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Copies to The Governor *
The Deputy Governor *
Mr Fforde *
Mr Dow
Mr Page
Mr Blunden
Mr Loehnis
Mr Balfour
Mr Coleby *
Mr Coote
Mr Dawkins
Mr Flemming
Mr George *
Mr Goodhart *
Mr Walker
Mr Quinn
Mr Foot *

Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

PRIME MINISTER

GR 13/10.

I attach a series of papers for our meeting on 13 October:

(a) monetary control

The Governor

I have reproduced your notes made on another copy on this.

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* For meeting at 9.15 this morning
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PRIME MINISTER

GR 13/10.

I attach a series of papers for our meeting on 13 October:

(a) monetary control
(b) the economic prospect
(c) the underlying monetary position
(d) the roll forward of the £M3 target
(e) the exchange rate

* For meeting at 9.15 this morning
TDR
13/10

2. You have already had a preliminary note on:

(f) money supply, interest rates, the PSBR and the exchange rate

and the first of the regular series of notes on:

(g) the CGBR, and the path of the PSBR for the rest of this year.

3. I have also sent you today a minute about public spending and pay. They form part of the background but I do not suggest that we consider them at Monday's meeting.

The Background

4. Since we came into office we have made great strides in removing distortions from the economy. These have included:

- the abolition of pay and price controls
- getting Clegg comparability out of the system

/ - abolishing

- abolishing exchange controls
- switching some of the burden from personal tax to VAT

5. Just as we were setting out on our programme we had to cope with a further substantial increase in the oil price in 1979. One result is that the whole world is moving into recession. It is not surprising therefore that there have been some difficulties. In particular the exchange rate has been higher than we - or anyone - thought; the company sector, especially the part engaged in international trade, has been hit harder than we hoped; and the money supply has grown faster than the target.

The Prospect

6. The prospect, based on the latest (though still preliminary) forecasts, is described in the note 1(b) above. The main points are:

(a) Inflation will continue to decline in the early months of 1981, but may get stuck before reaching single figures.

(b) Output is expected to fall in 1980 by 2½-3 per cent and may not start to recover until as late as autumn of 1981.

(c) The PSBR forecast has risen to £10¾ bn this year (the path is included in note 2(g) above) and £11¼ bn in 1981-82.

Smooth profile progression

(d) Bringing the growth of the money supply back within the medium term strategy will be difficult and probably require continuing high interest rates.

/7. The most

7. The most pressing problem now is to sort out the monetary situation so that we can be confident that we can maintain our strategy. If we do not there is little or no prospect
?? that we shall emerge from this recession without a further surge in inflation. So we must now bend all our energies to this end, and above all ensure that we make our policy actions consistent with it.

8. Our meeting on Monday must consider two key issues:

3 (a) Is the system of monetary control adequate to reduce monetary growth?

(b) Irrespective of the control system what measures do we need to take in order to get back on the track of the medium term strategy?

Monetary Control

9. The paper on monetary control by the Treasury is designed to help us answer the first question. It raises a lot of fundamental questions. They concern our attitude to fluctuations in monetary growth, the techniques to reduce monetary growth and the role which we are willing to give to interest rates and the market in controlling it.

10. This is not just an issue which has arisen since the corset. The present methods of control are plainly
Are they?
inadequate. We must make changes in order to have greater confidence that we can achieve our stated objective; but all changes have institutional implications and implications for sectors of the economy other than the banks. We must guard against forcing the pace so quickly that we create more problems than we solve. We need to discuss not only short term interest rates and the banking system, but also methods of funding and the possibilities for smoothing the path of public sector borrowing.

/Getting Back on Track

Getting Back on Track

11. If we are to get back to the path of the medium term strategy, we have to face up to the implications for interest rates and the exchange rate.

(a) If we stick to our monetary strategy there is no sure or easy way of doing anything about the exchange rate. As long as we are determined to reduce inflation the exchange rate, given by the market, is likely to be a high one. Moreover, if the exchange rate did fall substantially interest rates would probably have to rise, unless we were prepared to relax our monetary objectives.

