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# NOTE OF A MEETING HELD IN THE CHANCELLOR OF THE EXCHEQUER'S ROOM, H..M. TREASURY AT 9.30 A.M. ON MONDAY, 22 SEPTEMBER, 1980

Present:

1 ~~Mr Sutton~~
2 Mr Monck } to see + return
3 Mr Battishill
4. Mrs. Middleton.

Chancellor of the Exchequer
Chief Secretary
Financial Secretary
Sir Douglas Wass
Mr. Burns
Mr. Ryrie
Mr. Hancock
Mr. Littler
Mr. Middleton
Mr. Lavelle
Mr. Unwin
Mr. Ridley
Mr. Cropper

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ECONOMIC STRATEGY

The meeting had before it Sir Douglas Wass' submission of 18 September on the current monetary and fiscal situation.

2. Sir Douglas Wass said the purpose of his note was to pave the way for contingency work if the money and PSBR figures did not come right in the coming weeks and months. We could not now rely on things going right; and if they did not, the credibility of the Government's policy - which was fundamental to the success of that policy - would be at risk. The Chancellor accepted the need to substantiate the Treasury statement on 9 September. He recognised that we could find ourselves pressed to make a premature and over-large reduction in interest rates if - as he was inclined to expect - the next money figures looks reasonably favourable.

3. The Financial Secretary saw no immediate problem of credibility. Financial markets were strong, and the PSBR would undoubtedly turn round (although a question remained how small it would be

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in the first quarter of 1981). Difficulties remained over public expenditure, but although the policy might appear to be in poor condition, the Government's determination to stick to that policy despite the difficulties faced by industry was not in doubt; and the longer the Government persisted in this stance, the more credible the policy would be. The Financial Secretary saw no prospect of achieving significant changes in public expenditure or in tax receipts during the current financial year, other than through public services pay; and he saw no reason for tax increases now to reduce the 1980-81 PSBR. There was undoubtedly an imbalance between the personal and corporate sectors, and for this reason he favoured attracting more funds into national savings, even at the cost of a higher mortgage rate, together with restraints on consumer credit. He noted that it might be necessary to increase taxes in the 1981 Budget; but at that stage more options would be open, and it would be undesirable for the Government to take hasty and perhaps inappropriate action now.

4. Mr. Ryrie emphasised the strong political and industrial pressures for lower interest rates; but could interest rates be reduced consistently with the Government's strategy without some other action as well? He therefore suggested the possibility of a package of measures as a cover for a reduction in interest rates, and accepted that the measures would have to be primarily aimed at 1981-82. Although restraints on public services pay would affect both this year and next, higher employees' national insurance contributions would affect only 1981-82. Nevertheless an early announcement could give a substantial boost to confidence. Sir Douglas Wass pointed to the difficulty we should face if, following moderately good money figures and a reduction in interest rates, subsequent figures again ~~when~~ went sour. The Government would then be criticised for its premature action, and would be asked what was to be done to get the money supply back on course. A difficult monetary control mechanism might constitute part of the answer, but reassertions of the Government's commitment without any validating action could well lead to an erosion of

confidence in the markets.

5. The Chancellor noted that if the money and PSBR figures were bad, the issue would be relatively straightforward. But if the position were less clear, we should face conflicting pressures for a tightening of policy and a reduction in interest rates, and it would be desirable if possible to re-establish confidence without a major package. He saw the restraints on local authority expenditure announced on 20 September as one step towards this; the publication of the RSG and other cash limits could be a further useful step. He envisaged some sort of an announcement in the first economic debate after the Queen's Speech, another possiblity might be to announce the decision to cut back the Treasury supplement to the National Insurance Fund and the consequent need to increase employees' contributions.

6. Mr. Burns saw a problem of the coherence of policy; and it was questionable whether the monetary target could in practice be achieved. If the target were to be missed by a wide margin, it would be the more difficult thereafter to keep the various strands of policy together. The costs - in terms of future inflation - of being wrong could be very large, and there was at present undoubtedly a substantial excess over the target; we could only take credit for corset effects before February 1980 in adjusting the target base. We should face a continuing struggle to get the rate of monetary growth down, and it would be difficult to justify lower interest rates; on the other hand, if interest rates were not reduced, upward pressure on the exchange rate could continue. It had to be admitted, however, that lower interest rates combined with a package might not achieve much of a reduction in the exchange rate.

