SECRET AND PERSONAL

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CHANCELLOR

cc Chief Secretary
Financial Secretary
Sir D Wass
Sir K Couzens
Mr Ryrie
Mr Burns
Mr Middleton

POLICY OPTIONS

I agreed with the general drift of your discussion at No 11 on 11 November, and support the idea of an early reduction in MLR. However the reasons which how lead me to do so are perhaps worth recording, even though I have not had the opportunity to put them down very succinctly.

2. Douglas Wass's cover note suggests (para 3 of his Guy Fawkes' day minute) we need to begin by establishing the problems to be resolved. I would suggest that there are two. Present conditions threaten to make dangerous nonsense of the Government's commitment to controlling the money supply, and in the near future at that; and looking further ahead they pose an equally serious threat to the MTFS. There are, of course, plenty of other difficulties in the economy which are crying out for resolution. But they are of secondary interest at the moment.

3. Douglas asks (para 5) whether present policy is too severe, given the objectives set and the costs entailed. My answer is, unequivocally, "yes". I suspect that, had we been armed with a plausible and up-to-date medium-term assessment, his might have been too. He suggests (para 6) that business conditions, as they have evolved this year, are not significantly more serious than we expected them to be at the time the MTFS was set. That may be so in terms of trade and consumer's expenditure, but surely not in other respects. For example,

- the real exchange rate is way above the projected level;

- the company sector deficit is worse than anticipated;

- the growth of Bank lending to the corporate sector has

been far greater this year than was forecast by earlier NIFs and, it would seem, than our expert friends in the Banks (eg H Rose) foresaw;

- the opportunities available to Government to relieve industry's problems have, at the same time, diminished.

4. The political pressures associated with present policies and circumstances and a prolongation of both are going to get much greater. I am not referring to Sir T Beckett and the more emotional part of the CBI, but to a growing body of quiet and responsible critics. This observation proves nothing of itself. But if the policy is threatened with unviability in any case, then it matters a great deal.

Interest Rates and Monetary Control

5. I have been worried for some time that we have been underestimating the significance of the "distress borrowing" phenomenon. For a long time I felt, however, that this would be basically a short-term influence and that the restraining effect of high interest rates on the demand for credit, would win out after an acceptable time lag (eg by now). This no longer seems plausible, and my presumption is that such a restraining influence is unlikely to offset the growth of distress borrowing in a remotely acceptable timescale in present conditions.

6. I believe that circumstantial support for this view comes from the errors of successive NIF forecasts of company borrowing. If, as I gather from Mr Riley, these have underestimated company borrowing by "several billion pounds", then behaviour is clearly changing, and one or two things must be happening:

(a) interest rates are having less restraining influence than the traditional NIF equations suggest they used to;

(b) some other influences on the demand for credit are more influential than the equations recorded them as being; and/or new influences are coming into play. The "distress" phenomenon is the obvious candidate.

7. I gather that the forecasters have, understandably, been searching for statistical relationships which "explain" the recent behaviour of company borrowing more satisfactorily. Their latest equations succeed in doing this and, moreover, suggest that the interest rate remains a dominant influence in restraining the growth of credit. However my impression is that the new equations cannot be taken at face value, and may be compatible with the hypothesis that distress borrowing or other related influences have become much more important. This note being no place for the exposition of technicalities, the important point to stress is that the equations (both old and new) in the model may be misleading.

8. Looked at in a more abstract way, there is no general reason to believe that normal borrowing behaviour and sensitivity to interest rates should prevail today. The crucial issue is simple. In conditions of respectable profitability, buoyant demand, and relatively high stock levels, it is fairly evident that the bulk of firms can respond to the rising cost of interest payments by a variety of different means - cutting stocks, overheads, unprofitable product lines and so on. The more difficult conditions get, the less the room for manoeuvre left, and the more likely that desperate firms will borrow to pay interest or, when that is no longer possible, go out of business completely. It follows from such an analysis that one would predict an increasingly important degree of interest-insensitivity in companies as a whole as general economic conditions deteriorate and, beyond a certain degree of economic misery, the markedly perverse relationships postulated earlier. Such thinking seems to be implicit in Mr Burns' observation at your 11 November meeting to the effect that yet higher interest rates would be unlikely to lead to a reduction in company borrowing below what it might otherwise be.

