The Governor   Copies to The Deputy Governor
Mr Fforde 22 1 81
Mr Dow
Mr Loehnis
Mr Coleby
Mr Fleming
Mr George
Mr Goodhart
Mr Walker
GPS

Original filed in ...

NOTE OF A MEETING HELD AT 11, DOWNING STREET AT 8.30 A.M. ON THURSDAY, 22 JANUARY, 1981

Present:

Sec 20 1 81

Chancellor of the Exchequer	Governor of the Bank of England
Financial Secretary	Deputy Governor
Sir Douglas Wass	Mr. Fforde
Mr. Burns	Mr. Goodhart
Mr. Ryrie	
Mr. Middleton	
Mr. Monck	
Mr. Unwin	

BACKGROUND TO THE BUDGET

The Chancellor, opening the discussion, said he wished to compare notes with the Governor on the background to the Budget. The Treasury had as yet formed no very clear and definite views, and major uncertainties remained about the forecast for 1981-82. However, the Treasury's general inclination was that it would probably be necessary to aim in the Budget for a reduction in the PSBR below what it would otherwise have been, and to recover some of this year's excess monetary growth - although the timescale of this was still to be determined.

2. Mr. Burns said that work was currently under way to investigate the reasons why public sector borrowing in recent months had been so much higher than expected earlier. The main problem was on public expenditure; revenue was broadly in line with what had been expected, once allowance was made for the price level being below the previous forecast (so reducing revenue from VAT). Almost every item of expenditure was turning out higher than forecast: higher employment subsidies, higher unemployment benefit payments, less shortfall on all the cash limited programmes (although there were no significant excesses apart from defence), and more lending to nationalised industries because of their lower cash flow. And in

the medium-term the prospects for revenue were less satisfactory because the forecast of North Sea oil production had been reduced; this factor, together with the adverse impact on oil revenue from the higher exchange rate for sterling meant that total revenue from the North Sea was likely to be somewhat lower than indicated in the MTFS, despite the introduction of the additional tax.

3. Sir Douglas Wass thought the overall position on public expenditure very worrying; the next White Paper would show expenditure in 1981-82 some £2-3 billion higher than had been indicated last year, and it did not appear that the recession would provide an adequate explanation for the entire difficulty. The current year's PSBR now seemed likely to be in the range £13-14½ billion, and only about £2 billion of the excess over the FSBR forecast of £8½ billion could be attributed directly to output falling below the earlier forecast. Other factors were that unemployment was higher for a given level of output, and that private sector suppliers were seeking to accelerate their receipts from Government. Generally it seemed that the faster than expected fall in inflation was tending to push up the PSBR; public expenditure during the year was fixed in cash terms, and the effect of the more favourable price development was simply to increase the volume, while the effect on the private sector was to squeeze margins (so intensifying the labour shakeout) and to reduce expenditure in cash terms (so reducing the revenue from indirect taxes).

4. The Governor asked how far these adverse factors would continue to be felt in 1981-82. Could people have any confidence that the upward movement in the PSBR in money terms had been reversed? Mr. Burns said the current forecast of the 1981-82 PSBR was of the order of £11 billion, although there could still be further upward revision. In explaining that the total in cash terms would be lower than for the current year, it would be possible to point to the real reductions in public expenditure; the increase in employees' National Insurance contributions; and the new tax on North Sea oil. It was noted, however, that the public sector pay-bill was likely to continue to increase more rapidly than the

private sector pay-bill, both because of the staging of the 1980 public service settlements and because there would not be a reduction in numbers employed in the public sector on the scale of that which was taking place in the private sector. It was noted that the present unsatisfactory PSBR position was further confirmed by the fact that the underlying trend in borrowing through the current year was upward; the unadjusted PSBR seemed likely to be roughly the same in the first and second halves of 1980-81, despite the fact that substantial revenue payments were concentrated in the final quarter. However, it was arguable that there remained a good deal of confusion about the implications of seasonal adjustments.

5. The Governor said that the Bank were inclined to take a more pessimistic view of the outlook than the Treasury. So far, de-stocking had been the main source of the recession; from now on falling investment and exports, and higher imports (still further encouraged by the recent appreciation in the exchange rate) would be the main recessionary forces. The Bank were much less confident than the Treasury that there would be any upturn in GDP around the end of 1981. The Bank were very worried about the prospects for the PSBR, although their own forecast had not yet been completed. On the other hand, the Governor questioned whether - against the recessionary prospect - it would be appropriate to tighten both fiscal and monetary policy. One result could be a further appreciation in the exchange rate as compared with what it would otherwise have been, resulting from the improved current balance (against this it was pointed out that the lower PSBR would make possible lower interest rates, which in turn would tend to push the exchange rate down - there could be no certainty which of these effects would predominate). Nevertheless despite the poor prospects for output, the Governor was not advocating any degree of fiscal relaxation.

6. There was a short discussion of the imbalance between the personal and company sectors, and its impact on the overall economy. It was noted that companies had kept their financial deficit within

bounds much more successfully than in 1974-75, in effect by throwing much of the burden on the public sector (through employment subsidies, laying off workers, and seeking to speed up receipts from public sector customers). However, the underlying position of the company sector still gave grave cause for concern; although the financial position might be tolerable in the short run, real returns on investment had fallen to dangerously low levels. The Chancellor remained concerned to reduce the burden of the public sector on the rest of the economy; clearly the best way to do this would be to reduce the relative cost of the public sector by holding down public sector pay. Securing additional revenue through personal taxation was a less satisfactory way of reducing public sector borrowing, although the inflexibility of the UK economy meant that a good part of the consequent reduction in private sector demand would fall on imports rather than on domestic output.

JW

(A.J. WIGGINS)
22 January 1981

Distribution

Those present, including
Bank representatives
Mr. Battishill
Mr. Folger
Mr. Ridley