1) MR GOODHART
2) Governor's Office

Filed as 23.7.79

1. MR BRIDGEMAN
2. PRINCIPAL PRIVATE SECRETARY

The Governor

CAEG thought that you might care to be aware of this. He does not feel there is any need to do more than glance

Yes, thank you. I should like to see what goes to the Chancellor.

cc Chief Secretary
Financial Secretary
Sir D Wass
Sir F Atkinson
Sir L Airey
Sir K Couzens
Sir A Rawlinson
Mr Byatt
Mr Bailey
Mr F E R Butler
Mr Middleton o/r
Mr Unwin
Mr Ridley
Mr Goodhart - B/E

MR GORDON PEPPER'S SPEECH TO THE FINANCIAL TIMES CONFERENCE : 23 JULY

In Mr Middleton's absence on leave I am responding to the Chancellor's request for comments on Mr Gordon Pepper's recent speech on the 'Money Supply and Interest Rates after the 1979 Budget'. The attached note by Mr Grice reflects helpful comments from the Bank of England economists. While it is not actually a joint Bank/Treasury note, we are in broad agreement on the main points.

2. Mr Pepper's speech is a clear and useful analysis of the Budget and current prospects. There are however two main points where our emphasis would differ from his:

i. The speech gives the impression that he takes a more pessimistic view of the prospects for real economic activity than we would - though he offers no figuring of his own, so this impression may be misleading. One reason why he may take a more gloomy view is because he sees a very close relationship between the real money supply and real aggregate demand (though he also acknowledges that velocity tends to rise in a recession).

ii. We think he is rather optimistic about the ease with which the monetary targets can be met, and the scope for reductions in interest rates later this year.



CA EG 7/8

Incidentally, Mr Pepper suggests that monetary growth will slacken <u>because</u> of deepening recession: but most economists (including monetarists) would argue that restrictive monetary policy will itself be an important cause of falling real activity.

RL

RACHEL LOMAX
6 August 1979

# MR PEPPER'S SPEECH TO THE FINANCIAL TIMES CONFERENCE : 23 JULY 1979

Gordon Pepper's recent speech to the Financial Times conference, "Money Supply and Interest Rates after the 1979 Budget", contains a short discussion of his general approach to analysing economic policy. It also records his more specific reactions to the main Budget measures.

2. Pepper's general assertion is that inflation is caused by aggregate demand exceeding aggregate supply and that the only way to reduce inflation is either to increase the supply of goods or to reduce aggregate demand. He also believes that inflation causes unemployment. A further assertion is that the main determinant of aggregate demand is the real money stock. Pepper's researches lead him to believe that it does not matter whether it is budgetary or financial policy which changes the real money stock - both being equally efficacious. He therefore identifies aggregate demand with the real (ie constant price) money stock and it is for this reason that he makes the seemingly paradoxical remark that control of the money supply is demand management. Following naturally on from this analysis, he proposes to judge the Budget in terms of its impact on the supply of goods and on the money stock.

3. Such a framework, considering separately aggregate supply and demand, is an attractive and useful way to analyse policy. It is also common ground that the monetary effects of budgetary policy must be taken into account. Where, however, most economists - including the monetarists - would dissent from Pepper is in the assumption throughout the paper that the real money stock is identical to aggregate demand. The evidence is that in the short run other factors, particularly changes in disposable income and in non-monetary wealth, do affect demand independently of changes in the money supply. Identifying aggregate demand with the real money supply therefore seems an oversimplification of the interaction between the financial and the real sectors of the economy.

4. After setting out the framework of the paper, many of Pepper's further comments are episodic. His points are therefore discussed in the order that they are made in the speech.

A. <u>The level of demand</u>

5. The main points made are:

a. contrary to appearances, the Budget did not reduce the target range of £M3;

b. but the real money supply will be reduced by the Budget because of the direct effects of increased indirect taxes in raising prices.

