Econ Pol

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11th July 1980

T.P. Lankester, Esq.,
No.10, Downing Street

Dear Tim,

I attach a brief Mr. Burns has prepared for the Prime Minister's lunch with economists on 13 July. We hope this will provide a convenient annotated agenda, as well as giving a flavour of the views the Prime Minister can expect to hear.

She may also like to see a note prepared by officials here about the evidence Milton Friedman has submitted to the Treasury and Civil Service Committee in the context of their enquiry into monetary policy.

Yours

John

A.J. WIGGINS

COVERING: CONFIDENTIAL

Prime Minister
This is a very useful brief
TL.
11/7

MR. WIGGINS

c.c. Chief Secretary
Sir Douglas Wass
Mr. Ridley

Tim Lankester asked for some briefing for Sunday.

2. I attach a note on possible topics for discussion on both macro economic issues and supply side matters; the macro material is much fuller.

(TERRY BURNS)

11th July, 1980.

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CHEQUERS LUNCHEON FOR ACADEMIC ECONOMISTS

The possible topics for discussion fall into two categories:

(a) Macro-economic issues associated with the Government's monetary and financial strategy. These are probably the matters of greatest concern to Ball, Matthews, Minford and Griffiths.

(b) Supply side issues associated with public expenditure, technology, competition policy, and nationalised industries. These are probably the matters of greatest concern to Hague and Foster.

The issues are outlined in more detail below followed by a summary of the possible responses on macro-issues by the 'outside' invitees.

Macro-economic Issues

The major issue of macro-economic discussion will probably be the progress and prospects for the Government's monetary policy. This can usefully be divided as follows:

(i) Is the path for the monetary target set out in the Red Book the appropriate speed to attempt to reduce inflation? This confronts the differences between those advocating a sharp shock and those who wish to follow a more gradualist path.

(ii) Do we have the correct fiscal policy to achieve this monetary target? If the recession this year and next is deeper than was expected tax revenue will be less than planned and if spending plans are unchanged the PSBR will be higher than expected. Does this matter and would this point to a need for further spending cuts?

(iii) Is the present system of monetary control adequate? What has been the reception to the consultative document on monetary base control? Is there a need for more imagination in the type of debt sold by the government eg indexing?

/(iv)

(iv) How rapidly will inflation be reduced? There are several signs of success in recent inflation indicators; will they continue? The last pay round was disappointing but signs for next year seem better. Does the Government have the correct stance on pay? What should policy be towards nationalised industries.

(v) The exchange rate has been stronger than most forecasters expected. Competitiveness has declined dramatically. How serious is this for manufacturing industry? Can the Government take any action without endangering its monetary targets? Even if it could take action should it? What of the inflationary benefits from a high rate?

(vi) How serious will the recession be? How bad is the outlook for unemployment? The general consensus is that output will fall in both 1980 and 1981 with some recovery emerging in the second half of 1981. How strong is that recovery likely to be?

Micro-economic Issues

Following discussion with Douglas Hague I suggest the following topics:

(vii) Research and Development; technology transmission between countries. Is there a role for encouraging foreign participation, for example by licensing. How important is the role of the multi-national company? What should be the relative balance of the public and private sectors?

(viii) Training programmes; is training a sensible use of some of the oil revenues? How do we identify the skills that will be needed? How do we involve the private sector?

(ix) Unemployment; what supply-side policies will improve the labour market? Is it inevitable that unemployed people do no work. What schemes are available?

(x) Competition policy; are ideas for improving competition working? What can be done about the nationalised industries? What pressures can be brought to bear?

(xi) If further public expenditure cuts are needed in which areas should they be? Relative priorities of current and capital spending.

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MACRO-ECONOMIC ISSUES FOR DISCUSSION

Monetary Policy

Is the path for the monetary target set out in the Medium Term Financial Strategy (MTFS) the appropriate speed to attempt to reduce inflation. The target for 1980/81 is 7-11% falling to 4-8% by 1983/84. The degree of monetary pressure is well measured by the behaviour of the real money supply; that is the difference between monetary growth and the rate of inflation. The pressure has been intense over the period from June 1979 to April 1980 as the inflation rate has been close to 22% with 12% monetary growth. This pressure could be less in the period from March 1980 to December 1980 as inflation is slowing down sharply; the budget forecast for 16½% inflation by the end of the year is still possible.

