SECRET

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7 November 1980

SECRET AND PERSONAL

T.P. Lankester, Esq.,
No.10, Downing Street,
LONDON. S.W.1.

Dear Tim,

POLICY OPTIONS

The Prime Minister asked Sir Douglas Wass on 20 October to explore ways of mitigating the adverse conditions under which British industry is operating.

I now attach a copy of a note Sir Douglas Wass has submitted to the Chancellor in accordance with this remit. The Chancellor will be considering this further over the week-end before discussing it with a small group here; he has not yet reached any view about the options discussed. Meanwhile he has asked that the note should be sent at once to the Prime Minister.

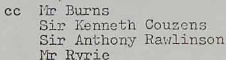
The Chancellor and Sir Douglas Wass have not discussed the options with the Governor; nor has he seen the paper. The Chancellor would like an early opportunity to discuss it privately with the Prime Minister well in advance of her meeting now fixed for 18 November. It will be important to ensure that that meeting is able to concentrate on the "operational" monetary policy issues requiring immediate decision.

Yours

John

A.J. WIGGINS

CHANCELLOR OF THE EXCHEQUER



cc Mr Burns
Sir Kenneth Couzens
Sir Anthony Rawlinson
Mr Ryrie

POLICY OPTIONS

I reported to you at the time the substance of my talk with the Prime Minister on 20 October when you were in Luxembourg and when she had just received from the ICI Chairman the news of the Company's third quarter loss. The Prime Minister expressed a very strong wish that I should explore ways of mitigating the adverse conditions in which British industry is operating, so that good and viable companies like ICI should not be driven to the wall. You yourself endorsed this wish and authorised me to submit some options to you.

2. I have done this in consultation with the Second Permanent Secretaries and a handful of people who have been drawn into the discussion on a strict "need to know" basis. I told the Governor in general terms what I was doing, but did not reveal in any detail what the scope of the study was.

3. It is important to establish at the outset the nature of the problem which we wish to resolve. The strong financial pressure to which business generally is being subjected is one manifestation of the policy which is intended to slow down the rate of inflation. I have never myself believed that the statement of the commitment to a deceleration in monetary growth would, through expectations, lead rapidly and as it were on its own account to a fall in wage settlements. In time expectations could well play an important part but until they do, the pressures on wage bargainers and price fixers has to be through powerful financial and economic forces - in short an inability of the customer (employer) to afford the goods or services in question at the price that would otherwise be offered.

4. It seems to me that the success we have been, and can look forward to, having on the inflation front stems directly from this. To appeal therefore for a relief from these financial pressures is implicitly to appeal against the policy being pursued, or at any rate to appeal

against the speed at which the policy has in practice taken effect. I submit that this basic fact has to be accepted at the outset, for almost all the suggestions that are advanced for relieving financial pressures involve in their very nature a relaxation in the policy for defeating inflation.

5. The prior question that has to be asked therefore is whether present policy is too severe, given the objectives set and the costs which it entails. The answer is by no means self-evidently "Yes". Although the achievement in bringing down the underlying rate of inflation to what currently may be thought to be about 12% is remarkable, there are plenty of signs that it may be very difficult to get much further reduction in the next twelve months; and the prospects beyond that are very uncertain indeed. A relaxation of policy could easily lead to a reversal of the trend we have seen in 1980 and make the medium term outlook distinctly worrying.

6. Nor can it be convincingly argued that business conditions as they have evolved this year are very much worse than we expected when we set the current targets and formulated the MTFS. The output path has not diverted much from the forecast and the company sector's financial deficit is not significantly more serious than we expected it would be, partly because de-stocking has proceeded at a faster pace than we predicted. The trade balance and consumer's expenditure have both been stronger than forecast and have gone a long way to offset other deflationary factors. If things are going much as we expected and if we set the parameters of policy with our eyes open, why should we now change?

7. The case for considering a change rests mainly I think on the fact that, as events this year have unfolded, the exchange rate has appreciated much more than we expected. This has had the initial effect of transferring more income than would have been expected from companies that trade internationally to other companies and to consumers. This transfer is mainly the result of smaller, even negative, margins, and partly the result of lower turn-over. A rough rule of thumb is that, ceteris paribus, a 10% appreciation in the effective rate redistributes in the first year about £6 billion of trading company income, £4 billion to persons and £2 billion to companies. Over time, wages and prices

will adjust and tend to restore the original distribution, although the limited scope at present for even more rapid deceleration of nominal wages may slow down the rate at which this occurs. In any case in the short run a sharp rise in the exchange rate can clearly have a serious effect on the finances of trading companies. However, the speed of the adjustment may be so rapid as to cause damage to the capacity of the manufacturing sector that, unlike the effects of reversible cyclical changes, may not easily be restored.

8. The untoward rise in the exchange rate has of course given us an uncovenanted benefit in the fight against inflation, both because it has made employers still more unwilling to concede large wage claims and because its favourable effect on the rpi has taken off some of the pressure for high nominal wages.

9. Not all of the business sector has suffered from the high exchange rate. The service industries (eg distribution) and those which mainly import and sell on the home market (eg the tobacco companies) are not complaining about sterling; nor should they. This has to be noted, because any general relief to the business sector would give a benefit to those who have not been damaged by the exchange rate.

10. These considerations have led us to explore primarily policy options which if implemented would (or perhaps one should say might) reduce the exchange rate somewhat. But we have also looked at other options which would transfer income generally from consumers to producers, irrespective of the latter's vulnerability to overseas competition. Such options are less satisfactory from that point of view. But they may be more satisfactory in other respects, for instance in relation to the damage they would do to the counter-inflation objective. So we have not ruled them out.

