of course arguable - and has been argued, although not by me - that if we were confident that the PSBR outturn would be contained within the £8.3bn target without the bulk of the disposals programme, then there is no need to go ahead with that programme. But the actual position is not like that at all: if anything, the present prospect is that we will have great difficulty in preventing the PSBR from exceeding the £8.3bn target even if we do achieve the full £1bn of disposals. That being so, to fail to meet the disposals target would have a shattering effect on confidence in the Government in general and in you as Chancellor; and part of the laborious task of rebuilding that confidence, so hard earned and so wantonly dissipated, would almost certainly be measures to secure a lower PSBR next year than you might otherwise need to aim for. The colleagues have been notably unhelpful and irrational over all this, and I rather feel the time has come for a 'bilateral' between you and the Prime Minister.

So far as the 1980-81 PSBR is concerned the prospect is indeed unpromising, although the margin of error in any forecast made at this stage (or for that matter in November) is very high indeed. I would, however, make two points. The first concerns the siren voices now urging you to have a substantially greater PSBR in 1980-81 (among whom, needless to say, are some of the same people who criticized you for allowing too large a PSBR this year). Their starting point is the absolutely correct theoretical observation that stability implies a higher PSBR when the economy is in recession than when it is not. They ignore, however, three fundamental points:

(i) the fact that we start from a wholly excessive PSBR (the costs of which are every day more apparent) and hence that cyclical considerations must at the very least be modified by the need for a secular decline in the PSBR;

(ii) the inevitable market response to a PSBR target of the size suggested and the equally inevitable misinterpretation of the reasoning that lay behind any such decision (which would appear to have owed more to the arguments of the TUC than those of the LBS*; and

(iii) the inherent fallaciousness, in the real world, of this (or any other) kind of fine turning, which can in practice do nothing but undermine those rules on which sensible economic management (and effective political persuasion) wholly depends. In this last context, you may be interested ... in the attached extract from a recent reply given by David Laidler to a rather good Treasury Paper on Monetary Targets and the PSBR. It was not of course written in the context of the latest debate about the appropriate size of next years' PSBR, but is I believe very appositive to it.

My second point about 1980-81 PSBR is this. Although I would hope we would have a PSBR target that represents a lower percentage of GDP, it seems inevitable that in money terms it will exceed this year's target of £8.3bn, and probaly exceed £9bn. In the light of your Budget commitment to a progressive reduction in the PSBR, this will present obvious difficulties and risk a crisis of confidence of the sort (altho' not on the scale) alluded to above. To some extent this might be mitigated by launching the new target at an early date - say at the time of the public expenditure White Paper - so as to condition market expectations rather than wait for them to form of their own accord. But above all it seems to me imperative that, this year, given the 1980-81 PSBR Budget, the figure does not stand on its own, but is presented in the context of a published medium-term financial plan to which the Government is committed.

7. Conclusion

This is absolutely right. I have only one comment, concerning the campaign to expound our policies that you (and some colleagues) are now about to launch. It is most important that this strikes all three of the right notes. At the present time I detect some danger of its striking only two of them. The two that are being struck are

(a) the bleakness of our present situation and the need for expectations (all round - not just of pay rises) to be reduced to meet the realities, and

(b) the absolute disaster that would follow any change of course.

But the third note that really must be struck, along with the other two, is the note of confidence and above all of hope; the message that there is indeed light at the end of the tunnel. This is absolutely vital, not least if we are to maintain a reasonable degree of business confidence over the difficult 18 months that lie ahead. But of course it goes wider than that. Churchill may have told the British people that he had nothing to offer them but blood, sweat, toil and tears, but that wasn't strictly true. There was something else he offered them: the promise of victory - and that was why they followed him.

PCD

PP NIGEL LAWSON
28 August 1979

(drafted by the Financial Secretary and signed in his absence)

* While you were away Burns and Budd were widely quoted in the press as favouring an increase in the PSBR in 1980-81 of £3¼bn. In a letter in today's Financial Times they deny this.