- Minford has argued recently that we should be aiming towards the lower end of the target range in order to bring about a rapid deceleration of inflation.

- Matthews will argue in a forthcoming CLARE group article that a more rapid deceleration in the form of a short-sharp shock is as likely to kill the policy, if not the patient.

- Greenwells (Pepper) is often quoted by Mr. Healey as suggesting that we should aim for the top of the range to avoid an excessive money squeeze.

Fiscal Policy

2. Do we have the correct fiscal policy to achieve this monetary target? The budget forecast was for a PSBR in 1980/81 of £8½b - 3.7% of total GNP. The MTFS looks for a reduction to 1½% of GNP by 1983/84. If the recession this year and next is deeper than was expected tax revenue will be less than planned; if spending plans are unchanged the PSBR will be higher than expected. Does this matter and would this point to a need for further spending cuts?

/ - Minford

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- Minford has argued recently that Public Sector borrowing should be held significantly below the £8½ billion for 1980/81.

- Matthews will argue that the PSBR receives too much attention and the government should play down its role. He will argue that we need to be ready with explanations of why the outcome for 1980/81 will be higher than £8½b, because of the lower level of activity. The same applies to 1981/82.

- Ball will probably agree with Matthews. If the PSBR is higher than expected because output is lower than expected this can be ignored providing the money supply target is met. The LBS have argued that the current fiscal stance is unnecessarily tight.

- Morgan Grenfell have argued recently that a much lower PSBR would ease the exchange rate pressure by reducing interest rates. We are sceptical of this argument because such action would probably also improve the current account of the balance of payments and improve expectations; both forces would tend to increase the exchange rate and offset much if not all the effect of lower interest rates.

- We would also want to argue that a low PSBR is necessary to reduce interest rates and reactivate the capital markets. This will form the basis for industrial recovery.

There has been a technical argument taking place recently on whether there is any statistical relationship between money supply and the PSBR. Kaldor has said not; as have the National Institute. Friedman has offered some unhelpful remarks in his evidence to the Treasury Committee (reprinted in last week's Observer). The

/LBS

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LBS have recently argued that whereas there is no simple short-run relationship there is a solid medium term relationship. Minford will argue along the same lines.

Monetary Control

3. The question of alternative methods of monetary control is still an important issue:

- Griffiths has been one of the leading advocates of monetary base control so that interest rates and exchange rates are genuinely market-determined prices. He has argued that there is a danger that the determination to keep interest rates high will result in overkill and undermine the medium term plan.

- Minford has argued that it is desirable to have an automatic system in which the monetary base is kept fairly rigidly on a target growth track; the lender of last resort 'activities' are suspended except for emergencies; and gilts are auctioned. But he argues that this must wait until monetary conditions are more settled because the system will inevitably go through a period of incomprehensibility and we cannot afford to lose our understanding of the aggregates at the moment.

- Matthews will argue that we need to devise methods of borrowing which can take advantage of differences in expectations and differences in the parties' needs eg selling "Granny bonds" to anyone with an upper limit for each individual.

Friedman has been very rude about the Green paper on monetary base control (probably encouraged by Griffiths); he argues for direct rather than indirect control. He uses the analogy of trying to control the output of motor cars. Our current system is like attempting to control the number of cars by influencing people's incomes (eg by fiscal policy) and the price of cars relative to other forms of transport (the equivalent of interest rates). He

/argues

argues that the direct route (equivalent to monetary base) would be to control the availability of steel to manufacturers.

The opponents of monetary base would argue that this would merely encourage motor firms to do two things; first they would search for cheap alternatives to raw steel (just as MBC might encourage substitutes for the items under control); second they would move the bulk of their operations to another country (just as MBC might encourage offshore banking business). They argue that at the end of the day by whatever means fiscal policy and interest rates have to be appropriate.

Pay and Inflation

4. How rapidly will inflation come down? Does the Government have the correct stance on pay? There are several signs of success on inflation:

- price increases in recent months have been quite low
- the CBI survey suggests this will continue
- manufacturers input prices are flat because of strong pound and weak commodity prices.

