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MR.McMAHON

Copies to: Mr.Fforde
Mr.Walker
Mr.Goodhart

THE CHANCELLOR'S MEETING WITH
OUTSIDE ECONOMISTS ON 5TH OCTOBER

This record was sent to me on a personal basis, but since the Governor and JSFf were at the meeting, it would seem odd to refrain from sending a number of copies.

Please protect my source.

JCRD

29th October 1979.
J.C.R.D.

CWM 29/10

SIR F. ATKINSON

Ends 29.10.79

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Minister of State (C)
Minister of State (L)
PCC
MEG
Mr Evans
Mrs Lomax
Mr Riley
Mr Sedgwick
Mr Page
Mr Cardona
Mr Cropper
Mr Ridley

I attach a note of the meeting you held on 5 October to discuss the medium term financial plan. It is deliberately full, so that it can be used for reference. You may therefore find useful the following summary of the main points of agreement and non-agreement among the visitors.

2. A broad concensus was reached on the following points:

(a) There should be a medium term financial plan, comprising annual targets for £M3 growth in each of the next five years, and tax and expenditure plans.

All agreed.

(b) The monetary targets should decline gradually, and not necessarily reach anything that suggested zero inflation after five years.

All agreed except Minford.

(c) The plan should not include targets for the PSBR

All agreed except Congdon.

(d) Tax and expenditure plans would have to be such as to bring about a secular reduction in the PSBR, and they should be consistent with the monetary targets.

cwsm 29/10

3. A consensus did not emerge on the following points:

(a) How to define the declining monetary targets.

Pepper favoured ranges, Congdon suggested single points in the later years, and Burns and Flemming suggested a level for the stock after five years with some flexibility about how it was reached.

(b) How much detail the projections accompanying the plan should show.

Budd, Burns and Flemming wanted a lot of detail including a PSBR forecast, Griffiths in one intervention appeared to take the same view but his final comment was against, and Pepper opposed showing projections based on the Treasury model.

John O-S.

J ODLING-SMEE
12 October 1979

Note of a meeting held at 3.30pm on 5 October in the Chancellor of the Exchequer's office at H.M. Treasury

(The order in which remarks were made has been altered slightly for clarity and coherence. They have been kept in context.)

Chancellor of the Exchequer	Mr A Budd	Sir A Rawlinson
Financial Secretary	Professor T Burns	Sir L Airey
Governor of the Bank of England	Mr T Congdon	Sir F Atkinson
Mr Fforde	Mr J S Flemming	Mr Bridgeman
Mr I Stewart	Professor B Griffiths	Mr Cassell
Mr Cropper	Professor P Minford	Mr Middleton
Mr Ridley	Mr G Pepper	Mr Unwin
Mr Page	Mr R A W Rudd	Mr Odling-Smee

MEDIUM TERM FINANCIAL PLAN

The Chancellor welcomed the visitors. He explained that the meeting was part of the process of sounding out informed opinion on important issues. It was an ad hoc gathering and not a permanent group of advisers. The discussion should be of the seminar type and the details should not be made public. It was not an occasion on which decisions would be taken.

Purpose and desirability of a plan

2. There was general agreement among the visitors that a medium term financial plan was desirable. It would lend credibility to the government's counter-inflation policy, it would have favourable effects on inflation expectations and it would re-assure the private sector that the government did not intend to relax fiscal policy just because the PSBR fell (as in 1977-78), that is, it was a bulwark against fine-tuning. If there were financial targets for only one year ahead there was no assurance that inflation would be reduced in the long run. Yet long run inflation expectations were what mattered to financial markets.

3. Mr Flemming and Professor Burns said that if the plan was to be credible policies for taxation and expenditure would have to be seen to be consistent with the monetary targets, without excessively high interest rates or other distortions to the financial system. This was generally agreed.

