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PRIME MINISTER

MEDIUM TERM FINANCIAL STRATEGY

As I have mentioned to you on previous occasions, I have been considering whether it would be possible to present our monetary and financial strategy for the medium-term in a manner and context that would strengthen its credibility and help to demonstrate what we have been saying so often - that by sticking to our monetary and fiscal intentions we shall be able in the longer term to achieve a lasting reduction in inflation and the conditions necessary for resumption of sustainable growth.

2. My thorough discussions with officials in the Treasury and with outside economists and commentators have convinced me that there would be advantage in setting out our strategy in quantified form in the Budget. There is, of course, widespread expectation among economic commentators that we shall do so. This is not itself a sufficient reason for proceeding; but I fear that if we fail to do so it will be widely assumed that this is because the medium-term numbers do not add up and that prospects are worse than in fact is the case.

3. My main doubts have centered on whether, on the evidence available, we could present a fiscal picture that would be thought credible and consistent with our monetary objectives. As you know, it was my concern about this that led me, with your support, to urge before Christmas that we should look again at the public expenditure plans both for next year and the later years.

/4. We have now

4. We have now constructed projections for the medium-term on the basis of the revised public expenditure plans and other more recent developments. Although the situation in the next two years is still likely to be extremely tight, the prospect thereafter - as we feel the full benefit of higher North Sea oil revenue - is a good deal easier and offers the prospect of substantial fiscal relaxation.

5. Although, therefore, there are still great uncertainties, and any figures we present would need to be heavily qualified as being no more than illustrative, I believe it would be possible to present a picture for the medium-term which hangs consistently together and fully supports our monetary objectives. Accordingly, what I would propose is that our strategy should be presented in the medium-term section of the Financial Statement and Budget Report, after ... the usual section on the short-term forecast. I attach a draft "mock-up" of what I envisage it might look like. (The figures are provisional; those published would need to take account of the Budget decisions).

6. As you will see, the draft seeks to concentrate attention on the money supply in the medium term - which is in any case the only period over which we can credibly control it - and makes it absolutely clear that fiscal and other policies will be subordinated to its achievement. There is no explicit commitment or assumption about the rate of inflation or the particular path of interest rates, but it is made clear that, though the timing is necessarily uncertain, we would expect inflation to fall until it is roughly in line with the monetary target; and that the PSBR path described would be consistent with a progressive reduction in nominal interest rates and a better environment for investment.

/Above all

Above all, the crucial point is made - and this has been the corner stone of our economic strategy since we took office - that if the economy develops in a way different from that illustrated, fiscal policy, and not the money supply objective, would be reassessed.

7. The PSBR projections for the medium term are set out in Table V, and start with the expenditure figures as we have recently agreed them. You will see that they also contain what we have called a "fiscal adjustment". This is the adjustment necessary to reach the PSBR that seems consistent with the target for the money supply and lower interest rates, and the figures imply that, although the budgetary position is likely to be tight in the next two years, there could be scope for substantial tax reductions in the last 2 years. The implication is, of course, that it should be possible to go a long way towards the achievement of our 25 per cent basic tax rate objective in the life of this Parliament. But I think it would be a mistake to be too precise or committal on particular fiscal priorities at this stage. The key point is that, although the projections must remain illustrative and subject to margins of error, they do, on the basis of the lower public expenditure plans we now have, show a credible path in the medium-term towards our monetary, inflation, and taxation objectives.

8. I should welcome an early opportunity to discuss these proposals with you. There are, of course, risks in exposing figures that could be invalidated if the economy develops in a way significantly different from that which now seems likely. But even if we do not publish them in this form, most of them are likely to emerge in one way or another anyway, if only under pressure from the new Treasury Committee who have been severely critical of the thinness of last November's

/public expenditure

public expenditure White Paper, and will be looking for a substantial analysis of the medium-term economic outlook in the second White Paper or in the Budget.

9. If this is so, we run the risk of making available figures for everything except the one policy to which we wish to be committed - a progressive reduction in monetary growth and the PSBR. Far better to take the initiative and to take credit for demonstrating in a credible way how we propose to achieve these objectives. Moreover, I think there is a good deal of force in the argument that by displaying a credible strategy for the medium-term we shall be better able in the Budget to ride out the immediate problems of high monetary growth and interest rates which, whatever course we follow, are still likely to take some time to bring under control.

G.H.

(G.H.)

20 February, 1980

CONFIDENTIAL

MEDIUM-TERM FINANCIAL STRATEGY

Objectives and Instruments

1. 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 (£M3) to about 6 per cent in 1983-84, and will pursue the policies necessary to achieve this aim. The Government intend to control the growth of the money supply in order to achieve the following path for the total money stock (£M3):

TABLE I

PATH FOR GROWTH OF THE MONEY STOCK

	1979-80	1980-81	1981-82	1982-83	1983-84
£M3: end-year nominal level (£ billion)	[58½	63	68	73	77½]
percentage change in year	[12½	7½	8	7	6]

This path is consistent with the annual growth of money supply being reduced by 1 per centage point a year after 1980-81.

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.

Public Expenditure

5. A key element in this strategy is a reduction in public expenditure. The plans announced in the recent public expenditure White Paper (Cmnd   ) show a reduction of about 4 per cent in the volume of public expenditure between 1979-80 and 1983-84 and imply a fall in expenditure as a proportion to GDP from [42] per cent to [   ] 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
Total 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

Revenue in the Medium-Term

6. 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 inflation.

7. Since 1973 GDP growth in the major OECD countries and the growth rate of trade in manufactures have both roughly halved (see Table III). 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 productiviy 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.

8. 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.

9. In the light of all these considerations it is only realistic to expect that the average growth rate of the economy over the next few years will be less than the 1 per cent a year recorded between 1973 and 1979. In the illustrative projections in Tables III-V an average growth rate of [1] per cent a year is assumed for the years after 1980, giving an average of [ ] per cent for the period 1979-83.

TABLE III

WORLD AND UK GROWTH RATES

(Annual average per cent)

	1964-73	1973-78	1978-80	1980-83
World Trade in manufactures	10.1	5.7	5.5	5
Growth of GDP*				
OECD	5.2	2.6	2	3½
United Kingdom	3.0	1.0	-1	1

/ Weighted by UK markets

* Weighted average of OECD countries, excluding UK

10. The implications for government revenues of this illustrative growth rate are shown in Table IV. Revenue is projected on the conventional assumption of constant index 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

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

12. 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 rate of GDP, present public expenditure plans and the assumptions about the tax structure described in paragraph 10 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 AND MONETARY GROWTH

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)
£M3 (end-year nominal level)	52	58½	63	68	73	77½
(percentage change)		12½	7½	8	7	6

13. 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 1973-78 there should be scope for tax reductions in the later years.

14. The final row of Table V shows the target path for £M3 (as in Table I). The path for the PSBR set out there 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

15. 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.

16. To maintain the target growth of money supply 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 deceleration, there would be no question of relaxing the money supply policy. Other policies, especialy fiscal instruments, would have to be tightened in order to keep the money supply on target. The monetary targets are the centrepiece of economic policy, and the Government will adjust other policies to the extent necessary to ensure that they are met.