CHANCELLOR OF THE EXCHEQUER

PM
Seen

Mr Lankester

Present draft, subject to further comments by Chancellor, Govr & others. Sidelined passages reflect changes in an attempt to meet Bank concerns.

JW

7/3

# MEDIUM-TERM FINANCIAL STRATEGY

## Objectives and Instruments

The Government's objectives for the medium-term are to bring down the rate of inflation and to create conditions for a sustainable growth of output and employment.

2. To reduce inflation it will progressively reduce the growth of the money stock and will pursue the policies necessary to achieve this aim. After 1980-81, for which a target range of 7-11 per cent has been announced for £M3, the Government intend to set a target range consistant with the annual growth of money supply being reduced to about 6 per cent in 1983/84. It is the Government intention that there should be a progressive deceleration over the period producing the profile shown in Table I. The precise target rate of growth in the intervening years will be decided at the time.

TABLE I 12 - 4

RANGES FOR GROWTH OF THE MONEY STOCK

| | 1979-80 | 1980-81 | 1981-82 | 1982-83 | 1983-84 |
|---|---|---|---|---|---|
| Percentage change in year | [ 12½ | 7-11 | 6-10 | 5-9 | 4-8 ] |

3. The aim is to bring inflation down until it is roughly in line with the monetary target. The speed with which inflation actually falls will depend crucially on expectations both within the United Kingdom and overseas. It is to provide a firm basis for those expectations that the Government has announced its firm commitment to a progressive reduction in money supply growth. Public expenditure plans and tax policies and interest rates will be adjusted as necessary in order to achieve the objective. At the same time the Government will continue to pursue policies to strengthen the supply side of the economy, by tax and other incentives and by improving the working of the market mechanism.

4. It is not the intention to achieve this reduction in monetary growth by excessive reliance on high interest rates. The Government will therefore plan for a substantial reduction over the medium-term in the PSBR as a percentage of GDP. The relationship between the PSBR and the growth of money supply is not a simple one; it is affected both by the economic cycle, the rate of inflation and by the structure of the tax and public expenditure flows generating the borrowing requirement. But although the relationship between the PSBR and £M3 is erratic from year to year, there is no doubt that public sector borrowing has made a major contribution to the excessive growth of the money supply in recent years. The consequence of the high level of public sector borrowing in recent years has been a high level of interest rates and a reduced availability of funds to the private sector. It has become clear that high nominal rates, even in the context of rapid inflation, are themselves a deterrent to investment. If interest rates are to be brought down to acceptable levels the PSBR must be substantially reduced as a proportion of GDP over the next few years. The projections summarised in Table V below show that the Government's fiscal plans are consistent with a progressive reduction in the PSBR to around 2 per cent of GDP, which would be roughly in line with the average ratio recorded in the 1960s. The fiscal plans are thus fully consistent with the monetary objective.

/ paragraph to be added_7

Public Expenditure

6. A key element in this strategy is a reduction in public expenditure. The plans announced in the Public Expenditure White Paper (Cmnd ) show a reduction of /4_7 per cent in volume of public expenditure between 1979-80 and 1983-84 and on the assumptions about GDP described below imply a fall in expenditure as a proportion to GDP from /42_7per cent to / _7 per cent over the period. Table II below shows the expenditure plans in cost terms at 1978-79 prices and allowing for shortfall. Total Government expenditure in these terms is gradually reduced over the next four years - from /£75/ billion in 1979-80 to /£69/ billion in 1983-84. The financial framework described below sets these expenditure projections against an illustrative projection of Government revenue.