4. Sir Fred Atkinson said that he was against a medium term financial plan. The additional credibility which having quantified targets rather than just a generalised commitment to reduce monetary growth produced was a small gain compared with the loss of freedom of manoeuvre. The publication of the plan would cause very little impact, except perhaps in financial markets, certainly not in the country as a whole and especially not in labour markets. On the other hand, the government might come to regret being committed to precise numbers. For example, wages might sometimes grow rapidly, which would require a restrictive fiscal policy to keep within the financial targets and could hence cause a severe recession. Without the published financial plan, the government could shift the emphasis slightly, and, without going anywhere near complete accommodation of the faster growth of wages, avoid excessive reduction in output.

5. The Chancellor said that he recognised that inflation expectations in labour markets might not be much affected by the publication of a plan. Labour markets had shown little response to the traditional arguments about high wage increases causing inflation and unemployment, and "one man's wage increase, another man's price increase", so why should they to monetary targets? Professor Griffiths said that it was quite likely that the plan would have very little effect on expectations when it was first published. Other governments had said that they would control inflation, but had failed, and so there was a credibility gap to overcome. The government could do this only gradually, by sticking to its financial targets, even in the face of adverse changes, such as a rise in unemployment, a fall in the exchange rate or bankruptcies.

6. Mr Budd said that the policy of accommodating high wage increases was exactly what had gone wrong in the past. Professor Minford agreed, but argued that high wage increases would anyway not occur. The growth of wages was determined by inflation expectations; empirical work could not find any spontaneous element in wages growth. Mr Flemming commented that the residual variance which was observed in all wage equations was the spontaneous element.

7. Sir Lawrence Airey said that he doubted whether wage bargainers paid any attention to monetary targets beyond the present year. Perhaps irrationally each group assumed that they would be able to increase their relative incomes the harder they bargained. The Chancellor said that the impact of declining monetary targets was certainly blunted if people thought that it was always other people who would suffer from them. Professor Minford said that wage bargainers were especially influenced by the state of their own industry, and financial targets would certainly squeeze output and profits at the industry level. Sir Lawrence Airey said that there was no equivalent discipline in the public sector. Professor Griffiths said that cash limits had a role to play. Professor Minford said that PSBR targets would also help.

8. The Chancellor asked why a medium term financial plan had not been published before, either in the UK or elsewhere. Mr Budd said that under fixed exchange rates there was no need for monetary targets, since money supply could not be controlled and inflation was largely determined abroad. They had only become important with floating exchange rates and the high inflation rates of the 1970's. Mr Congdon said that the UK was unique in that there was a long tradition of looking at the links between public sector borrowing and money supply. The association was not so clear in other countries, and so they were not so concerned to establish the consistency of fiscal and monetary policies.

Monetary targets

9. The Chancellor invited the visitors to comment on the form that the monetary targets should take. Should there, for example, be targets for monetary growth for each of the next five years, or only for the last year? There was general agreement among the visitors that there should be targets for individual years, not just for the final year. Inflation psychology was such that people would not believe that the policy was sustainable and credible without year by year targets.

10. Professor Minford said that the target for monetary growth after five years should be consistent with zero inflation. This was the only way to make a significant impact on inflation expectations. It was an illusion that one could keep options open by setting a more modest target: if expectations were not shifted.

all options would be closed. The Chancellor said that, although he recognised that the government would have to show its determination to stick to its targets if it was to bridge the credibility gap, the gap would be too wide to bridge if there was a zero end-point. Mr Rudd said that it was better to set a modest target and achieve it than an ambitious one and fail. Mr Flemming said that he too would proceed cautiously so as to develop credibility gradually. Once credibility had been built up, after the first year or two, there would be greater scope for flexibility of policy (contrary to what Sir Fred had said) because of increased confidence in financial markets. Professor Minford said that there was a tendency to make unnecessarily cautious assessments of what was politically feasible: high interest rates such as we now have were once said to be infeasible.

11. Mr Pepper also supported a gradual reduction in monetary targets. He would put ranges round them. In both these ways the risk that the financial system would be put under intolerable pressure would be minimised. He also recommended avoidance of excessively slow monetary growth, as occurred in 1974-75 and contributed to the bankruptcies at that time. Professor Griffiths and Professor Burns agreed that monetary growth had been too slow in 1974-75. Mr Cassell said that this was not obviously so, taking a longer period, say, 1972-75. Mr Flemming said that it was more appropriate to consider a longer period (eg. five years rather than two).

