176

COVERING: CONFIDENTIAL

Keep somewhere

MR. WIGGINS

c.c. Chief Secretary
Sir Douglas Wass
Mr. Ridley

Tim Lankester asked for some briefing for Sunday.

2. I attach a note on possible topics for discussion on both macro economic issues and supply side matters; the macro material is much fuller.

(TERRY BURNS)

11th July, 1980.

708/7

CONFIDENTIAL 177

CHEQUERS LUNCHEON FOR ACADEMIC ECONOMISTS

The possible topics for discussion fall into two categories:

(a) Macro-economic issues associated with the Government's monetary and financial strategy. These are probably the matters of greatest concern to Ball, Matthews, Minford and Griffiths.

(b) Supply side issues associated with public expenditure, technology, competition policy, and nationalised industries. These are probably the matters of greatest concern to Hague and Foster.

The issues are outlined in more detail below followed by a summary of the possible responses on macro-issues by the 'outside' invitees.

Macro-economic Issues

The major issue of macro-economic discussion will probably be the progress and prospects for the Government's monetary policy. This can usefully be divided as follows:

(i) Is the path for the monetary target set out in the Red Book the appropriate speed to attempt to reduce inflation? This confronts the differences between those advocating a sharp shock and those who wish to follow a more gradualist path.

(ii) Do we have the correct fiscal policy to achieve this monetary target? If the recession this year and next is deeper than was expected tax revenue will be less than planned and if spending plans are unchanged the PSBR will be higher than expected. Does this matter and would this point to a need for further spending cuts?

(iii) Is the present system of monetary control adequate? What has been the reception to the consultative document on monetary base control? Is there a need for more imagination in the type of debt sold by the government eg indexing?

/(iv)

CONFIDENTIAL

(iv) How rapidly will inflation be reduced? There are several signs of success in recent inflation indicators; will they continue? The last pay round was disappointing but signs for next year seem better. Does the Government have the correct stance on pay? What should policy be towards nationalised industries.

(v) The exchange rate has been stronger than most forecasters expected. Competitiveness has declined dramatically. How serious is this for manufacturing industry? Can the Government take any action without endangering its monetary targets? Even if it could take action should it? What of the inflationary benefits from a high rate.

(vi) How serious will the recession be? How bad is the outlook for unemployment? The general consensus is that output will fall in both 1980 and 1981 with some recovery emerging in the second half of 1981. How strong is that recovery likely to be?

Micro-economic Issues

Following discussion with Douglas Hague I suggest the following topics:

(vii) Research and Development; technology transmission between countries. Is there a role for encouraging foreign participation, for example by licensing. How important is the role of the multi-national company? What should be the relative balance of the public and private sectors?

(viii) Training programmes; is training a sensible use of some of the oil revenues? How do we identify the skills that will be needed? How do we involve the private sector?

/(ix)

179

CONFIDENTIAL

(ix) Unemployment; what supply-side policies will improve the labour market? Is it inevitable that unemployed people do no work. What schemes are available?

(x) Competition policy; are ideas for improving competition working? What can be done about the nationalised industries? What pressures can be brought to bear?

(xi) If further public expenditure cuts are needed in which areas should they be? Relative priorities of current and capital spending.

CONFIDENTIAL

MACRO-ECONOMIC ISSUES FOR DISCUSSION

Monetary Policy

Is the path for the monetary target set out in the Medium Term Financial Strategy (MTFS) the appropriate speed to attempt to reduce inflation. The target for 1980/81 is 7-11% falling to 4-8% by 1983/84. The degree of monetary pressure is well measured by the behaviour of the real money supply; that is the difference between monetary growth and the rate of inflation. The pressure has been intense over the period from June 1979 to April 1980 as the inflation rate has been close to 22% with 12% monetary growth. This pressure could be less in the period from March 1980 to December 1980 as inflation is slowing down sharply; the budget forecast for 16½% inflation by the end of the year is still possible.

- Minford has argued recently that we should be aiming towards the lower end of the target range in order to bring about a rapid deceleration of inflation.

- Matthews will argue in a forthcoming CLARE group article that a more rapid deceleration in the form of a short-sharp shock is as likely to kill the policy, if not the patient.

- Greenwells (Pepper) is often quoted by Mr. Healey as suggesting that we should aim for the top of the range to avoid an excessive money squeeze.

Fiscal Policy

2. Do we have the correct fiscal policy to achieve this monetary target? The budget forecast was for a PSBR in 1980/81 of £8½b - ? of total GNP. The MTFS looks for a reduction to 1½% of GNP by 1983/84. If the recession this year and next is deeper than was expected tax revenue will be less than planned; if spending plans are unchanged the PSBR will be higher than expected. Does this matter and would this point to a need for further spending cuts?

/ - Minford

CONFIDENTIAL

- Minford has argued recently that Public Sector borrowing should be held significantly below the £8½ billion for 1980/81.

- Matthews will argue that the PSBR receives too much attention and the government should play down its role. He will argue that we need to be ready with explanations of why the outcome for 1980/81 will be higher than £8½b, because of the lower level of activity. The same applies to 1981/82.

- Ball will probably agree with Matthews. If the PSBR is higher than expected because output is lower than expected this can be ignored providing the money supply target is met. The LBS have argued that the current fiscal stance is unnecessarily tight.

- Morgan Grenfell have argued recently that a much lower PSBR would ease the exchange rate pressure by reducing interest rates. We are sceptical of this argument because such action would probably also improve the current account of the balance of payments and improve expectations; both forces would tend to increase the exchange rate and offset much if not all the effect of lower interest rates.

- We would also want to argue that a low PSBR is necessary to reduce interest rates and reactivate the capital markets. This will form the basis for industrial recovery.