9. This line of reasoning has obvious implications for your chances of achieving the £M_3 targets at acceptable cost. We may suspect that the continuation of a high MLR in recent months has recently added, on balance, to Bank lending to industry and money supply growth. More important, to continue with a high MLR - let alone increase it, would make the £M_3 path

worse still than might otherwise be expected, and this would render the policy of monetary control incredible before very long. The abnormal behaviour of the economy in extreme conditions puts us in a vicious circle as long as we cling to orthodoxy. Moreover an early move towards a more automatic interest-rate generating mechanism (which I strongly favour) would not help matters either, unless the trend level of interest rates has fallen substantially by the time it takes place.

10. It may, of course, be the case that it is impossible by any means now available to get back to within an acceptable distance of the MTFS limits for £M_3. However, as I have argued to you and others before, we should not underestimate a second influence which could come to our aid before long if interest rates fell, in the form of a revival of the capital and debenture markets. The argument is in danger of becoming old hat, but familiarity should not be allowed to breed contempt. In 1975 industrial and commercial companies raised about £1¼ bn (over a third of their cash requirement) from the market and borrowed merely £500 m from the banks. The calculation at the foot of Table 1, which analyses the pattern of company borrowing since 1963, suggests that a repetition of the 1975 pattern could mean that the markets providing companies with some £2¼ bn of their cash requirements in 1981. If that was a total substitute for bank lending, the initial effect would be to reduce £M_3 by some 3½%. This kind of recourse to the capital market cannot be counted on, as para 12 of Annex A of the Guy Fawkes papers points out. But that is no ground for ruling the possibility out of court. Some such revival has occurred regularly, if not spectacularly, in each recession, most notably in 1966 and 1971 as well as 1975.

11. The phenomenon of switching borrowing partly away from the Banks to the capital markets is not captured explicitly by the forecasting relationships in the model. While it may be in some measure implicitly, I remain to be convinced that it does so adequately. That is one more ground for a certain scepticism about the conclusions suggested by this part of the model.

The Exchange Rate and the MTFS

12. If one is looking for reasons why the corporate sector should find themselves so wedged-in that they cannot cut their borrowing in response to interest rates, the extreme and unanticipated pressure of the high exchange rate is obviously a major part of the story - not only through its direct influence on the trading sector but, equally important, through the trading sector's impact on domestic suppliers. But there are other aspects to the high real exchange rate which are more worrying. This is well illustrated by the rule of thumb in Douglas Wass's para 7, which suggests that a 10% appreciation of the real exchange rate (and we are currently at 78 on the index of real competitiveness, about 10% above the 71 which was embodied in the MTA projection earlier in the year) takes about £6 bn away from trading companies' income, gives £4 bn to persons and about £2 bn to other companies.

13. The first striking point is that this £4 bn is roughly equivalent to the fiscal adjustment in the terminal year of the MTFS. I read the position as being that, even if output and the PSBR were to proceed henceforward exactly as projected in the MTFS, then there would be no scope in 1983/4 for the adjustment to be given away in tax cuts to persons (or anyone else for that matter). As individuals we are now enjoying the MTFS adjustment through the route of favourable terms of trade and lower inflation.

14. Unfortunately it is not likely that the MTFS output path can be achieved if the real rate remains at anything like the present level. It is not clear by how much GDP would fall short, and hence there would be a further shortfall of revenue addition to the £4 bn in persons' hands which has already been referred to. Para 12 of Annex B suggests a 10% depreciation would add to GDP by 1-2% after two years. On that basis I should imagine, ceteris paribus, that a 10% appreciation in real terms sustained above the real exchange rate assumed in the MTFS would knock 2-3% off GDP after 3-4 years. That would depress receipts of revenue still further, quite apart from implying higher levels of social security and other expenditure.

15. But, as para 12 of Annex B rightly observes, the estimate just quoted of the effect of a 10% depreciation takes no account of the special features of our present predicament.

"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 that 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."