11. It should also be stated that the options are not all mutually exclusive, though some clearly are. For example, a cut in interest rates could be combined with some fiscal switch. But equally some of the options would be inconsistent with possible future policy developments. For example, a large administered reduction in interest rates would clearly not be compatible with an early move towards monetary base control.

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The Options

12. The options we have considered, which in some cases are discussed in greater detail in the supporting Annexes, are:-

(i) Inflow controls and some minor measures intended to reduce the exchange rate;

(ii) a modest cut in interest rates;

(iii) a large reduction in interest rates;

(iv) an explicit exchange rate policy;

(v) a significant tax switch to the benefit of companies;

(vi) a pay freeze.

13. The first four options are listed in descending order of compatibility with the Government's present strategy of gearing down inflation through strict control of the money supply. The last two options are not incompatible - option (vi), for example, would if successful actually reinforce the Government's monetary policy - but they present difficult problems of other kinds. I have ranked the pay freeze last because it is so obviously in conflict with everything Ministers have said about an incomes policy and because of the trouble it stores up for the future.

14. Although each of the first four options would involve a relaxation of monetary policy, the first two could just about be presented as consistent with the objectives which have been publicly defined. Many of us have grave doubts, however, whether such consistency would be substantive, particularly given the present underlying rate of increase in the money supply, and developments in the months following their implementation could well show those doubts to be justified. But at the time of their introduction, at least a brave show could be made of their compatibility with policy. Options (iii) and (iv), however, amount to a significant and unconcealable shift in policy. As such they would present political problems of the most serious kind. The

fact that they are included does not indicate that even *a priori* we think that they are starters.

Inflow controls and other minor measures to reduce the exchange rate

15. So far as inflow controls are concerned, I do not think I need comment in any detail here. Both you and the Prime Minister have seen recent detailed studies and you share our view that such controls would be unlikely to be effective and would create very tiresome administrative problems. But we cannot exclude the possibility that they might offer some short-term gains, if only presentational. On the other hand I must remind you that in our judgement controls on capital inflows would almost certainly lead to some expansion in the money supply. (The reason for this is that some of the transactions you can best block are harmless to the money supply – eg foreign purchases of gilts. Inflows would tend to be diverted to assets which are more harmful to block – eg lending to companies which do affect the money supply. TL)

16. For the rest, there are one or two minor measures that could be considered. These include taking purchases of sterling by other central banks (customer purchases) off the market; and taking the opportunity of any fall in interest rates to draw the attention of some European etc sovereign borrowers to the possibility of borrowing sterling in the London market. But there is no guarantee that either would achieve anything worthwhile and, like inflow controls, to the extent that they had any effect as intended they would mean taking risks with the money supply.

A modest cut in interest rates

17. What I have in mind is a reduction of 2% at most in MLR. The value of such a move would be partly in the relief it would bring to businessmen through a fall in their interest charges and partly in the hope that it would eliminate the present interest differential in favour of sterling against the dollar and reduce it against other currencies, check the inflows and exert a moderate downward pull on the exchange rate. The former would certainly follow; the latter might not. Overseas investors might smell the interest rate fall as the first move in a sequence of cuts and might actually step up their purchase of gilts (and sterling). There could then be a perverse reaction. To prevent this it would be necessary to authorise the Bank to intervene strongly to stop this happening. Again this might or

might not be successful. Substantial intervention would of course be likely to inflate the money supply.

18. We have considered - and dismissed - the idea of accompanying a cut in MLR with a deliberate and simultaneous move to sell sterling to edge the rate down. Such a move would quickly become apparent to the market who would interpret it in the only possible way - viz that the authorities wanted the exchange rate down and that the twin measures of an interest cut and intervention had this as their end. The effect on the foreign exchange market might then be very marked. There is an immense amount of mobile capital in London which would be likely to move rapidly if it thought both that we wanted - and were prepared to act - to move the rate down and that we were relaxing our monetary stance. The experience of 1976 shows how quickly and strongly an avalanche of selling can take place if the motives of the authorities come under suspicion. The Americans had a similar experience in 1978. So we do not favour intervention to get the rate down in these circumstances; only intervention to stop it rising.

19. There would be some presentational difficulties with a modest interest rate cut, particularly following the October monetary figures. These could be mitigated if the move were linked to some apparent strengthening of fiscal policy - eg an announcement of the outcome of the public expenditure review (though this does not now look a promising piece of cover), or of the new taxes that have been under discussion, or the outcome of our consideration of monetary base control.

A large reduction in Interest Rates

20. This option consists of a decisive and dramatic reduction in MLR, say of 4%. (A variant consisting of a quickish succession of smaller cuts adding up to the same amount is a possibility, though it would lack the signal element of the single large reduction).

21. Because this is what so much of business is now asking for it would do much to mitigate the criticism now being made of Government policy. It would immediately cut the interest costs of business debt and help both cash flow and net profits. It would be surprising if it

did not bring the exchange rate down, but how far it would do so is an open question. In some circumstances the fall might not be large. But if the market interpreted the change as a substantial departure from previous policies, the effect on the exchange rate could be dramatic, and the fall difficult to control - though we do of course have large foreign exchange reserves and could intervene to some extent to try to smooth the fall.