7. The Financial Secretary questioned how far the possible elements in a package would help with the problem of excessive monetary growth; there would be no immediate and direct impact on sterling M3. He would prefer policy measures aimed directly at the monetary overshoot. Sir Doulgas Wass noted that some

commentators were already arguing for higher interest rates, which were politically not feasible - so it would be difficult to avoid fiscal measures. Moreover a package would indirectly help with monetary control by facilitating funding.

8. Mr. Middleton emphasised the importance of defining the Government's immediate objectives. Was the objective to get monetary growth back within the target range during the second half of 1980-81? If so there was no available fiscal package affecting the current year which could justify an appreciable reduction in interest rates. He thought the main problem was to do something about the imbalance between the personal and company sectors, to which the 1981 Budget should be directed; meanwhile we should do nothing to make the correction of the imbalance more difficult. He was inclined, therefore, to prefer the Financial Secretary's view that immediate action should be avoided, while we should press ahead with funding initiatives; but there would inevitably be risks.

9. Mr. Ridley pointed to the contribution lower long-term interest rates could make towards monetary control, by encouraging firms to raise money through writs and debenture issues rather than borrow from the banks; a comparable development had taken place in 1975. He suggested a number of other elements in any package: changes in the machinery of monetary control, perhaps on an interim basis; improvements in public expenditure control and monitoring; the announcement that the Cmnd 7841 public expenditure totals would be maintained; more effective control of local authority borrowing; some action to counter the nationalised industry Chairmen's present subversive activities; measures affecting bank liquidity (where the Chancellor's recent informal seminar would have focused attention); and restraints on consumer credit. Action in any or all of these areas could help towards the Government's objectives. (It was noted, however, that not all these ideas pointed in the same direction; lower interest rates were not compatible with a reform in the techniques of monetary control which to be effective would rely on pushing

interest rates upward.)

10. Mr. Hancock agreed that - as hitherto - the exchange rate should not be an objective of policy; he suggested, however, that the authorities might try talking it down a little. For example, a statement that the present rate represented something of an overshoot, and that it could be expected to settle back, could have a useful effect - particularly if the Bank refrained from intervention to hold it up. Mr. Lavelle noted that this possibility, together with the possibility of imposing a control on foreigners' purchases of gilts, would be covered in the paper EF were producing for the Prime Minister. In further discussion it was noted that the pressure to tighten fiscal policy could increase if attempts were made to talk down the exchange rate.

11. The Financial Secretary suggested that there were actually two separate problems; one of excessive monetary growth, and a fiscal problem arising from the public/private sector imbalance. These should be tackled separately. The point was made by Mr. Burns in reply that the PSBR during the first half of 1980-81 had been an important ingredient in the monetary problem; if the PSBR had been running at an annual rate at the £8½ billion indicated in the FSBR, the position would be much easier. Even if the PSBR were to turn round during the second half of the year, the margins of errors in forecasting were still such as to leave us at risk of a PSBR in the region £12-13 billion. Mr. Littler accepted that if the PSBR were substantially wrong during the current year, there could be a case for early action affecting 1981-82; but as yet he saw no conclusive sign that the PSBR had gone dramatically wrong. If the problem were that of the private/public sector imbalance, then it would be better to tackle it in the 1981 Budget. We had always recognised that 1981-82 would be a particularly difficult year. Sir Douglas Wass, however, remained worried that the position could break down before next spring; there was a high risk that the unconstrained banking system could continue to result in monetary growth well above the target range, and the thought that a very tough

Budget was likely to be needed next year in any event. Mr. Burns saw the reassertion of monetary control as a necessary condition of achieving the tough Budget consistent with the Government's strategy; if monetary control were not reasserted, people would conclude it was impossible, and there would then be a search for new and different policies.

12. The Chief Secretary noted that the Government would need to be prepared for open disagreement with the CBI. A reduction in interest rates, when it could be achieved, would not make very much difference to the exchange rate, and present complaints would soon re-emerge. He accepted that if the money figures continued to be unsatisfactory, it might be necessary to take now some measures primarily directed at next year; some indication of this possibility should be given in the announcement of the roll-forward of the monetary target.

13. The Chancellor of the Exchequer, summing up this part of the discussion, suggested a number of conclusions:-

(i) the importance of monetary policy should be reasserted, and every effort should be made to elucidate underlying monetary growth.

(ii) More attention should be given to the quarterly and even monthly profile of the PSBR; while the Government were probably right in preferring a gradual reduction in the PSBR, so far too little had been achieved.

(iii) The 1981 Budget was fundamental to the Government's success; the Government must get its medium-term fiscal stance correct (Mr. Burns promised an early paper on this issue).

(iv) Studies should go ahead of possible ways of improving control over local authority borrowing (the Financial Secretary confirmed that this work was being pressed forward).

