

PRIME MINISTER

The Budget, etc.

1. When we are buffeted around by massive shifts in the target variables as we saw in this morning's (Tuesday's) meeting, the strategic planning of the budget is extremely difficult. The most important elements, the PSBR, with the IM_3 equation and interest rates, emerge with lurches of frightening magnitude. It is very difficult to create stable conditions in such an environment. We cannot make nice adjustments in any meaningful way. But we ought to plan on the basis of our past experience.

2. The trend of the forecasts of PSBR is upwards - and, by the nature of the extrapolative forecasts, they are unlikely to undershoot unless there is a marked turn around in the economy. True there will be attempts to cut spending, but it would be unwise to be sanguine about the result of such attempts. We are likely therefore to budget for too low a reduction in PSBR (as we did in 1980/81).

3. This will lead either to an additional late summer or autumn budget (which is to be avoided) or to putting great strains on funding. This last resort may lead to a funding crisis, but it will certainly lead to high interest rates, retaining high exchange rates and yet another squeeze on the private sector. This outcome must be avoided - it would be a quite impossible scenario for the approach to an election.

4. Painful decisions now, properly packaged as being due to the costs of last wage round and NI Losses, and put forward as an employment budget, might get things right in time for an election. But there is little time even to make the decisions, let alone package and sell them to Colleagues who must be persuaded that we have got it right.

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A. Walters

PRIME MINISTER

BUDGET AND MONETARY POLICY

1. What are our objectives in budget?

Mainly

- i. "to re-establish credibility in our monetary and public expenditure objectives" (Chancellor memo 5 February).
- ii. "persevering with a tight fiscal and monetary policy". (Chancellor memo 5 February).

Given the high public expenditure, however, the Chancellor's memo implies increased taxes to give a £1 to £1½Bn net reduction in PSBR (down to about £9½ to £10Bn).

2. What will be the reaction of this tough budget on consumer spending, investment and, cet par, the level of activity and unemployment?

Is it reasonable to assume that most of the increased tax on disposable personal income (of the order of 2 to 3 percent, say) will be paid out of the present high savings so that the level of activity will be roughly the same? What are our expectations?

3. What will be the effect on interest rates and the funding problem?

A decrease in the expected PSBR may be needed to prevent a funding crisis - but does this mean that interest rates will be lower as PSBR decreases and so the exchange rate will be subject to downward pressure?

Note: The Chancellor expects exchange rate to stay at a "high level" p.3 of memo of 5 February.

4. The exchange rate is crucial in both budget and monetary strategies. The effects of the rapid appreciation in the real effective exchange over the latter part of 1979 and 1980 have still to work through the economic system. There was an 11% increase in sterling real effective exchange rate from January 1980 to January 1981. This would imply, inter alia, at least a 9 to 14 percent decrease in manufactured exports and corresponding reductions in import substitutions spread over 1981-82.

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L a rough rule a 10% decrease in the exchange rate will add 8% to 13% to exports of manufacture with an average lag of 1 year 3 months./

The effect of the high exchange rate in increasing unemployment and public spending needs to be seen in both a budgetary and monetary context. The present planning for unemployment benefits uses the government actuary's estimate of unemployed - but this may be far too low in view of sterling's rise in late 1979-1980.

5. In terms of our £M3 criteria and performance, a reduction of MLR (which is very desirable) should be interpreted as a relaxation of monetary policy. There is an apparent contradiction in the movements in our fiscal and monetary stance. In my view this is sensible since monetary policy has been very tight while the PSBR has been too loose. The combination of a downward path for MLR and a decrease in PSBR seems right, but it needs a better rationalisation than the £M3 figures provide.

6. What is our monetary policy and how do we exercise control to ensure that it is consistent with the budgetary policy?

We know that the relationship between MLR and £M3 is not tractable or even perverse. How are we to keep some control on £M3 when we cannot control the extension of bank credit to the private sector? The financial community know this and are looking for some well articulated alternative such as MBC - would it not be best to announce that the objective is MBC so that institutions can adjust?

There is an urgent problem to ensure that the recent rapid expansion of interest-bearing liabilities in £M3 does not become monetised by the Bank of England.

[Gordon Pepper is also concerned about this./

This could be prevented by a suitable form of monetary control, but it needs to be put into place very soon.

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