The last wage round has been disappointing with earnings figures at around 20%. Will the next wage round be much better? There are hopeful signs:

- manufacturing industry seems prepared to settle at low figures
- public service pay will not be allowed to damage the bargaining climate.

Can the Government do much more than maintain the monetary squeeze and prevent public sector pay awards getting out of step? Are there any presentational issues? What is appropriate stance towards the nationalised industries?

/ - Matthews

- Matthews may argue for avoiding making policies appear more abrasive than they really are and for some guiding figure on pay. He will also argue that the government has no option but to get involved in public sector pay; by being tough on central government employees; a tough rate support grant; by exhortation with nationalised industries.

- Minford has been arguing on the basis of 'rational expectations'; this has been criticised as being over optimistic and unrealistic during the past year. He argues that "inflation is now poised for a steady downward plunge".

- Ball may worry that it may be some time before we see the major reduction in inflation but that it will come.

Exchange Rate

5. The exchange rate has risen by about 10% over the past year. At the same time UK earnings growth has been 10% more than the average in competitor countries. As a result competitiveness has declined sharply. Possible reasons for strong exchange rate

- tight monetary policy
- high interest rates associated with high PSBR
- oil prices

- Matthews will argue that the result is worrying but that it is the natural consequence of attempting to reduce inflation more rapidly than elsewhere. He will not advocate strong action to lower it immediately but he would possibly like the government to deplore the high £, intervene in the forward market and not argue that the market gives a desirable exchange rate.

- Ball may argue that a sharp fall in the exchange rate is possible over the next year.

/ - The

- The Morgan Grenfell argument that a lower PSBR would lower the real exchange rate may be mentioned. This is referred to in paragraph 2 above.

- Our position is that we are not in a position to produce a lower exchange rate without losing monetary control. Most devices either will not work or will expand the money supply. The exchange rate is higher than expected but is also having beneficial effects on inflation.

Output and Employment

6. How serious will the recession be? What about the outlook for unemployment? The general consensus is that output will fall in both 1980 and 1981 although by mid-1981 there could be some recovery emerging.

	% change in output	
	1980	1981
LBS	-2.3	-0.4
NIESR	-1.1	0.6
Phillips and Drew	-2.0	-0.1
H.M. Treasury	-2.5	

- Matthews will argue that the output assumptions in the MTFS will not be achieved and the PSBR will be greater than shown. He will also argue that it is difficult to identify the forces that will produce the assumed rise in output in 1982-83 and 1983-84 unless wage settlements are very low or world trade expands greatly. If the government perseveres by 1983-84 the British economy will be operating at a low level of output; the strategy is unlikely to change the long-established phenomenon of slow British growth.

/ - Minford

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- Minford will also argue that the recession is here; de-stocking is heavy and world growth is slowing. However he expects the effects to be less damaging than many because of a sharp drop in imports and continued resilience of retail spending. Once MLR does come down and prices have decelerated the cash flow pressures on industries will abate and the current apprehension will subside. Therefore it will be a mild recession with recovery in 1981.

- Ball will probably follow the line of the LBS forecast which shows a sharp drop in output in 1980; recovery is expected later in 1981 as world output recovers, de-stocking comes to an end and real incomes can grow within the monetary target.

The approach that we are taking is to accept that unemployment will rise sharply in the year ahead; but the extent of the rise depends upon the speed with which pay and prices move into line with the monetary target.

Reasons for poor performance

Don't act as a govt. overshot powers

Avoid rdaing rather work.

Agree - must be maintained

Energy Investment.

Technical Training - Ind^{al} structure.

Adjustment in regions.

Contribution to Infrastructure.

- Housing -

cc Mr Burns
Mr Middleton
Mr Bridgeman

MR WIGGINS

SELECT COMMITTEE: EVIDENCE OF MILTON FRIEDMAN

I attach a note on Professor Friedman's evidence to the Select Committee, which the Chancellor may care to send to the Prime Minister in advance of the meeting they are to have with a group of outside economists on Sunday. I have not referred to the proposal that the real PSBR should be zero because that did not appear in the part of the evidence reprinted in the Observer.