What does this mean?

(b) Interest rates will have to fluctuate more; they will amost certainly stay high for a considerable time and may even have to rise. If we are going to pursue an effective monetary policy, interest rates, like the exchange rate have to be determined more by market forces.

12. I remain convinced that if we are to both tackle industry's problem while sticking to the monetary strategy, it is essential to control the PSBR, and do what we can to adjust the fiscal balance in favour of industry. This route means tackling the two major imbalances in the economy, between the public and private sectors and within the private sector, between financial companies on the one hand and non-oil companies facing international competition on the other. The note on the economic prospect draws attention to these issues in para 4-7. Anything which we can do here will also ease the monetary situation.

? between companies on the one hand and persons on the other.

/13. But tackling

13. But tackling the level and structure of the PSBR to achieve this objective will involve painful decisions:

(a) My minute on public expenditure shows that tough decisions will be needed if expenditure is to be held back to conform with our published plans. These decisions concern both the volume of expenditure and no less important, the pay element. Getting back to the July target would reduce the PSBR by something over £½ bn compared with the forecast. We must do better than that.

?

(b) Tax policy will have a crucial role:

(i) I am reviewing the North Sea tax regime to see whether more revenues can be raised, especially in the vital next few years.

How much will it help money growth?

(ii) In one way or another we shall have to raise some of the money we need from persons. Officials are urgently looking at actual possibilities including increasing the employees NIC and the National Heath contribution as a step along this road.

(iii) I am investigating the scope for both obtaining a contribution from the banks to the cost of fixed rate export credit at times of high interest rates and of transferring more fixed rate export credit paper to the banking system.

/They will

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They will thus help finance the public sector. This seems a more attractive route than taxation - although this could raise more revenue and I have still not ruled it out.

(c) Although public sector prices will certainly need to rise we shall have to be very careful about future Government measures which add to the RPI until the money supply is more closely under control. This applies to both public expenditure and tax.

14. Extra revenue will clearly have to be directed in the first instance towards reducing the PSBR in order to relieve the pressure on interest rates. But it would be desirable to have something in hand to help the company sector directly, e.g. through the revised arrangements for stock relief which we shall in any case need to bring in as a first step in adjusting the corporation tax for inflation accounting.

15. The balance between the sectors can also be helped through our funding policy where greater reliance on National Savings will relieve pressure on the capital markets though at some risk to mortgage rates.

16. By this approach we should be able to mitigate some of the effects of a high exchange rate without removing the incentive to companies to control their own costs. Cost increases are responsible for most of the loss of competitiveness which has taken place. I shall not miss any opportunities to move in this direction in the run up to the Budget, but there are limits to what can be done in advance of that.

Rolling Over the Monetary Target

17. Perhaps the single most immediate question is whether to roll over the £M3 target. We face the continuing

/uncertainties

uncertainties following the removal of the corset - brought out in the note on the underlying situation. There is also uncertainty about this year's PSBR though we are still confident that it will fall sharply in the first quarter of next year, as is brought out in the note on this subject. As the note on the roll forward itself says, one obvious option is to stick with the existing target to the Budget. We can then reassess the whole position in relation to the medium term financial strategy at Budget time.

18. There is a lot to get through, at our meeting on Monday. Though we shall not be able to take final decisions I hope that we shall emerge with a clearer view about the way forward in 2 respects:

(a) on questions of monetary control where the consultations following the Green Paper are now complete and an indication of Government policy is awaited.

(b) On the immediate issue of rolling forward the monetary target.

19. The Governor and I will both have to make major speeches at the Mansion House on 16 October in which we shall need to say something about monetary policy.

20. I am sending copies to Sir Robert Armstrong and Robin Ibbs.

(G.H.)
October, 1980

Funding – what if we had raised more
– + a/c to profile
– problem of perversity
– level of aggs since ~~1976~~ 1973

EAJG + JSFf : on tender for N.I.