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## CABINET

## PUBLIC EXPENDITURE: ECONOMIC AND MONETARY BACKGROUND

Memorandum by the Chancellor of the Exchequer

1. At Cabinet on 13 December (CC(79) 25th Conclusions, Minute 6) I was asked to circulate a further paper on the economic background to the public expenditure problem and on the Government's monetary strategy and methods of monetary control.

## ECONOMIC BACKGROUND

2. My earlier paper (C(79) 61) explained why the reduction in public expenditure plans agreed by the Cabinet last autumn were insufficient and why it was essential to secure levels of public expenditure much closer to those originally proposed by the Chief Secretary, Treasury, and myself. There have been several unfavourable developments in the world and domestic scenes since our last discussion.

3. On the external side, political uncertainties have worsened and higher oil prices have caused most forecasters substantially to reduce their projections of world trade and activity. The Organisation for Economic Co-operation and Development (OECD) estimate that each 10 per cent rise in the world oil price will reduce the growth of OECD economies as a whole in 1980 by about  $\frac{1}{2}$  per cent. They now forecast little, if any, growth for industrialised countries in the coming year.

4. The higher oil prices are less immediately damaging to the United Kingdom than to most industrial countries, but they are damaging nonetheless. They do not improve the Public Sector Borrowing Requirement (PSBR) prospect in 1980-81 and only slightly in 1981-82. This is because the United Kingdom, as a country selling one-third of its manufacturing output abroad, cannot escape the contractionary effects of higher oil prices on world activity. The effect on United Kingdom activity of this and of any further worsening in competitiveness is to reduce receipts from other taxes, offsetting the increased receipts from North Sea taxation. And many North Sea fields in any case still have capital allowances to offset against additional profits before paying Petroleum Revenue Tax (PRT). Moreover, because of



start-up delays and other technical troubles in some North Sea fields, as well as the flaring restrictions, estimates of United Kingdom oil production over the next few years have recently been substantially scaled down; the earlier hopes that we would be self-sufficient in oil in 1980 are now unlikely to be realised.

5. Thus higher oil prices are unlikely to solve the particularly severe budgetary problems we face in the next two years. I shall be exploring the scope for raising the PRT rate. Even if this proved justified its main yield would be beyond these two critical years.

6. On the domestic side, there is little sign as yet of improvement on the major problems confronting the economy - inflation, low productivity and poor trading performance. Pay settlements, and inflationary expectations, remain high; and the steel strike, if long continued, will have an increasingly disruptive effect on industry. Money supply growth has slowed, but it is too early to be certain that the trend is now within the target range. Moreover, despite the action I took in November, the latest indicators suggest that it is virtually certain that this year's PSBR will come out higher than the £8.3 billion budgeted for in June. In short, there is nothing in recent developments to suggest that the prospects for the PSBR in 1980-81 and 1981-82 are now better than those indicated in paragraph 11 of my earlier paper (C(79) 61), and they have almost certainly worsened.

7. If we are to create conditions in which interest rates can be reduced it is vital to secure a better balance between revenue and expenditure. This means restraining the borrowing undertaken by Government in competition with the private sector. It is only when we have done enough along these lines to set interest rates on a downward path that we can begin to find room for our other objectives - lower personal and capital taxes.

8. Nothing that has happened in the past month eases our problems in these respects; indeed recent events have made the constraints even tighter. Expenditure savings of the order of £1 billion in 1980-81 and £2 billion a year thereafter beyond those agreed last year (in Survey prices and in addition to whatever reduction we can get in the net contribution to the European Community) are the minimum required to avoid serious damage to our tax objectives and the risk of even higher interest rates. Without these savings there is a serious risk that I shall have to increase taxes in the coming Budget.

#### MONETARY STRATEGY AND METHODS OF CONTROL

9. Disciplined and tightly controlled money supply is essential in a world of floating exchange rates. It provides the only effective means of reducing inflation to a lower level and keeping it there. This requires us to achieve the initial aim of bringing down the rate of monetary growth from the level we inherited, 13 per cent - or perhaps 3 per cent more allowing for the growth of near-substitutes - to our target of 9 per cent, and thereafter to achieve a



sustained reduction over later years. The target of 9 per cent was in any case the highest compatible with our general approach, given our predecessors' target of 10 per cent.

10. Monetary policy needs to be applied consistently for several years if it is to work. Only if it is sustained will it have the effect on expectations necessary to create the climate once more for responsible pay bargaining - a crucial message that we must all strive continually to get over. This will not be easy. To abandon it at the first sign that it was proving painful would be disastrous, since it would immediately signal that we had abandoned the struggle against inflation and ruin our chances of destroying the pernicious expectation that inflation will continue. The effect on confidence in financial markets would be extremely serious. The exchange rate would inevitably come under pressure, and this would quickly add to inflation. Nominal interest rates would be driven higher, possibly sooner, certainly later, because they would adjust to the change in inflationary expectations. So the risks to the economy of failing to carry through the policy to which we are committed are very much greater than any short-term difficulties we may face in securing it.