M. E. May

pp A J C BRITTON

11 July 1980

Professor Friedman's Evidence to the Select Committee

Professor Friedman's evidence deserves special attention because of his eminence, because much of it has been reprinted in the Observer (copy attached), because he is known to be a supporter of the Government's strategy, and because his evidence is (in some passages but not others) quite outspokenly critical of aspects of current policy.

2. Friedman's memorandum begins by expressing firm support for our economic strategy as the only means of curing inflation:

> "Restraint in the rate of monetary growth is both a necessary and a sufficient condition for controlling inflation":

> "I strongly approve of the general outline of the monetary strategy outlined by the Government"

and best of all perhaps:

> "The numerical targets for the growth of £M3 set forth in the Financial Statement seem to me of the right order of magnitude, and to decline at about the right rate."

3. He goes on to criticise the emphasis we place on the control of the PSBR - mistakenly describing the figure set out in the Financial Statement as targets. He wants us to think of the PSBR in "real" terms that is after subtracting the reduction in the real value of the outstanding public sector debt which is the result of inflation. If the "real" PSBR in these terms were zero new borrowing by the public sector would exactly offset the effects of inflation and the real value of public sector debt would be constant.

4. Currently the "real" PSBR in these terms is in fact in surplus: the real value of the public sector debt is falling. This means that fiscal policy is contributing to the strategy for the reduction of inflation. The growth of the money supply is well below the rate of inflation - as it must be to achieve our objectives. It follows that the growth of public sector debt must also be held back relative to the inflation rate - the only alternative would be higher interest rates.

5. There may not be much of substance at issue here between Friedman and ourselves. For any given rate of inflation a change in the actual PSBR is also

a change in the "real" PSBR. He agrees that "the size of the PSBR does affect the level of interest rates". That is the main point we have been trying to get across.

6. Friedman is, to put it no stronger, unhappy with bits of the Green Paper on Monetary Control. He is of course a keen proponent of the monetary base system and his memorandum echoes many of the points made by Brian Griffiths. The whole passage about "Rip van Winkle" needs to be understood as a bit of deliberate provocation. He suggests, quite unjustifiably of course, that the authors of the Green Paper do not understand the difference between money and credit. More to the point he also suggests that the effect of interest rates on the demand for money is "highly erratic and undependable". This overstates the point, but it is true that manipulating MLR is not an instrument capable of controlling the money supply with short-run precision. That in fact is why the Green Paper was issued to encourage debate on possible alternatives. That debate continues.

7. Taking the evidence as a whole there is more in it to help than to harm our presentation. It is already well known that Friedman is an advocate of monetary base control, so his reaction tothe Green Paper cannot be a surprise - and he has always been known for the vehemence of his language.

TREASURY PRESS CUTTING SECTION
ROOM 107/2 Tel: Ext. 3639
Extract from: THE OBSERVER Dated: 6/7/80

FRIEDMAN ON BRITAIN

Dr Milton Friedman, the American economist, has been hailed—and castigated—as the guru of the Government's economic policies. But what does he really think of the way Mrs Thatcher has applied his principles? His view, given as evidence to the Commons Select Committee on the Treasury and published here—in extract—for the first time, is far from approving.

BRITAIN, like the US and many other countries, faces two different though related problems: inflation and slow growth.

Though one word, 'stagflation,' has been used to encompass both, the two problems are separable: Salazar's Portugal had no inflation and no growth; late nineteenth-century US and Britain, deflation and rapid growth; many countries in the Thirties, deflation and contraction; post-war Germany and Switzerland, low inflation and rapid growth; Brazil in the Sixties and early Seventies, and Korea more recently, high inflation and rapid growth; Britain, the US and many other countries currently, high inflation and slow growth or contraction.

Inflation over any substantial period is always a monetary phenomenon, arising from a more rapid growth in the quantity of money than in output. Few economic propositions are more firmly grounded in experience — experience extending over thousands of years and the face of the globe.

A successful policy of reducing inflation will have as an unavoidable side effect a temporary retardation in economic growth. However, continuation of the present levels of inflation, and, even more, further acceleration of inflation would at best postpone the retardation at the expense of a more severe retardation later.

Past mistakes in economic policy have left us with no soft options. Our only real alternatives are to accept a temporary economic slowdown now as part of a programme for ending inflation, or to experience a more severe slowdown later as a result of continued or accelerated inflation.