TABLE II

GENERAL GOVERNMENT EXPENDITURE

| (£ billion) | 1978-9 | 1979-80 | 1980-81 | 1981-82 | 1982-83 | 1983-84 |
|---|---|---|---|---|---|---|
| General government expenditure at 1979 survey prices* | 68.1 | 70½ | 69½ | 69 | 68 | 67½ |
| Total Expenditure in cost terms at 1978-9 prices | 64.3 | 66 | 65 | 64 | 62½ | 62 |
| Shortfall | +0.4 | 0 | -¾ | -¾ | -¾ | -¾ |
| Interest Payments | 7.8 | 8 | 8 | 7½ | 7 | 7 |
| National Accounts Adjustment | 1.3 | 1 | 1 | 1½ | 1½ | 1½ |
| Total Expenditure in National Accounts Terms | 73.8 | 75 | 73½ | 72½ | 70 | 69½ |

*Total spending on programmes by central government and local authorities plus the contingency reserve. Debt interest is excluded.

Revenue in the Medium-Term

7. The growth of Government revenue over the medium-term is dependent upon the growth of national output. This is heavily conditioned by the underlying growth of productivity, the growth of the world economy, and the speed of reduction of the recent high rate of inglation.

8. Since 1973 growth in output has fallen both in the UK and in the rest of OECD (see Table III). Over this period growth in OECD output and in world trade in manufactures has roughly halved. It seems unlikely that world output and trade will grow faster over the next few years than in the past five years. In most of these countries there is strong evidence of a slow-down in productivity growth in recent years. In Britain, recorded productivity growth (for the whole economy excluding the North Sea sector) over the period 1973-1979 averaged [¼] per cent a year - compared with an average of 2½ per cent in

the preceding decade. One consequence of the slower growth in productivity in the 1970s is that there has been less excess capacity in the economy than might have been expected, on earlier experience, given the slow growth of output.

TABLE III

WORLD AND UK GROWTH RATES

(Annual average per cent)

| | 1964-73 | 1973-78 | 1978-80 |
|---|---|---|---|
| Growth of Output | | | |
| OECD* | 5.2 | 2.6 | 2 |
| United Kingdom ≠ | 3.0 | 1.0 | -1 |

* Weighted average of GNP of OECD countries, excluding UK.

≠ GDP

9. The process of reducing Britain's high rate of inflation may entail some transitional losses of output. A stricter monetary policy is likely to involve a tighter fiscal stance, higher interest rates and a higher exchange rate, and these will have some depressing effects on activity in the short-term. The size and duration of these effects, however, will depend in large measure on how quickly behaviour, particularly in pay bargaining, takes account of the new monetary environment. As inflation subsides, nominal interest rates can come down and, for any given nominal exchange rate, competitiveness will be better and the basis will be laid for sound, sustainable growth. If inflation comes down the monetary growth set out in Table I will permit a return to an acceptable rate of economic growth.

10. Although it is hoped to do better it would be imprudent, in the light of all these considerations, to assume that the average growth rate of the economy over the next few years will be above the 1 per cent a year recorded between 1973 and 1979. Since the growth of the economy strongly affects the growth of Government revenue at unchanged tax rates the illustrative projections in Tables III-V make the deliberately cautious assumption of an average growth rate of [ 1 ] per cent a year for the years after 1980, giving an average of [ ] per cent for the period 1979-83 as a whole.

11. The implications for Government revenues of this illustrative growth rate are shown in Table IV. Revenue is projected on the conventional assumption of constant indexed tax rates and allowances at current, 1980-81 levels. The low average growth of the economy over these years is reflected in a virtually flat profile in real terms for revenues from the traditional major taxes. However, the rapid rise in revenues from the North Sea in the later part of the period adds substantially to total tax receipts. Over the period 1979-80 to 1983-84 as a whole total Government receipts (at 1978-79 prices) rise by about £4 billion.