22. The move would of course involve formidable presentational difficulties - much more serious than those which arise with a small interest rate cut. It could hardly be described as consistent with your medium-term strategy - and this would I think be true even if you had not formulated it in the precise and quantified terms of the MTFS. You would have to relate the move to the plight of the business sector and to say that you were broadly satisfied with progress, and with the outlook, on the inflation front and that you were prepared to take some risks on the money supply.

23. Our assessment is that the risks you would be taking would be very substantial indeed. Annex A discusses the consequences in greater detail. You could hardly formulate a money supply target for the year ahead in terms which were reconcilable with the MTFS and if you did you would soon be off course. Many of your stronger supporters would be dismayed and in political terms the move would be seen to be an acceptance of the Opposition's arguments.

An explicit exchange rate target

24. This option would take a number of forms but in its simplest terms it would consist of a statement that henceforth the Bank of England would intervene to hold the exchange rate within some prescribed limits (which might or might not be made public). Interest rate policy would be implemented so as to reinforce this objective and would no longer be determined by reference to the money supply. This is the sort of policy followed briefly (and in money supply terms disastrously) by the Swiss and German authorities when they become alarmed at the drift of the Swiss Franc and the DM respectively.

25. We should need to decide what the exchange rate target should be. The least difficult course might be to freeze it where it is now, in

which case we might consider systematising it by joining the EMS. This step would reassure business that we planned to arrest the erosion of competitiveness through the exchange rate and the fears that the rate would climb even higher would be allayed. But it could well produce consternation among those firms who found the present rate impossible, for the move would largely rule out any relief from their present plight. And further upward pressure on the rate, which we would have to meet by intervention, could not be excluded.

26. A more extreme approach would be to announce a target 10 or 15% below the present rate - rather as was the case when a devaluation took place under the old fixed rate system. But we could not be sure that we could actually enforce such a step-change. If the market judged that we had gone too far, and tried to push the rate up again, we could only hold it down if we were prepared to accept an open ended liability to sell sterling and inflate the money-supply in a unlimited way. On the other hand the market could form the view that the Government had abandoned the present strategy and conclude that sterling was no longer a good risk. The fixed rate would then come under such heavy downward pressure that we might not have the resources to hold it. For my part I think that this would be an unlikely eventuality, though I have to acknowledge that we would be in completely unknown territory and the markets might be very disorderly indeed for a time. The option of entering the EMS would not arise - at least for some time - if our target was much below the present rate, not least because our partners would look critically at the rate we had chosen.

27. From the counter-inflation point of view the move would be severely adverse. Quite apart from the immediate effect on the price level, there would be a substantial risk that the money supply would be inflated even more than with a straightforward and substantial cut in interest rates. It would be quite impossible even to pretend that we were still on a money target policy; at best we would have to say that it was temporarily in suspension and that we would revert to it "when conditions had settled down".

28. Thus whether at the end of the day the company sector would be any better off would be problematical. The initial relief at becoming more competitive might disappear quickly as inflationary expectations

were rekindled.

29. This option is discussed in greater detail in Annex B.

A significant tax switch to the benefit of companies

30. What we have principally in mind here is a reduction in the national insurance surcharge (and possibly also employers' NIC contribution) in addition to the Corporation Tax stock relief measure, both financed by an equivalent increase in taxes on persons (eg an increase in employees' insurance contributions). The reductions could not take effect until next April, but there should be some beneficial expectational effects in the meantime. The order of magnitude of this switch would be for discussion, but the sort of figures we have in mind would be in the region of £3 billion per annum. The move would be an explicit attempt to reverse the distributional effects of the unexpected rise in the exchange rate in recent months and would have to be presented as such.

31. While the immediate effect of the switch would be helpful to companies the effect would be likely to wear off in time. Wage pressures would be strengthened and employer resistance diminished. Indeed it would almost certainly not be long before the trade unions saw the switch as something which they ought explicitly to reverse by putting in inflated wage claims.

32. Another difficulty which the move would present would be that you would have partially preempted the taxable capacity of the personal sector which you will almost certainly have to exploit further in your Budget in March. Following the present public expenditure round it seems likely that you will have to raise personal taxation in relation to what is in the forecast. If you take (say) £3 billion from the personal sector not to reduce the PSBR but to hand over to companies you will be markedly reducing your room for manoeuvre. And you would be thought to be abandoning, or at least postponing, your objectives on personal taxation.

33. Finally the tax switch would give help not only to the hard-pressed business sector but the much less hard-pressed business

sector - ie the banks, the oil companies etc, none of whom have been hard hit by the exchange rate. We have considered whether the tax relief could be slanted particularly to the companies which have been adversely affected by the high exchange rate; but such discrimination would be administratively very difficult and would almost certainly conflict with our European obligations. We think that the benefits would have to be given to all employers alike.

34. One very big advantage in the switch would be that, on the footing that it would be neutral with respect to the PSBR, it would not damage our money supply objectives. There would be no problem of presenting the measure as in conflict with the overall monetary strategy. Indeed it might actually help to ease the pressure on the money supply to the extent that it led to reduced bank borrowing, because the personal sector tends to borrow less when its disposable income falls. The company sector, already borrowing heavily, is unlikely to borrow more.

35. A fuller discussion of this option is set out in Annex C.

Pay freeze

36. This option consists of the immediate announcement of a freeze for twelve months on all employment incomes in both the public and the private sector. Its purpose would not however be primarily that of freezes in the past, viz to check runaway inflation, but to secure a redistribution of income from the consuming to the producing sector.