Restraint in the rate of monetary growth is both a necessary and a sufficient condition for controlling inflation. Controlling inflation, in turn, is a necessary *but not sufficient* condition for improving Britain's productivity, which is the fundamental requirement for a healthy economy. That requires measures on a broader scale to restore and improve incentives, promote productive investment, and give a greater scope for private enterprise and initiative.

I strongly approve of the general outlines of the monetary strategy outlined by the British Government: taking monetary growth as the major intermediate target; stating in advance targets for a number of years ahead; setting targets that require a steady and gradual reduction in monetary growth: and stressing the Government's intentions of strictly adhering to those targets.

The numerical targets for the growth of M3 set forth in the Financial Statement and Budget Report for 1980-81 seem to me of the right order of magnitude, and to decline at about the right rate.

The key role assigned to targets for the Public Sector Borrowing Requirement, on the other hand, seems to me unwise for several reasons.

First, the numbers produced by the UK Government are highly misleading because of the failure to adjust for the effect of inflation. Second, there is no necessary relation between the size of PSBR and monetary growth. The current loose relation holds only because of the undesirable techniques used to control the money supply.

Third, although the size of the PSBR does affect the level of interest rates, the major effect is from the real, not the nominal PSBR. In any event in line with the Government's commendable policy of relying on market mechanisms, interest rates should be left to the market to determine.

Fourth, emphasis on the PSBR diverts attention from the really important aspect of government fiscal policy: the fraction of the nation's output that is diverted to uses determined by government officials rather than by the individual members of the public, who, for the most part, produce the output. Total government spending, not taxes and not borrowing, measures the true current cost to the citizenry of governmental activities (with only minor qualifications to allow for capital transactions).

The Government has expressed the intention of reducing government spending as a fraction of national income, but the planned reductions seem to me too little and too late. It would be

> **The key role assigned to targets for the Public Sector Borrowing Requirement seems to me unwise for several reasons.**

far better to cut both spending and explicit taxes more rapidly, even though that led to a higher PSBR. That might even reduce pressure on interest rates because the additional demand for credit by the Government might be more than offset by an additional supply of credit (in real terms) generated by the combination of a contemporaneous and a prospective reduction in the Government's command over resources.

When we shift from the strategy of monetary policy to the tactics, it is essential to distinguish lip-service from a change in policy. Central bankers throughout the world have rendered lip-service to the control of monetary aggregates by announcing monetary growth targets. However, few have altered their policies to match their professions of faith. Most have continued to try to ride several horses at once by simultaneously trying to control monetary aggregates, interest rates, and foreign exchange rates—in the process introducing excessive variability into all three.

And few have altered their operating procedures to make them consistent with the professed goal of controlling monetary growth.

The United Kingdom is an egregious example, as has been shown most recently by the March Green Paper on Monetary Control. I could hardly believe my eyes when I read, in the first paragraph of the summary chapter: 'The principal means [of controlling the growth of the money supply] must be fiscal policy—both public expenditure and tax policy—and interest rates.' Interpreted literally, this sentence is simply wrong. Only a Rip Van Winkle, who had not read any of the flood of literature during the past decade and more on the money supply process, could possibly have written it. Direct control of the monetary base is an alternative to fiscal policy and interest rates as a means of controlling monetary growth.

Of course, direct control of the monetary base will affect interest rates, but that is a very different thing from controlling monetary growth through interest rates.

This remarkable sentence in the Green Paper reflects the myopia engendered by long-established practice. For most of its history, the Bank of England has regarded itself as concerned with credit conditions. Under a classical gold standard, it had no direct control over the quantity of money. That was determined by international payment flows. It could affect the quantity of money (or the monetary base) over anything but very short periods only by acting on the credit markets to alter the quantity of money demanded.

Under the fixed exchange Bretton Woods system that prevailed for most of the post-war period, the Bank's leeway was somewhat greater, but still it had to operate with primary concern for the balance of payments, and hence, again, it was largely limited to operating either through foreign exchange control or on the credit markets—that is, to trying to affect the quantity of money demanded. Of course, the fact that the Bank of England had to operate under a gold standard, or chose to operate under fixed rates, did not prevent changes in the quantity of money, however produced, from having predictable effects on nominal income, output, prices, and interest rates.