There has been a technical argument taking place recently on whether there is any statistical relationship between money supply and the PSBR. Kaldor has said not; as have the National Institute. Friendman has offered some unhelpful remarks in his evidence to the Treasury Committee (reprinted in last week's Observer). The

182

CONFIDENTIAL

LBS have recently argued that whereas there is no simple short-run relationship there is a solid medium term relationship. Minford will argue along the same lines.

Monetary Control

3. The question of alternative methods of monetary control is still an important issue:

- Griffiths has been one of the leading advocates of monetary base control so that interest rates and exchange rates are genuinely market-determined prices. He has argued that there is a danger that the determination to keep interest rates high will result in overkill and undermine the medium term plan.

- Minford has argued that it is desirable to have an automatic system in which the monetary base is kept fairly rigidly on a target growth track; the lender of last resort 'activities' are suspended except for emergencies; and gilts are auctioned. But he argues that this must wait until monetary conditions are more settled because the system will inevitably go through a period of incomprehensibility and we cannot afford to lose our understanding of the aggregates at the moment.

- Matthews will argue that we need to devise methods of borrowing which can take advantage of differences in expectations and differences in the parties' needs eg selling "Granny bonds" to anyone with an upper limit for each individual.

Friedman has been very rude about the Green paper on monetary base control (probably encouraged by Griffiths); he argues for direct rather than indirect control. He uses the analogy of trying to control the output of motor cars. Our current system is like attempting to control the number of cars by influencing people's incomes (eg by fiscal policy) and the price of cars relative to other forms of transport (the equivalent of interest rates). He

/argues

CONFIDENTIAL

argues that the direct route (equivalent to monetary base) would be to control the availability of steel to manufacturers.

The opponents of monetary base would argue that this would merely encourage motor firms to do two things; first they would search for cheap alternatives to raw steel (just as MBC might encourage substitutes for the items under control); second they would move the bulk of their operations to another country (just as MBC might encourage offshore banking business). They argue that at the end of the day by whatever means fiscal policy and interest rates have to be appropriate.

Pay and Inflation

4. How rapidly will inflation come down? Does the Government have the correct stance on pay? There are several signs of success on inflation:

- price increases in recent months have been quite low
- the CBI survey suggests this will continue
- manufacturers input prices are flat because of strong pound and weak commodity prices.

The last wage round has been disappointing with earnings figures at around 20%. Will the next wage round be much better? There are hopeful signs:

- manufacturing industry seems prepared to settle at low figures
- public service pay will not be allowed to damage the bargaining climate.

Can the Government do much more than maintain the monetary squeeze and prevent public sector pay awards getting out of step? Are there any presentational issues? What is appropriate stance towards the nationalised industries?

/ - Matthews

CONFIDENTIAL

- Matthews may argue for avoiding making policies appear more abrasive than they realy are and for some guiding figure on pay. He will also argue that the government has no option but to get involved in public sector pay; by being tough on central government employees; a tough rate support grant; by exhortation with nationalised industries.

- Minford has been arguing on the basis of 'rational expectations'; this has been criticised as being over optimistic and unrealistic during the past year. He argues that "inflation is now poised for a steady downward plunge".

- Ball may worry that it may be some time before we see the major reduction in inflation but that it will come.

Exchange Rate

5. The exchange rate has risen by about 10% over the past year. At the same time UK earnings growth has been 10% more than the average in competitor countries. As a result competitiveness has declined sharply. Possible reasons for strong exchange rate

- tight monetary policy
- high interest rates associated with high PSBR
- oil prices

- Matthews will argue that the result is worrying but that it is the natural consequence of attempting to reduce inflation more rapidly than elsewhere. He will not advocate strong action to lower it immediately but he would possibly like the government to deplore the high £, intervene in the forward market and not argue that the result market gives a desirable exchange rate.

- Ball may argue that a sharp fall in the exchange rate is possible over the next year.

/ - The

185

CONFIDENTIAL

- The Morgan Grenfell argument that a lower PSBR would lower the real exchange rate may be mentioned. This is referred to in paragraph 2 above.

- Our position is that we are not in a position to produce a lower exchange rate without losing monetary control. Most devices either will not work or will expand the money supply. The exchange rate is higher than expected but is also having beneficial effects on inflation.

Output and Employment

6. How serious will the recession be? What about the outlook for unemployment? The general consensus is that output will fall in both 1980 and 1981 although by mid-1981 there could be some recovery emerging.

% change in output

		1980	1981
	LBS	-2.3	-0.4
	NIESR	-1.1	0.6
	Phillips and Drew	-2.0	-0.1
Not published	[H.M. Treasury ,	-1.9	-2.0]

- Matthews will argue that the output assumptions in the MIFS will not be achieved and the PSBR will be greater than shown. He will also argue that it is difficult to identify the forces that will produce the assumed rise in output in 1982-83 and 1983-84 unless wage settlements are very low or world trade expands greatly. If the government perseveres by 1983-84 the British economy will be operating at a low level of output; the strategy is unlikely to change the long-established phenomenon of slow British growth.

/ - Minford

- Minford will also argue that the recession is here; de-stocking is heavy and world growth is slowing. However he expects the effects to be less damaging than many because of a sharp drop in imports and continued resilience of retail spending. Once MLR does come down and prices have decelerated the cash flow pressures on industries will abate and the current apprehension will subside. Therefore it will be a mild recession with recovery in 1981.

- Ball will probably follow the line of the LBS forecast which shows a sharp drop in output in 1980; recovery is expected later in 1981 as world output recovers, de-stocking comes to an end and real incomes can grow within the monetary target.

The approach that we are taking is to accept that unemployment will rise sharply in the year ahead; but the extent of the rise depends upon the speed with which pay and prices move into line with the monetary target.