37. It would in fact be seeking to do by administrative means - but to a larger degree - what the tax switch would be doing by fiscal means. To have this effect it would positively not have to be accompanied by a price freeze, though increases in public sector prices could perhaps be moderated somewhat as a result of the check in the rise of wage costs. Whether the freeze was statutory or not would be an important but not perhaps a decisive question. Of much greater importance would be the chances of compliance. The Trade Unions would probably not take much notice of statutory penalties unless they applied to union funds and even then ways could be found round a liability which would arise if strike action were resorted to. The freeze would only work if the public generally thought that it was a sensible step.

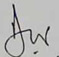
38. On this there would be some puzzlement. However it was presented, it would look like an old-fashioned freeze and people would ask why we were introducing it when wage pressures were actually falling. It would too look like an incomes policy no matter what was said about its purpose or about the freedom of wage bargainers at the end of the freeze.

39. The one advantage of a freeze, if it could be made to stick, apart from the distributional advantage, is that it would not conflict with the Government's monetary objectives. Indeed it would be likely to lead to a lower growth in money supply and/or to lower interest rates, and it would produce lower inflation. Further analysis is set out in Annex D.

Conclusions

40. The common feature of the options discussed above is an attempt to accelerate the contraction of real personal incomes that is already beginning to take place and to transfer income from persons to the manufacturing and trading sector. This is bound to add to existing tensions and could put the personal sector under intolerable strain. This is something you will want yourself to judge. But the need for this shift arises, of course, from the fact that we start from an existing position of disequilibrium between the two sectors.

41. I refrain, however, in this note from making any recommendations, for the subject is fraught with political overtones. In a matter of this sort the decision turns as much on these factors as on the one of deciding on economic priorities.



DOUGLAS WASS
5 November 1980

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ANNEX A

4% CUT IN MLR

Modalities

The alternatives are a cut of 4% in one go, or a series of smaller steps between now and say Christmas. A large change might do more to put heart into industry: but it would also look more like a sudden failure of nerve. If we could be confident of low money supply figures between now and Christmas, smaller step changes might be easier presentationally - but of course this cannot be guaranteed. The short term prospects for debt sales would be rather better with a slide than a step change.

2. We would expect other 3month rates including banks base rates to fall by about the same amount. Mortgage rates would typically come down more slowly; the prospect of a rise next April (reflected in the NIF) would be averted. The effect on long rates is uncertain, but almost certainly very much smaller - we would guess roughly half the effect on short rates, and under current circumstances maybe even less. The need for the Bank to give substantial amounts of assistance to prevent excessive rises in very short term rates would almost certainly remain. The net effect on the amount of assistance needed is uncertain. A fall in non-bank demand for gilts should make it easier for banks to satisfy their demand for reserve assets. On the other hand, to the extent that bank lending increases, or a withdrawal of overseas £ deposits squeezes bank liquidity, the amount of assistance might have to be increased.

Presentation

3. The market already seems to be discounting some fall in MLR. But it would be difficult to reconcile a 4% cut, even in steps, with continued public commitment to the monetary target for 1980/81. The MLR change could be coupled

with an announcement about PPT, and the prospect of a £1 billion cut in the PSBR; we might stress the seasonal pattern of the PSBR in arguing that monetary growth from now on was likely to be very low; and we might have to call in aid the argument, advanced by several commentators, that the distress element in current levels of bank borrowing by ICC's implies that lower interest rates are more likely to reduce bank advances than increase them, at least in the short term. These arguments would carry some weight. But there must be a strong possibility that such a large fall in MLR coming at a time of manifest and continuing failure to meet the £M3 targets would be interpreted as an abandonment certainly of the 1980/81 target, and possibly of the MTFS as well.

4. At the least the change would create considerable uncertainty. It would be essential to make an early statement about the rollover. This would <u>either</u> (i) reaffirm the Government's commitment to essentially the present targets, explaining why this should be credible, <u>or</u> (ii) set out details of a higher target for the coming year which would also effectively allow for a considerable amount of base drift. The exchange rate might be used as a justification for not compensating for the past overrun on the monetary target, and for raising the MTFS range. The new target would start from September or October: the figuring discussed below suggests that a range centring on 12% would be a realistic estimate of what might be achieved. It might be difficult to announce in the same breath a substantive step to MBC, or more market determined interest rates.

Economic Effects

5. It would be surprising if the exchange rate did not fall by several percent. Our normal rules of thumb, based largely on the experience of the last two years, would point to a fall in the region of 5-10%, within about six months of a 4% cut in MLR

(ie. back to an effective of around 71-75). It should be recalled however, that the effective rate, at 80, is now over 5% above the level forecast for 1980 Q3.

6. Naturally, these estimates are extremely uncertain. In favour of a rather large effect is the possibility that a big cut in MLR could cast doubt on the Government's commitment to tight monetary policies in the medium term; failing this, overseas investors in gilt edged securities could feel that no further falls could be expected for the time being and might be tempted to realise their capital gains and move elsewhere: and a 4% cut would put sterling at an interest rate disadvantage (of about 2%) compared with the $ for the first time since the early Spring.

7. On the other hand, even after a 4% fall, three month rates on sterling would still be significantly above those on all other major currencies except the US dollar and the Italian lire: eg. there would still be a 4% differential over the DM, about 8% over the Swiss franc, and over 3% over the yen. A cut in MLR will not reduce pressure on sterling associated with money market shortages. And of course, interest rates are not the only factor underpinning sterling at present. Earlier this summer, the interest rate differential against the dollar virtually disappeared with little perceptible impact on the rate - and at a time when the money supply overshot substantially. The reasons were probably the deteriorating situation in the Middle East, and the weakening of the DM - factors which may carry weight for some months to come.