12. There was some discussion about what was meant by not putting the financial system under pressure. Mr Fforde and Mr Middleton suggested that it meant avoiding bankruptcies in industry as well as the financial sector, and therefore it was similar to Sir Fred's worry about sticking to a tight monetary policy in the face of rising costs. The Chancellor said that there might be little difference between the problems identified by Sir Fred and Mr Pepper, but there was a considerable distinction between the solutions proposed: in one case not making any commitment to targets at all, and in the other having targets which permitted gradualism and some flexibility. Mr Congdon said that he was as opposed to accommodating the financial system as he was to accommodating wages.

13. Mr Congdon said that if the monetary targets were expressed in the form of ranges throughout the five year period, successive ranges would overlap. It would be possible for monetary growth to rise between two years, which would cause confusion. It would be better to express the targets as single points in the later years. Another problem was the level of the target in the final year. If it was to be consistent with 5% inflation after five years, monetary growth would have to be lower than 5% before five years, because of the upward trend in velocity and the lags between monetary growth and inflation. Professor Burns said that the upward trend in velocity could be ignored because it had in the past been roughly offset by real output growth, but the point about lags remained. Professor Minford said that anyway velocity might not rise, and might even fall, because of the falling interest rates associated with falling inflation expectations.

14. Professor Burns asked whether one was aiming for a level of money stock at the end of the period, or for a rate of growth. He would prefer a level, because then one was excluding base drift on average, and yet there was some flexibility about the width of the range in earlier years. Mr Flemming said that this formula could be generalised to allow some base drift, the permissible cumulative amount of which would have to be specified. As the five year plan would presumably be rolled forward every year, there was some flexibility at the end of the period.

15. Mr Pepper was against specifying levels because he preferred the flexibility provided by ranges for growth rates. He envisaged a series of target ranges something like 7-11%, 6-10%, 5-8%, 4-7%, 3-5%. In setting it, a judgement would have to be made about what the financial system could stand. The Governor asked how he knew that 3-5% in the final year would not over-strain the financial system. Mr Pepper said it was probably the lowest that was compatible with a change in real monetary growth that avoided a financial crisis (ie. a series of bankruptcies).

16. The Chancellor asked for views on which monetary aggregate should feature in the plan. Mr Cassell said that it was desirable to avoid distorting the financial system by controlling a particular aggregate. Mr Budd and Professor Minford said that such distortions were the consequence of inconsistencies between monetary and fiscal policy. Professor Griffiths said that the present system of direct controls on credit caused distortions and such controls should be abolished. Professor Burns said that one should keep an eye on all the monetary aggregates: if they were growing at very different rates, something was wrong somewhere. Mr Congdon said that the target should be expressed in terms of only one aggregate, and that £M3 was the best because of its relationship with public sector borrowing. Mr Pepper also supported £M3. He said that it was possible to understand and allow for the distortions to £M3.

PSBR targets

17. The Chancellor invited comments on whether the medium term financial plan should include PSBR targets. Mr Budd drew the distinction between having PSBR targets which the government tried to meet by adjusting tax and expenditure policy, and providing a forecast of the PSBR over the medium term to show that fiscal policy was consistent with the monetary targets, and hence to add credibility to the latter. Most of the visitors were against PSBR targets but in favour of forecasts.

18. Mr Flemming said that, as the PSBR was a function of output, any attempt to adjust policy in order to achieve a PSBR target was similar to adjusting policy to achieve an output target, and hence subject to the same objection about Keynesianism and the problems of forecasting that were raised against fine-tuning output. Mr Budd said that what was important for the credibility of the monetary targets was the structure of fiscal policy, that is the expenditure plans and tax rates, not the particular PSBR that they imply which is dependent on output. Professor Griffiths said that the danger of the medium term financial plan is that it would be discussed as the monetary version of the National Plan. This danger would be reduced if there were neither PSBR nor output targets. Mr Pepper said that there should not be PSBR targets because the government could not control the PSBR.

19. Mr Congdon was in favour of declining PSBR targets. They were necessary in order to ensure that declining monetary targets were achieved. The PSBR could be controlled by the government.