6. With respect to the monetary target, Pepper argues that although the Budget lowered the range to 7-11 per cent from 8-12 per cent, the base was itself raised when it was altered from mid-April to mid-June. The mid-point of the target range is thus virtually unaltered. Mathematically, this is in fact true insofar as it relates to 1979/80. But it may be argued against this that the change did represent a tightening of monetary policy. Because the Government has indicated an intention to reduce the target progressively, future monetary growth is intended to be lower than if the Budget had not lowered the current maximum percentage increase. On the other hand, we would accept the assertion that the real money supply is likely to fall over the next year but not the view that real demand will fall by an exactly equivalent amount. The forecasts are for a fall in real demand of about 1½-2 per cent, rather less than the 4-5 per cent which may be deduced from Pepper's analysis.

B. <u>The Budget measures</u>

7. Pepper's reactions are:

a. to welcome the projected cuts of £3 billion in public expenditure for 1979-80 but to record disappointment at the rise in general government expenditure between 1978-9 and 1979-80;

b. to welcome the cuts in higher marginal rates of income taxation because of their beneficial effects on the supply of goods and the increases in allowances because of their reducing the extent of the "poverty-trap";

c. to criticise the reduction in the standard rate of income tax and the consequent necessity to increase indirect tax rates; and

d. to endorse the relaxations of exchange control.

8. Pepper's disappointment with respect to the expenditure cuts stems from his claim that the Budget forecast shows a rise in general government expenditure from a provisional outtum of 43½ per cent of GDP in 1978-9 to 45 per cent for 1979-80. This appears, however, to be a mistake. The outturn is expected to be itself 45 per cent so that there is no rise between the two years. (I understand that Miss Brown has minuted the Chancellor separately on this apparent error.) A further point is that if public expenditure is expressed in the more customary White Paper terms rather than as general government expenditure then the proportion in both years drops to about 42 per cent.

9. In support of his claim that the cuts in income tax rates will increase the supply of goods, Pepper quotes the work of Professor Laffer. "As Professor Art Laffer has said, we have consistently taxed work, effort and employment and subsidised leisure, lack of effort and unemployment. Exactly, in accordance with the basic laws of economics, the outcome has been less work, less effort and less employment." Again, however, Pepper seems to be oversimplifying. A decrease in the income tax rate has two offsetting effects on work effort and a priori one cannot tell which will predominate. On the one hand, the fact that work per period will now be more rewarding will unambiguously increase work effort - this is the 'substitution effect'. But on the other hand, individuals will find themselves with higher income as the result of the lower tax rate and they will tend to use part of this increase to purchase extra leisure, ie to work less. This 'income effect' may or may not dominate the substitution effect.

10. In the United Kingdom, the evidence suggests that for males the two effects approximately cancel out though it is true that for married females a reduction in tax rates would increase the quantity of labour supplied. The evidence also suggests, however,

that other variables - particularly umemployment, real wealth and family structure - are important, as well as real post-tax wages. Some of these variables will themselves be affected by the change in tax rates and it is therefore dangerous to consider the effects of tax changes alone. Simulations on the Treasury's labour supply model indeed suggest that overthe next year the Budget will make little difference to the supply of labour since the incentive effects of the reduction in income tax will be offset by the fall in real wages.

11. Pepper believes that the rises in indirect taxes were mistaken for two reasons; first, because the base of expenditure taxes is lower than that of income tax necessitating higher rates for the same revenue; second, because the direct effects on the price level necessitate higher interest rates and may trigger inflationary wage settlements. While there seems to be merit in both of these arguments, the issue must really turn on whether the cut in the basic rate of income tax was beneficial. Given that the short run scope for public expenditure cuts was limited (which Pepper accepts) and the need to maintain monetary control, inevitably the fall in income tax rates has to be financed by a rise in indirect tax revenues. The judgment of the Budget - reflecting pledges made by the government in advance - was that a fall in the basic rate was desirable because of its beneficial effects in incentives and hence aggregate supply. Pepper presumably does not accept that the benefits outweighed the costs but that must be a matter of personal judgment. It is worth noting in this connection that on Pepper's own analysis, the effect of the indirect tax rises should be dis-inflationary insofar as they reduce the real value of the money supply and hence aggregate demand.

12. Pepper welcomes the relaxation of exchange controls not only because he believes it will reduce distortions but also because it will place downward pressure on the exchange rate which he thinks too high in the short run. (The pound is now at almost exactly the same level as when the speech was given.) On the other hand, he appears to accept what officials have consistently argued, that dismantling controls should not be regarded as an instrument of short run exchange rate management, since the immediate effects are likely to be unpredictable and possibly perverse.