8. On balance, therefore, we could not count on a very substantial effect on the exchange rate even with a 4% MLR cut, though some reduction in the rate is probable. The wider effects on the rest of the economy are however critically dependent on the exchange rate response. For working purposes, therefore we have assumed an immediate fall in the rate of about 6%, with initially comparable gains on competitiveness. Much of these effects is likely to be temporary in the absence of further interest rate reductions, since in principle, the nominal exchange rate change should fall back once international portfolios have fully adjusted

to the new pattern of rates.

9. The size of the competitiveness gain depends on the effect on domestic price and earnings. Since the mortgage rate has quite a large weight in the RPI, a fall in both interest rates and the exchange rate may even leave retail prices lower - always providing building society rates follow MLR down. There is no comparable offset on consumer or wholesale prices, though to the extent that a smaller rise in the RPI helps to hold earnings down, the general inflationary consequences of a fall in the exchange rate may, at least in the short to medium term, be less if it is brought about by a fall in interest rates than say intervention.

10. Even if they eventually prove to be temporary, the effects on the exchange rate may still last long enough to produce a significant improvement in the position of the non-North Sea Company sector and some increase in manufacturing (and total) output and employment. A lower exchange rate will also raise the £ price of oil and increase the value of North Sea output, including the tax take. Higher taxes and lower interest payments will reduce the PSBR. Lower interest rates will also improve company disposable income very directly - this could amount to something in the region of £1 billion in 1980, for a 4% MLR cut.* All these effects will take time to build up, of course.

11. Turning to the monetary effects, model relationships might suggest a rise in the money supply building up to about 4 or 5% within six months. Over and above this there is the risk that a fall in interest rates well in excess of market expectations will precipitate a more serious pause in funding. On the other hand other special features of the

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* ICC's only (ie. excluding financial companies and North Sea)

present situation suggest the effect on £M3 may be smaller than usual in the first few quarters, though probably not in the longer term. The balance sheet pressures on banks may mean that the monetary consequences of a fall in gilt demand are less than we would normally expect (since a rather high proportion of gilts are likely to be sold to banks to relive their liquidity problems). The short run response of bank lending may be small, if current levels of ICC's NAFA imply a highly interest inelastic demand for advances.

Industrial and Commercial Companies' net acquisition of financial assets

12. In the longer term, - (ie. a year to eighteen months) we would expect a total response of £M3 to rise, broadly in line with past experience. The only major reason for expecting a smaller response is the hope that a sharp fall in interest rates would revive the debenture market. Perhaps as critical as the size of the fall in long rates is whether companies believe rates are likely to fall further in the foreseeable future. A large MLR cut would help here but clearly a revival of the debenture market cannot be counted on. Other effects work in the direction of increasing £M3. Even if bank lending fails to respond much to interest rates, higher prices (due to a lower exchange rate) may push up the demand for advances. And the effect of an increased demand for bank lending, against the background of extreme liquid asset pressure on the banks, may be an unusually large rise in the money supply. The precise size of the total effect on £M3 will of course depend on the exchange rate. If a fall in MLR did succeed in precipitating a sharp drop in the exchange rate, the effects on the money supply after a year or so would be correspondingly larger.

(i.e. the corporate deficit!)
TL

Overseas Interest Rates

	3 month rate now	Differential against £ after 4% MLR cut
US (Euro $ rate) (4/11)	16.1	-3.2
Germany (3/11)	9.2	3.7
France (3/11)	11.4	1.5
Japan (Gensaki) (3/11)	9.5	3.4
Switzerland (3/11)	5.2	7.7
Italy (3/11)	17.8	-4.9
Canada (3/11)	12.3	0.6
UK 4/11 (interbank rate)	16.9	

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ANNEX B

AN EXPLICIT EXCHANGE RATE POLICY/INTERVENTION

Modalities

The Bank would be given an exchange rate objective and told to spend as much as was necessary to achieve it. The difficulty with this approach is that it represents an open ended commitment which could result in an explosive growth in the money supply. We have very little idea of how much intervention would be needed to achieve a given effect on the exchange rate, or what the monetary consequences of such intervention might be. The abolition of exchange controls has almost certainly sharply reduced the leverage of official intervention. It has also increased the speculative options open to residents - and hence the potential impact on £M3 of net flows across the exchanges. There is moreover no scientific way of establishing what would be the appropriate level of an exchange rate target if we decided to have one.

2. A less drastic approach might be to give the Bank a fixed sum and tell them to use it to get the rate down as far as was consistent with stable markets. But we do not believe this could be relied upon to produce useful results. (Nor could we be sure what the monetary consequences would be.) The main problem is the difficulty of intervening to depress the rate on a falling market without giving the market the impression that the authorities have some particular objective for the exchange rate. Once this happens, it becomes hard to distinguish between this option and the one outlined in para 1: but without aggressive intervention in this sense, the scope for reducing the exchange rate is strictly limited.

3. It has always been the case that the effect of intervention on expectations is crucial. If the market believes the authorities want the rate down - and have the means to achieve

this - very small amounts of intervention may produce a large change in the rate (eg. Spring 1976). But if operators believe official efforts to influence the rate are doomed to failure - either because reserves are limited, or because the implications for the money supply will ultimately cause them to lose their nerve - large sums can have very little impact. Intervention totalled over £7 billion in 1977 - mostly in a series of fairly short bursts (including £1 billion in July alone) - before the rate was finally uncapped in October - only to rise by a modest 2 points in effective terms. Both the Germans and the Swiss have had similar experiences.