What the Annex says, correctly, about unemployment rests, of course, on a comparable deeper judgement about the response of output to competitiveness. It must be doubted whether the equations used in the model are appropriate to present conditions of an extreme loss of competitiveness for which, as Mr Burns pointed out, we can find no parallel in economic history. For the bulk of internationally trading firms in normal circumstances in the past, a modest change in competitiveness of, say, 5% in relation to what they were used to led to a relatively marginal decision to sell more or less of their products. However a 10% deterioration in circumstances in which the bulk of firms are already making negligible profits provokes a much more dramatic choice between continuing at an even larger loss or abandoning a whole product line, or even liquidating. In such circumstances (well illustrated by BL and by what we know might happen if it had to close), one is then confronted by a variety of domino effects. Such reasoning suggests that the output response to a 10% change in the real exchange rate might well be much larger than the 1-2% over two years suggested by the model.

16. On this basis the fiscal side of the MTFS might be even more seriously at risk than the model-related speculation in para 12 above suggests. The high real exchange rate would thus exact a very high price indeed over the years in exchange for this year's £4 bn bonus on living standards and a lower rate of inflation.

Looking ahead

17. Looking immediately ahead the exchange rate problem reinforces the case for an early cut in interest rates. The two obstacles to so doing are, first, a move MBCwards, already referred to, and the fact that a lower MLR might be frustrated by high money market rates. There may be no way round that obstacle. But one imagines that it could equally well be the case that this obstacle may rise partly or wholly for "artificial" reasons, because of the present reserve asset requirements. If so, that is one more reason for getting rid of them quickly. [I imagine that the model could offer one useful guidance about the effects of so doing.]

18. In the longer term, the problem of the imbalance of resources can be solved by depreciation, the Burns-Middleton tax shift or some combination of the two. It being improbable that the depreciation route could achieve all that is required, one obviously has to look very actively for B-M-type measures. But I have no doubt myself that they must be second-best; above all, because they cannot match the impact of the high real exchange rate at all closely firm by firm, even if there is no problem about finding the resources.

19. Some, however, would tend to argue against the depreciation route on other grounds, principally the bad consequences for inflation of allowing a fall in the real value of the pound. This is a very misleading argument. If the present real exchange rate continues, the basic problem is the same in both cases, viz how to extract the recent £6 bn bonus from companies and above all persons and get it back into the pockets of the trading sector. The depreciation route uses the deterioration in the terms of trade, feeding through higher import prices and lower real p.d. income. It will only succeed in shifting those resources if persons do not try and offset the addition to prices and threat to their living standards. The B-M route would have to operate by raising taxes, direct or indirect, on persons (and the profitable companies). The conditions for success are very much the same. As p.3 of Annex C makes clear.

"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 forward 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."

B-M

On that assessment a/package is of very transient benefit indeed. All of which goes to show that it is desperately important to bring about a radical change in behaviour if any remedy to our present plight is to work. And if one won't work, the other probably won't either.

20. It is all rather reminiscent of the problem of a child who finds the box of chocolates he is to be given for Christmas days in advance and is caught eating them. It is extremely difficult to get him to give them up. There is much less left to give him on the great day, and little pleasurable surprise involved. To make matters worse, the parents are too poor in this case to buy him anything else!

AR

ADAM RIDLEY
13 November 1980

I have not yet circulated this to other recipients

TABLE 1

SHARES (%) OF MAJOR SOURCES OF INDUSTRIAL AND COMMERCIAL COMPANIES' FUNDS 1963-79

	Bank Borrowing	Ordinary Shares	Debentures	Shares & Debentures	Other*
1963-68	47	11	25.5	36.5	16.5
1969-73	58	9	11	20	22
1974-78	48	18	1	19	33
1979 (1st half)	63	4.5	-	4.5	32.5
1973	70	2	1	3	27
1974	71	2	-1	1	28
1975	14 (£482m)	30	6	36 (£1,235m)	50
1976	47	15	1	16	37
1977	55	14	-1	12	33
1978	54 (£4,913m)	16	1	14 (£759m)	32

* Mortgages, "other loans" (?leasing) and intra-company investment across the exchanges. The latter became a massive source of finance between 1974 and '79. Since the ending of exchange controls, however, there has been a net outflow.

SOURCE: ECONOMIC TRENDS SUPPLEMENT 1980 pp 174, 175

NB If total bank borrowing in 1980 by ICCs is now forecast at, circa, £8 bn; if companies could raise 30% from shares and debentures, that would raise about £2½ bn, which (ceteris paribus) would mean a commensurate reduction in £M_3.