C. <u>The money supply</u>

13. The main points are:

a. that in spite of the worrying behaviour of the broader aggregates over the last six months, the monetary targets will be met provided that the pressure of the corset is maintained;

b. that velocity of circulation will rise between now and 1980 since nominal income is likely to grow by 5 per cent or more than the maximum target monetary growth rate;

c. that the expected recession in 1980 will lead to an early reduction in the rate of monetary growth since changes in the latter normally precede changes in the rate of growth of national income.

14. By and large, the Treasury/Bank financial forecast would endorse points (a) and (b). They predict that the monetary target can be met while at the same time velocity is expected to rise for the reasons Pepper gives. There are a number of doubts, however, about the ease with which Pepper suggests that the required fall in monetary growth may be achieved:

i. bank lending to both persons and companies has been surprisingly buoyant recently, confounding earlier expectations of a tail-off in demand for advances;

ii. three of the clearing banks are reported in the Financial Times (Saturday 4 August) as expecting buoyant demand for advances to continue to at least the end of the year;

iii. even if there is a sharp recession next year, this of itself will generate involuntary corporate stock-building, necessitating bank finance. Famous last words

15. For all these reasons, we do not expect the monetary targets to be met with ease. There is indeed a certain circularity in Pepper's reasoning. At times, he appears to be arguing that slow monetary growth will cause a recession next year: at other points in his speech, he argues that the resulting recession will allow the authorities to have slow monetary growth. The causal direction in his argument is not clear.

D. <u>Interest rates</u>

16. Pepper believes:

a. MLR is likely to fall in the course of 1979; and

b. interest rates will be lower in 1980 than now and falling rapidly.

17. To a large extent, these assertions are the counterpart to Pepper's relatively optimistic view on future monetary growth. There must be doubt about this for the reasons given above. Officials see no scope for reduction in long term interest rates and very little room for a reduction in short rates if the monetary targets are to be met. It is worth noting, however, that if the more severe domestic recession which Pepper envisages were to occur, then interest rates might be somewhat lower.

18. One specific reason Pepper gives for his expectation is that if a monetary base control is adopted then the authorities will have less need to sell long dated gilts and hence long rates will fall. This is one of Pepper's favourite points but one we have had difficulty understanding. Whatever the merits of monetary base control, we would not expect its adoption to lead to any significant fall in interest rates.

26.7.79

GPS

Copies to The Chief Cashier*
Mr.Dicks-Mireaux
Mr.Quinn
Mr.Foot/Mr.Green/Mr.Taylor*

GORDON PEPPER'S SPEECH ON "MONEY SUPPLY AND INTEREST RATES AFTER THE 1979 BUDGET"

Greenwells have now circulated the speech given by Gordon Pepper on 23rd July to a recent Financial Times conference on "Budget 1979 - New Directions for the British Economy". Pepper's speech does not reveal any new ideas that we were not already familiar with. Nevertheless it sets out his current views in an easily and quickly readable form. If the Governor has time, he might be interested to glance quickly through. Copies are also being sent to those names marked with an asterisk.

CAEG

26th July 1979.

C.A.E.Goodhart

30.7.79

The Governor OR 30/7
to be aware

NOTE FOR RECORD
MR.GOODHART

Copies to: Mr.Dicks-Mireaux/
Mr.Walker o/r

Martin Hall (Chancellor's Office) telephoned on Friday morning to say that the Chancellor had asked for comments on the latest Greenwells Bulletin, which consists of Pepper's speech at the F.T.Budget Conference. I understood from Martin Hall that Peter Middleton would be dealing for HMT, but Martin Hall enquired whether we would wish to liaise or produce our own comments. I mentioned this to CAEG on Friday. He tried without success to contact Middleton or others in his area.

I have spoken today to Tony Battishill about this - he suggested that CAEG might talk to Middleton who is now back from leave.

1) ~~Mr. Goodhart~~

2) G.P.S.

May I be advised how matters now stand please?

1/8

3/8

~~Mr~~ Beverly
We spoke. I have warned MDKWF in case HMT's draft comes tomorrow when I am away. CAEG

2) Governors Office

J.S.Beverly (4121),
Governors' Office.
30th July 1979.