4. The scope for covert intervention is limited. It is not non-existent. but the circumstances have to be right. In the first half of this year for example, the Bank undertook nearly £½ billion spot intervention and as much again in the forward market. without arousing widespread expectations that it was systematically trying to hold the rate down. The fact that the Bank was intervening could be deduced from the monthly reserves announcement. The low key response was probably due to a number of factors:

(i) intervention could be justified with reference to official debt repayments;

(ii) market intervention was relative small - most of the intervention was the counterpart to off-market transactions with Bank customers which were not subsequently unwound;

(iii) the externals were consistently, often heavily negative. thanks to the combined effects of exchange control abolition on private sector capital flows, and the current account deficit: in effect, the authorities were accommodating an excess demand for sterling from non-residents which did not therefore add to £M3;

(iv) the exchange rate was rising, so the story that the Bank was only smoothing had some credibility.

4. For the future, the Bank could be told not to divert customer demand onto the market, as they have been doing recently. As long as customers were a significant source of demand for sterling, this would give them some scope for off-market intervention. They might intervene in the market when the rate was rising, but not when it fell. However if the current account continues in surplus, intervention may lead to positive externals, even if the effect of ending exchange controls ensures a continued capital outflow from the UK private sector. More seriously, it is unlikely that the Bank could achieve a sizeable reduction in the rate from present levels (as distinct from checking a further rise) without resorting to aggressive intervention ie. selling on a falling market.

5. Past experience gives us no reason to suppose that the Bank knows how to intervene in a controlled and limited way to produce an orderly fall in the exchange rate at predictable cost to the monetary target (if it did, it would be unique among Central Banks). On the contrary, experience suggests that such operations either backfire or are ineffective, and that the consequences for the money supply cannot be precisely estimated in advance or at the time. Accordingly the most realistic assumption is that effective intervention to reduce the exchange rate would involve sharply modifying and probably abandoning the present commitment to controlling the money supply.

Presentation

6. If a policy of influencing the exchange rate directly were to succeed without unnecessarily compromising the Government's ultimate objectives eg. on inflation, it would be important to provide some public explanation of what was intended and how this related to the existing strategy. There are in principle a spectrum of possibilities between outright and unqualified commitment to money supply targets, at one extreme, and an equally unqualified and open ended commitment to an exchange rate target at the other.

7. Taking the extreme situation first, the MTFS might be explicity abandoned and the money supply targets might be replaced by a target for the exchange rate. It would not be easy to give substance to a convincing exchange rate target in present circumstances. Given US rates of inflation, a commitment to a given $/£ rate would offer little reassurance that inflation would be successfully brought under control in the medium term. A fixed £/DM perhaps in the context of EMS is slightly more promising - though the flexibility of the EMS limits its value as a medium term constraint on inflation. Choosing an appropriate rate would be difficult, especially since we would need to choose a rate which would be sustainable for some time to come. The UK's special position as an oil producer would make this especially hard. More generally, there must be a questionmark over the credibility of an exchange rate target as an effective discipline on domestic economic policies. It is after all less than a decade since the post-war Bretton Woods system finally collapsed.

8. It is sometimes suggested that we could move towards an exchange rate policy without abandoning the commitment to monetary targets completely, or for all time. Several of those who gave evidence to the Select Committee advocated modifying the commitment to the monetary targets in some way explicitly related to the exchange rate. This is the "flexible rule" approach advocated by, for example, Artis, Miller and Buiter. They envisage that the Government would say that the MTFS targets were conditional on the exchange rate remaining within some pre-specified and probably very broad band (say 60-75 effective). The new "rule" is that within this band there is no intervention and instruments are directed exclusively to domestic objectives (as now). But when the rate rises above the band, £M3 targets are temporarily suspended and policy is directed to bring the exchange rate back (much as if we had an explicit exchange rate policy).

9. The justification for this hybrid approach is essentially the source of the current anxiety about the rate: that the exchange rate is a key part of the transmission mechanism, and an unexpected rise in the rate alters the impact of a given monetary stance in an unintended way - altering the scale and distribution of the effect on output as well as the effect on inflation. But there are problems both of principle and practice. As we have pointed out ourselves to the Select Committe complicated rules may not be worth having. They will be less easi understood and so have less effect on expectations. Moreover, in present circumstances, this approach offers no new solution to the immediate problem of getting the exchange rate down. Indeed since the top of the band would almost certainly be below the present market rate it might be sensible to wait until the rate had reached more acceptable levels before announcing the band at all. In the meantime, we would effectively be operating an unmodified exchange rate policy.

Economic Effects

10. It is not possible to say much about the exchange rate and monetary consequences of given amounts of intervention. We can say a bit more about the effects of a change in the exchange rate, assuming one can be successfully engineered. The critical issue is of course how quickly earnings and prices respond and hence how long the gain in competitiveness lasts. Current estimates suggest that a 10% depreciation would increase prices by about 2 or 3% after a year, and perhaps 4% after two. To the extent that the current level of the exchange rate has not yet fed through to the price level, (and is not even reflected in the forecast) this change would largely be forestalling a bonus on the price level which we have not yet fully taken into account.

11. A lower exchange rate will redistribute income from persons to companies. There will also be a substantial redistribution within the company sector towards industries trading in international markets and away from those relatively sheltered from competition. These changes are, in principle, only temporary; as earnings rise to compensate for the change in the rate, the initial switch from wages to profits will be reversed. The corollary is that the redistributive effects of the recent rise in the rate will be only temporary too - though we have little evidence on the effects of appreciations, and it is at least possible that they are not simply the mirrow image of depreciations.