TABLE IV

GENERAL GOVERNMENT RECEIPTS

| General Government Receipts at 1978-79 prices (£ billion) | 1978-9 | 1979-80 | 1980-1 | 1981-2 | 1982-3 | 1983-4 |
|---|---|---|---|---|---|---|
| Taxes on Income, Expenditure and Capital | 48.2 | 51½ | 51½ | 50 | 53 | 55½ |
| [of which North Sea taxes] | [0.6] | [2] | [2½] | [2½] | [4] | [4½] |
| National Insurance etc | 10.2 | 10 | 10 | 11 | 11 | 11 |
| Interest and other receipts | 6.3 | 4½ | 5½ | 5½ | 5 | 5 |
| Total Receipts | 64.7 | 66 | 67½ | 66½ | 69 | 71½ |

Money Supply and Public Sector Borrowing

12. This revenue profile, in conjection with the declining profile of public expenditure produces a progressive reduction in the PSBR after 1980-81. This is shown in Table V.

13. This particular path for the PSBR is not to be interpreted as a target. It is a projection of the course of the PSBR based on the

assumed growth of GDP, present public expenditure plans and the assumptions about the tax structure described in paragraph 11 above. Fiscal policy will be operated so that the PSBR for any particular year will be consistent with declining monetary growth in the particular circumstances of the time. The chosen PSBR could be higher or lower, according to circumstances, than that shown in the table. The PSBR path shown requires, on the assumptions made, a 'fiscal adjustment'. If such adjustment turns out to be necessary for a particular year the Government would assess nearer the time whether it should adjust public expenditure, tax, or some combination of the two, and also the precise items within these that would be changed.

TABLE V

PUBLIC SECTOR BORROWING

1978-9 Prices (£ billion)

| | 1978-9 | 1979-80 | 1980-1 | 1981-2 | 1982-3 | 1983-4 |
|---|---|---|---|---|---|---|
| Total Expenditure | 73.8 | 75 | 73½ | 72½ | 70 | 69½ |
| Total Receipts | 64.7 | 66 | 67½ | 66½ | 69 | 71½ |
| Fiscal Adjustment | 0 | 0 | 0 | 0 | -3½ | -5½ |
| GGBR | 9.1 | 9 | 6½ | 6 | 4½ | 3½ |
| PSBR | 9.3 | 7½ | 6½ | 5½ | 4½ | 3½ |
| (as % of GDP at market prices) | (5½) | (4½) | (4) | (3½) | (2¾) | (2.0) |

14. As is now generally recognised projections of this sort are subject to wide margins of error not just because they depend crucially on the assumptions about developments in the rest of the economy, but because even with reasonably firm knowledge of such developments it would be difficult to predict revenue and expenditure with any precision. Nevertheless if their limitations are borne in mind the projections described above suggest that if GDP growth after 1980 were at about the same rate as in 1973-79 there should be scope for tax reductions in the later years.

15. The path for the PSBR set out in Table V is consistent with achieving the planned reduction in the growth of money supply over the medium-term with lower interest rates. It is not possible to predict the path of interest rates year by year, but the strategy set out above implies that though financial conditions must remain quite tight in the immediate future while inflation remains high relative to the monetary target, there should over the period as a whole be a progressive reduction in nominal rates and a better environment for investment.

Responses to alternative outcomes

16. The projections shown in Tables III-V are within a wide range of possible outcomes. Events could develop so as to produce a very different situation. World trade could grow faster or more slowly than assumed; the supply response of the UK economy could be very different, with consequences for productivity and trade performance; oil and other commodity prices could show different movements; and the behaviour of earnings is always difficult to predict. Any of these outcomes, and many others, could significantly change the growth rate of the economy over the next few years, and hence the finances of the public sector. This is true even with a large change in prices, such as a rapid rise in commodity prices, because this will feed back on to output growth.

17. To maintain a progressive reduction in monetary growth in these circumstances it may be necessary to change policy in a way not reflected in the above projections. The Government would face a number of options for policy changes to keep to the monetary targets, including changes in interest rates, taxes and public expenditure. If events developed in such a way that it became easier to achieve monetary deceleration, it would even be possible to keep fiscal stance and interest rates unchanged and to allow monetary growth, and hence inflation, to fall faster. But if the opposite happened, and it became more difficult to achieve monetary develeration, there would be no question of relaxing the money supply policy, which is the centrepiece of the Government's economic strategy.

-7 MAR 1980