The elimination of exchange controls and the acceptance of a floating exchange rate have changed circumstances fundamentally. The balance of payments can be taken care of by the market. Of course, if the Bank sought to peg or manipulate the exchange rate, that would correspondingly limit its ability to control monetary growth.

The attempt to control the money supply through interest rates reflects a long-standing confusion between money and credit.

Interest rates are the price of credit not the price of money. The price of money is the quantity of goods and services that will 'buy' a piece of money. Manipulating interest rates may have a decided influence on the demand for credit — though even that is dubious because of the limited range of interest rates that the Bank can manipulate. But it has a highly erratic and undependable influence on the quantity of money demanded over the kind of short periods which are crucial for monetary control (periods of a few months up to a year or more).

Why else has it been that central banks seeking to control monetary aggregates in this way have had so poor a record in achieving their monetary targets, while they have had an excellent record in achieving their specific interest rate targets? Trying to control the money supply through 'fiscal policy . . . and interest rates' is trying to control the output of one item (money) through altering the demand for it by manipulating the incomes of its users (that is, the role of fiscal policy) or the prices of substitutes for it (that is, the role of interest rates).

The authorities can control the monetary base directly. However, currently they have surrendered control of the base by standing ready passively to provide reserves to the banking system at the option of the banks. That is, I believe, a serious mistake. The authorities should decide directly the amount of base money, including reserves, that is issued, rather than seeking to guesstimate the terms on which a target amount will be demanded.

Control of the monetary base does not produce rigid and precise control of the money supply. The link between the base and the money supply is currently far too loose, thanks primarily to the institutional arrangements under which banks can hold a variety of assets to meet reserve requirements. It would be highly desirable to replace this multiple reserve system by one in which only a single asset—liabilities of the Bank of England in the form of notes or deposits (i.e. base money) — satisfies reserve requirements.

This is probably the most important single change in current institutional arrangements that is required to permit more effective control of the money supply (either through controlling the base, or through the present obsolete methods). No doubt other institutional changes would help.

Control of the monetary base should be exercised through open market operations primarily in short-term debt, which, with a single reserve asset, would no longer be close to a perfect substitute for base money. There is a variety of ways in which the amounts to be purchased or sold each week can be determined, and there is an extensive literature on alternative techniques.

The key point, however, is that the Bank should decide in advance each week how much to buy or sell, not the price at which it will buy or sell. It should permit interest rates to be determined entirely by the market. (None of this would prevent temporary lender-of-last-resort operations in case of emergency.)

Opponents of control through the monetary base typically maintain that such a technique would lead to an undesirably wide variation in market interest rates. With respect to very short-run movements, that may be the case. But with respect to movements over periods of more than a few weeks, the result would be precisely the opposite. As in any market, the effect of pegging a price is to permit disturbances that would have been eliminated by moderate changes in price to accumulate and ultimately force major changes.

As these remarks indicate, debt policy (as distinguished from the 'public expenditure and tax policy' that the Green Paper regards as 'fiscal policy') does play a critical role in controlling monetary aggregates. In this respect, I have long felt that nominal gilt-edged long-term securities are a highly undesirable vehicle both for monetary policy and for funding the PSBR.

Recent experience dramatically illustrates the point. The Government is committed to ending inflation. Yet it is issuing long-term securities that offer yields justified only if substantial inflation continues. Of course, the market is setting those rates and the continuance of such high rates reflects a lack of confidence in the ability of the Government to achieve its objectives.

Does the Government share that lack of confidence? Are the terms on which it is offering long-dated debt a more accurate reflection of its intentions than its firm and repeated public pronouncements? If not, and if the Government succeeds in reducing inflation, it is saddling itself or its successors with unconscionably and unnecessarily high future interest payments.

The correct resolution of these problems is either to issue no long-dated debt, or to issue such debt only in a form fully indexed for future inflation. I have, in any case, long favoured such an indexed debt issue on other grounds, notably equity to lenders and smoother economic adjustment to rising inflation.

MICHAEL BRENNAN

Friedman: Likening our Government to Rip Van Winkle