

CHIEF SECRETARYMEDIUM TERM FINANCIAL STRATEGY

Thank you for your minute of March 4th about the financial strategy. Your anxieties partly match those of the Bank of England, which will, I trust, be largely met in the latest draft. With these amendments, I see the case for publication as still being very strong.

2. Our economic strategy has no real precedent. Under the Labour Government, monetary control was only of central importance for a short period, in 1976-7. For most of their time Labour had no long-term economic strategy, and changed direction every few months. Not surprisingly, therefore, their monetary policies did not have the lasting, radical impact on behaviour and attitudes which both circumstances and our approach now demand.

3. Since the election we have only succeeded in stopping the rot we inherited. To achieve positive success - which you may at moments doubt to be possible - our policies must do more. The business world, financial institutions, labour markets and ordinary people (particularly our supporters) must have a vision of how we intend to proceed hereafter. They want to know the course we intend to steer in relation to expenditure and taxes, and what our commitment to monetary discipline might mean. Furthermore, the way the policy works implies that they need to be given a clear indication of the limits within which we intend to manage public spending and the money supply, so that they can adjust their behaviour rationally to fit in with those limits. But they also need a demonstration that our intentions and the policies which will realise them are consistent, technically sound, and will bear fruit. At present there is a measure of uncertainty about all of these.



4. We need, therefore, to illustrate the modest realism of our goals and to marshal the wider support which will follow from so doing. The more we do so the more we can hope to get into the virtuous circle in which the greater credibility of our policies makes them more effective and their effectiveness increases their credibility.

5. It is this line of reasoning which leads me to take issue with your numbered points:

(1) The demand for a strategy certainly comes from the commentators. This is surely <sup>not</sup> an argument against it, not least because of their crucial role in shaping public opinion. If the heavy-weights believe our policies are credible, they can do more than any other group to make them credible to the world at large. That is no mean prize. But it is not the commentators alone who are, by and large, in favour. I believe there are many in the commercial world who welcome the idea, too. However the central issue is not who is advocating a financial strategy, but whether it could be helpful. For the reasons already given, I believe it can be.

(2) You fear that the statistics published in the strategy have to be forecasts rather than "illustrative" figures if they are to be credible. Of course as it happens some of them are undoubtedly straight forecasts or plans - most obviously the public spending proposals. Others - the possible path of Government revenue and PSBR - are prudent "worst case" projections. In neither case is credibility a serious issue. The indications of the intended path of M3 are not forecasts at all and are not intended to be. They are statements of firm intent. With proper presentation and acknowledgment of the need for some year to year flexibility there is nothing intrinsically incredible about them. One might, of course, wish to question the figures presently adopted, but that is a quite separate issue.





(3) and (4) We would all agree that no "mechanistic" connection between monetary expansion and subsequent inflation can be demonstrated. However, you go on to suggest that a published financial strategy is only credible if it also includes estimates of "recorded inflation" [I assume you mean "forecast inflation"] of a kind which are unattainable without such a mechanistic relationship. At that point I would part company with you.

What matters is our monetary policy and that we adhere to it, not that it is accompanied by precise RPI projections which no one believes. For surely you would accept that the reason for a policy of steady reduction in monetary growth is that there is a firmly established, if imprecise, relationship between trends in the money supply over time and inflation at a later date. Provided one accepts that as unchallengeable, then the absence of accompanying figures for inflation does not matter. Indeed, for just the reasons you give it would be foolish to offer any such figures at all, as they would imply greater claims for the efficacy of the policy than any of us would wish to make or defend.

It is worth stressing, in passing, that the essence of such a financial strategy is that it describes one's plans in relation to those things one can control fairly directly, so as to increase one's power over factors such as inflation over which the Government's influence is only indirect.

(5) Your final anxiety is that a published financial strategy will convey an impression of certainty about pace and direction which we do not possess. I entirely agree that we should not claim an ability to foresee or manipulate the future which we do not have. However, provided that we do not make the money supply figures unduly precise, and provided we do not publish RPI projections, I do not see this as an insuperable problem. Indeed my own anxiety is rather the opposite of yours, namely that



without such a strategy we could end up conveying no sense of pace or direction whatever. To allow that to happen would certainly be an unmitigated disaster.

6. I trust that these comments go a good way towards answering the points you have raised.

7. I am sending copies of this minute to the Prime Minister and Sir Douglas Wass.

A handwritten signature in dark ink, appearing to be "W. H. H.", written in a cursive style.

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