20. Although most of the visitors were against PSBR targets, they all argued that there would have to be a secular reduction in the PSBR. Professor Burns and Mr Budd said that the constant employment PSBR should decline. Any rise in the actual PSBR would just be because of the fall in the level of activity and the operation of the automatic stabilisers. Professor Minford said that if the PSBR did not decline and monetary growth did, interest rates would have to rise to very high levels and there would be crowding out. Mr Flemming said that there were further reasons why the PSBR should decline. The PSBR was higher now than it would be in a long run steady-state with a lower inflation rate and full employment. The reduction in inflation would lower debt interest payments, and the increase in the level of activity would raise revenue and reduce unemployment benefits, both of which would reduce the PSBR. Sir Fred Atkinson said that the Treasury believed that fiscal policy would have to be such as to bring about a secular reduction in the PSBR if declining monetary targets were to be achieved. But he did not want to set PSBR targets.

21. Mr Flemming said that allowing the automatic stabilisers to work did not mean that only the automatic stabilisers should operate. It was a separate question whether to change fiscal policy in a discretionary manner as well.

Material to Accompany the Plan

22. It was generally agreed among the visitors that expenditure and tax plans would have to be published in order to provide credibility to the monetary targets. Professor Burns said that he would be less enthusiastic about the financial plan as a whole if there were no such supporting material. A forecast of the PSBR might be included. If the government did not publish its own version other people, including the LBS, would publish theirs. Any inconsistencies between fiscal and monetary policy

that were revealed would reduce the credibility of the plan. Mr Flemming agreed, and said that the Public Expenditure White Paper already contained most of the relevant information: tax and expenditure projections, and a GDP forecast implicit in these.

23. The Chancellor said that it was agreed that the Plan should consist of monetary targets and tax and expenditure plans. Should there also be PSBR forecasts? There was a problem in that unsophisticated people in the City thought that the PSBR had to decline year by year if monetary growth was to decline. And yet forecasts of the PSBR might occasionally show an increase between two successive years. Would it be bad for credibility to publish such forecasts?

24. Mr Budd said that he thought that people would be able to understand the effect of automatic stabilisers on the PSBR. A rise in the PSBR resulting from a fall in activity can still be financed within the monetary targets. Professor Burns said that offsetting changes in bank lending, sales of gilts and other counterparts would occur. Mr Pepper said that it would be better to show the public sector deficit rather than the PSBR because it was less distorted by sales of assets and other financial transactions.

25. Mr Rudd said that it was necessary to think about the "unsophisticated" people in labour markets and elsewhere as well as those in the City. They could only absorb a simple message, and his view was that it should comprise just the declining monetary targets. Detailed supporting material and forecasts could also be provided for the experts. Sir Anthony Rawlinson agreed that the message had to be simple, and he wondered whether it was possible to publish even monetary targets let alone PSBR targets without excessive qualification. The Chancellor said that the problem was one of finding acceptable concepts which were simple enough to be intelligible to everyone, and yet conveyed enough information about policy to be more convincing than the usual politicians' promises.

26. Professor Griffiths said that the answer was to have a very simple Plan, but to publish it with a technical appendix. Mr Flemming said that the technical appendix was very important. By explaining some of the problems which might arise in future, such as a rising PSBR in a recession, at the beginning it would create more confidence than if nothing was said until they happened.

27. In drawing the meeting to a close the Chancellor asked the visitors if there was anything more that they would like to say. Mr Congdon said that the growth of revenue from North Sea oil should be used to reduce the PSBR. That way North Sea oil would not be frittered away. Mr Rudd repeated the importance of presenting a simple message and avoiding complications. Professor Minford said that it was important that government policy was seen to be consistent. Professor Griffiths said that it would be best to publish as little as possible: the more that was published, the more like the National Plan, and the more exposed the government were to criticism. Mr Pepper said that material based on the Treasury model should not be published, because people did not trust it. Mr Budd said that if the government published nothing, other people including the LBS would certainly make their own quantified assessments of the consistency of government policies. Professor Burns said that the credibility of policy and hence its impact on expectations depended on the publication of detailed projections.

28. The Chancellor thanked the visitors.