11. The main ways in which the Government can secure control of the money supply and the related level of credit creation are fiscal policy and the level and structure of interest rates. Interest rates affect both demand for credit by the private sector, and our ability to finance the PSBR outside the banking system, ie in a way which does not add to the money supply. Fiscal policy - both tax and public expenditure decisions - also affects demand for credit by the private sector and by the public sector, by its effects on the PSBR.

12. I fully understand the case for trying to avoid this primary reliance on fiscal policy and interest rates by using more direct controls, for example over bank lending. (I am, after all, the main target of complaints against the present system.) For this reason I have myself investigated carefully (indeed hopefully) all the alternative or supplementary methods that have been suggested. But I have not yet discovered the Alchemist's stone.

13. The truth is that financial markets operate in the same way as any other. There is in the end no alternative, by means of controls however subtle, to allowing the market to balance itself. Thus in a sophisticated financial system, alternative channels are rapidly developed outside any system of quantitative controls that seeks to constrain the level of credit extended below that demanded at the current level of interest rates. Experience of the "corset" has shown this clearly. It may have some slight effect on borrowing at the margin, but the one very strong and increasing effect has been to develop alternative credit channels outside the control. A clear example of this has been the growth of acceptances held outside the banking system, under which money is channelled from one bank customer who has money to spare to another bank customer who wishes to borrow,



without it passing through the banking system. It is therefore not recorded in the money supply statistics. Avoidance of this kind, if significant in amount and sustained over time, both means that the authorities are not constraining liquidity and credit to the extent required by the policy, and brings the target and monetary policy itself into disrepute. It was because of these obvious shortcomings of the "corset" that I said on 15 November that I did not see it as a permanent feature of the system of monetary control.

14. Similar arguments apply to direct controls on consumer credit, such as most of the hire purchase controls and credit cards. In 1973, the last Conservative Government reimposed hire purchase controls and asked the two credit card companies to impose stiffer minimum repayments. At that time these two steps were reasonably effective in having a once-for-all effect on consumer credit. But since then, the possible forms of consumer credit have widened very considerably because of the Consumer Credit Act, and the issuers of credit cards have proliferated. Any attempt to repeat the 1973 exercise would have had much less effect, mainly diverting credit into other channels outside the controls and discriminating against those within the existing controls. Indeed, it must be open to doubt whether the two major credit card companies, Access and Barclaycard, would have agreed to voluntary restraint without the requirement being imposed on all issuers of credit cards, and on consumer credit generally: the latter would have required both new legislation and a new bureaucratic apparatus to enforce it.

15. Last October we took the opportunity of a period of upward pressure on sterling to abolish the remaining exchange controls. This removed an artificial obstacle to investment overseas and will, over the period of peak North Sea oil production, help to build up a stock of profitable assets yielding an income to the current account of the balance of payments to replace income from North Sea oil when production begins to decline. Although it was not our objective to achieve any particular rate for sterling, the competitiveness of British industry will over time benefit because the exchange rate is likely to be lower than it would otherwise have been. Our manufacturing sector will thus no longer have to take the full force of the adjustment of our balance of payments to increasing North Sea oil production.

16. The abolition of exchange control has not fundamentally affected our ability to control the domestic money supply. While domestic and external financial markets have become more closely linked, and there is much greater scope for transactions between the two, fiscal and interest rate policy will affect conditions in both domestic and external sterling markets in much the same way as they have hitherto influenced the domestic sterling market. It is true that the abolition of exchange controls has increased the potential for evading the scope of direct controls, such as the "corset", by providing another route for evasion. But, as explained above, such direct controls could not play a significant part anyway: in particular, we could not have continued the "corset" for much longer, even if there had been no relaxation of exchange control.



17. Last summer I instructed the Bank and the Treasury to press ahead in the study of more effective methods of monetary control. We shall be issuing shortly a consultative paper about some possible changes, including the question of whether it would be desirable to introduce a variant of what is called "monetary base control". The consultations will help establish whether such developments would be likely to provide a quicker, and to some extent more automatic, method of generating the changes in interest rates which are necessary to achieve the monetary target: if they were to do so, it might enable us to secure a smoother path for the growth of the money supply, with an ability to control it over periods of, say, six months rather than the period of a year or so which is possible with existing techniques. It would not however remove the need to move interest rates to whatever levels prove necessary - rather the reverse. The two ways in which the Government can secure a lower general level of nominal interest rates remain, first to succeed in its counter-inflation policy, so that the market builds in a smaller margin on account of inflationary expectations, and second to take the necessary public expenditure and fiscal decisions, so that less of the burden of monetary control falls on interest rates.

#### CONCLUSIONS

18. No-one now disputes that strict monetary control is fundamental to reducing inflationary expectations, defeating inflation itself and creating the right conditions for revitalising the economy. But the next two years are critical. Both present very severe budgetary problems and it is imperative to achieve the lower levels of public expenditure I have proposed if we are to stick to our monetary targets and avoid the risk of even higher interest rates and of increasing taxation. As growth resumes and revenue from North Sea oil increases, we can move towards lower taxes as well as lower interest rates. But this will only happen if we successfully negotiate the very difficult period ahead.

G H

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