12. A 10 per cent depreciation might raise GDP by about 1 or 2 per cent after 2 years - trade would benefit but consumer spending would be cut. This figure takes no account of the special features of the outlook for the next year. To the extent that poor profitability is likely to lead companies to lay off workers to an unusual extent, the easing brought about by a depreciation may have a somewhat larger and quicker effect on unemployment than we would normally expect. Perhaps more important a lower exchange rate would reduce the risk of large scale industrial collapse in a way which cannot easily be quantified.

13. The monetary consequences are inevitably very speculative: very broadly a 10 per cent depreciation might add about 5 per cent to £M3 after a year (with a little more to come in the second year). In present circumstances it is worth noting that intervention will have the effect of increasing bank liquidity, thus helping to tak some of the pressure off very short rates (and possibly also the exchange rate) and reducing the amount of regular assistance which the Bank need to give to prevent interest rates rising further.

ANNEX C

Tax switch from persons to companies

Modalities

Employers' NI contributions and/or the surcharge would be reduced from April 1981, and direct taxes on persons increased to the same extent. The intention to do this would be announced in November. The corporation tax stock relief scheme would also be reformed from April 1981, and announced in advance.

Decisions would have to be taken about the scale of the tax switch, and about the following other aspects:

(a) whether the benefits to the company sector (NI contributions and stock relief) should exactly match the costs to the personal sector, and if so whether they should be equated in revenue or PSBR terms;

(b) the balance between the NI surcharge and basic employers' contributions in the company package;

(c) the mix of changes in basic rate, higher rate, allowances and thresholds, and employees' NI contributions.

The stock relief proposals cost about £300 million in 1981-82. They could thus be combined with either a 2½% points reduction in NIS, costing about £1.7 billion, and a £2 billion increase in personal sector taxation (about 2¼% increase in basic rate, or an increase in allowances and thresholds 12% points less than full revalorisation); or abolition of NIS and reduction in other employers' contributions of about £1.3 billion, and a £4 billion increase in personal sector taxation; or any other scale. Where quantitative effects are given below they refer to these small or large packages as specified.

It might be desirable, although it would be administratively difficult (perhaps impossible in the first year or so) to concentrate the reduction in employers' contributions on the manufacturing sector, or perhaps on a slightly wider grouping designed to include some of the non-manufacturing traded goods (and services) sectors. If it was concentrated on manufacturing a £2 billion switch might permit the abolition of NIS for manufacturing firms, and the reduction of their other employers' contributions by about £1 billion.

Presentation

The medium term financial strategy does not contain any commitment to a particular structure of taxes, and so the tax switch is broadly consistent with it. However, it conflicts with the objective of reducing the burden of personal taxation. This could be justified as being a temporary expedient, necessitated by the unplanned and unexpectedly, big squeeze on trading companies caused by the exchange rate. There would therefore be an implicit commitment to reverse the situation

within a few years. However, the tax switch would improve interest rates, another objective.

Economic effects

The main impact of the tax switch is on the sectoral distribution of income in the short run and interest rates. Aggregate output and prices are not much affected, although, to the extent that they are, the effects are beneficial.

Output may rise slightly (perhaps by as much as ½% with the large package), because the beneficial competitiveness and domestic supply effects from reducing the payroll tax probably outweigh the reduction in demand from lower real personal incomes. The improvement in output will disappear over time.

The RPI may be marginally lower, but probably not by more than ½% even with the large package. The downward pressure from lower costs and interest rates is offset by upward pressure from wages which respond to increased personal taxation and lower employment costs. With unchanged money supply any change in the RPI will also disappear over time.

The size of the ex post shift in income distribution from persons to companies depends on how quickly the impact of the tax changes is dissipated through wage and price adjustments. Despite their difficult financial position companies are likely to begin passing some of the tax cuts forwards into prices and backwards into wages during the first year. Similarly the effects

of higher personal taxes are likely to lead to higher earnings within a year. A rough rule of thumb is that non-North Sea company disposable income improves by about half the size of the package in the first year, and by virtually nothing in succeeding years. Company net acquisition of financial assets might improve by less, mainly because of a recovery of stockbuilding, and personal sector income might deteriorate by about the same amount. Thus the large package might improve company income by about £2 billion in 1981-82, and the small package by £1 billion.

Interest rates might be expected to ease, despite little or no change in the PSBR. This would follow from a reduction in bank borrowing. The personal sector tends to borrow less when disposable income falls, while the company sector would not be expected to borrow more given the existing high level of borrowing. A lower level of bank borrowing would reduce the pressure on banks' balance sheets, and hence their need to bid for funds in the short-term money markets. The large package might produce falls in short rates of 2-2½ percentage points in the first year or two (beginning with the announcement of the measures rather than their implementation), and the small package falls of 1-1½ percentage points.

Little significant change in the exchange rate should be expected There will be downward pressure from lower interest rates and upward pressure from possibly higher output. On balance the rate might be

lower, perhaps by ½-1% with the large package. Labour cost competitiveness will, of course, be significantly better, by 3-4% with the large package in the first year (but much less thereafter), because of the reduction in employers' contributions.

If the reduction in employers' contributions were concentrated on manufacturing the improvement in output might be somewhat more marked, because of the non-linear effects of better competitiveness and company disposable income when profits are subject to a severe squeeze. The distribution of disposable income within the company sector would also be different, of course, and this could lead to a greater fall in interest rates than if the employers' contributions were spread evenly.

ANNEX D

WAGE FREEZE

Modalities

The wage freeze would be imposed with immediate effect, and would last a whole year. There would be no controls over prices or dividends. Many decisions would have to be taken about the details, and about what guidances or institutional arrangements should succeed it. The main issues include:

(a) where exactly should the line for the beginning of the freeze be drawn (eg should groups with agreed settlements, but with a delay in implementation, be allowed to go ahead)?

(b) what, if anything, should be done about normal annual increments?

(c) can anything be done to prevent some wage drift, associated with regrading jobs, productivity agreements, payment-by-results, cheating, etc?

(d) should an announcement be made at the beginning about the institutional arrangements (defined broadly to include free collective bargaining) which the Government hope will succeed the freeze?

(e) if so, what should it say?

Presentation

A wage freeze can easily be presented as being consistent with the medium term financial strategy. Its purpose is to redistribute income from persons to companies in the short term to help compensat for the high exchange rate, speed up the reduction in inflation that will anyway occur, and reduce the transitional loss of output and employment. It is more difficult to meet criticism that it represents the abandonment of the commitment to liberate markets. The justification would have to be twofold.

First, market forces have been slow to adjust to the new liberal regime. The adjustment mechanisms of the labour market in particular, after decades of intervention and protection from some of the harsher realities, are very rusty and are operating only rather slowly. In time they will gain in efficiency, but that might be too long to avoid considerable further loss of output and employment. The wage freeze provides a short cut, without significantly damaging long term market forces. [This line would have to be accompanied by a commitment to re-establish the market at the end of the freeze.]

Secondly, the transitional loss of output and employment associated with reducing inflation has been augmented by the unplanned and unexplained part of the rise in the exchange rate. There is therefore a greater strain on the traded goods sector than was intended, and policy must be adjusted to alleviate it. A wage freeze without price controls will initially bring about a large transfer of income from persons to companies. This will be partly reversed after the end of the freeze, but by then the beneficial competitiveness, real wealth and interest rate effects will be having a substantial effect on output and profits.

As a defensive point, the substantial loss of real wages implied by the freeze (at the end of 1981 5-8% below the forecast level which itself is lower than at the end of 1980) might be presented as the price to be paid for higher output and employment from 1982 onwards.

Economic effects

The medium term effects depend crucially on what happens to nominal wages at the end of the freeze. There will presumably be some bounceback, so that real wages move up to and perhaps beyond the level they would have been at (beyond if workers manage to restore the cumulative loss of real income during the freeze). While real wages are unlikely to remain at the level they reach at the end of the freeze, nor would one expect them to overshoot so as to restore the full cumulative loss within the first year or so.

There is a temporary fall in output because of the reduction in personal disposable income. It will probably not last very long (a year or so) and might not exceed ½%. After that higher output than would otherwise occur might be expected, stimulated by:

(a) the improvement in competitiveness;

(b) lower interest rates;

(c) higher real wealth, and

(d) possibly higher real personal disposable incomes (depending on the degree of bounceback of nominal earnings).

In two or three years' time, the stock of unemployment might be lower than without the wage freeze.

The speed at which prices come down depends on how quickly companies choose to pass on the reduction in their costs. This might be slower than in more normal times, because they could take the opportunity to improve their profits and cash flow, but it might be faster because the sheer size of the fall in costs (relative to forecast) means that they only have to hold back a small part. By the end of 1981 the fall in prices might be about half of the fall in costs (both relative to base). Beyond 1981 the rise in prices will depend on what sort of wages bounce-back occurs. The rate of inflation is likely to be higher for a few years than it would have been. It could therefore rise from, say, 5-8% for the year to 1981 Q4 to 10-15% for the year to 1982 Q4. However it would probably not be so high as to raise the price level above the base. Indeed, if the cumulative loss of real wages is not fully restored, the price level might remain lower than in the base for a number of years although eventually it will tend to the same level, with given monetary growth.

The transfer of income to companies in 1981 could be large, perhaps as much as £2½-3½ billion. Much of this would disappear in 1982 and beyond, although the higher level of output and competitiveness would produce a continuing net improvement in company finances for a number of years. By contrast real wages would fall, by perhaps 5-8% at the maximum at the end of 1981. The level of real wages could be expected to recover quickly, and perhaps overshoot temporarily.

The reduction in the price level and the improvement in the company financial position will put downward pressure on interest rates, for given monetary growth. Assuming that financial markets anticipate the bounceback of nominal earnings after the freeze, short term interest rates might fall by 1-2% points in the first year or so. After that the fall in the PSBR resulting from higher output, lower prices and lower debt interest payments puts added downward pressure on interest rates, so that the fall (relative to base) after 3-4 years may be larger still.

Competitiveness improves considerably in the first year or two, mainly because of the lower earnings and prices rather than because of a lower nominal exchange rate. The exchange rate is subject to conflicting pressures: in a downward direction from capital account and, after the first year or so, the pressure of demand, and in an upward direction from the effects of lower prices and costs on the current account. The resulting movement may not be large.

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Tue 6
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Wolfson

PSF 11.11.80

10 November 1980

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Policy Options

The Prime Minister has read the memorandum prepared by Sir Douglas Wass which you enclosed with your letter of 7 November. She would like to discuss the memorandum with the Chancellor and with Sir Douglas, and we are trying to fix up a meeting for the middle of this week. The Prime Minister's preliminary view is that options (iii), (iv), (v) and (vi) are non-starters: in her view, the long-term damage that they would cause would be too great.

T. P. LANKESTER

A.J. Wiggins, Esq.,
HM Treasury.

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