(v) The attitude of the nationalised industry Chairmen represented a serious problem for the Government's stance on pay (the Chancellor noted that he was to discuss this issuc with his sponsor Minister colleagues immediately after the Party Conference, but preferred in the meanwhile not to send a letter about it because of the danger of a leak).

(vi) Further work on funding options should be pressed forward, including both further initiatives of index-linked national savings and the possibility of introducing index-linked gilts restricted to institutions (RIGs).

14. In further discussion, the link between funding initiatives and monetary base control was noted. If the authorities were were aiming at more flexible interest rates, there might be some scope for securing additional funds through the issue of very short gilts; but the decision on this would needed to be taken in the light of the Government's intentions about monetary base control. Mr. Middleton said that all possibilities in the fields of funding and the manipulation of the structure of interest rates would be covered in the papers currently in course of preparation analysing the current monetary situation and considering possible improvements in monetary control. Action would needed to be taken on reserve assets, where the reduction in the PSBR expected in the first quarter of 1981 would produce an unsustainably tight squeeze. But it would not be sensible simply to implement Mr. Pepper's idea of relieving the squeeze by allowing them to count more commercial bills as reserve assets; this amounted to validating the present level of bank lending by giving the banks the money to support it. Some view would

need to be taken of the authorities' future approach to monetary base control before any decisions were reached on the treatment of reserve assets. A separate paper would be prepared about the structure of bank's balance sheets. The Chancellor said he was now inclining towards letting interest rates respond more to market movements, and restricting the extent to which they could be influenced by the Bank and the Government; he recognised, however, that this inclination was not compatible with a stance of policy designed to prevent any increase in short-term interest rates.

15. Three main questions were noted about monetary base control: would it affect bank behaviour? If so, how? What would this do to interest rates? The answers to these questions would be much affected by the rapid development of competition all round the financial markets; there were undoubtedly risks that attempts to control what was happening through the banking system would induce a larger volume of transactions to flow through channels outside the UK banking controls, and even through offshore financial centres (a large proportion of German banking business was now done in Luxembourg).

16. The Financial Secretary suggested that some kind of restriction of consumer credit would be an appropriate ingredient in any package designed to get the money supply under better control. The Chancellor, however, noted that he had not previously been attracted by this form of restriction, which seemed unlikely to be effective because of the large number of loopholes, and would not have any significant impact in relation to the size of the problem. However, he would be ready to look again at the idea following his return from the IMF meeting; the papers already prepared, subject to any necessary minor updating, should provide an adequate basis for a decision.

17. On public expenditure, the Chancellor noted that nothing (other than pay restraint) could affect the position significantly during the current year; but some issues, like obliging the

banks to undertake part of the burden of subsidising export credit, should be pursued for implementation later. Action to restrict public sector pay and pensions in 1981-82 was essential both for the purposes of fiscal control and to influence expectations throughout the economy. Further thought might be given to bringing forward the announcement of cash limits, so that there was no question of pay negotiations proceeding with the participants having an inadequate perception of the Government's determination to keep public services pay increases below 10 per cent. One possibility might be to announce the cash limits with the monetary target roll-over in, say, late October/early November; all the cash limits would need to be announced together, and there could be no question of announcing the cash limit for civil service pay at a much later stage, as had been done last year. Mr. Ryrie confirmed that questions about the timing of the cash limits in relation to pay negotiations were currently under examination; the present plan was to publish all the cash limits (apart from that for the NCB, which would need to be published earlier) in late November, but there were opportunities for clearer signals to be given about tolerable pay increases, e.g. in the Chancellor's Mansion House Speech.

18. In further discussion, the Chancellor confirmed his rejection of any idea that the Government should state a specific figure for pay increases in the public services. Although this would make the message clearer to the private sector (particularly if the Government were to aim for increases of 5 per cent or less), it would be regarded as a form of incomes policy, it would upset powerful groups, and would increase the risks of political challenge to the policy. It was better to retain some element of flexibility, so that not every group needed to be treated in exactly the same way; fixing the cash limit provision for pay increases at, say, 8 per cent would in practice leave the local authorities very little scope for making significantly higher overall settlements.

The Chancellor warned against the presentation of the Government's policy on pay and cash limits in terms of a once-for all belt-tightening; this would only lead to catching up problems later. Rather public servants should be reminded of the advantages they enjoyed in terms of job security, index-linked pensions and so on. It was essential that civil servants should be in no doubt that the present pay agreement had been suspended. (A letter subsequently received from the Lord President confirms that further steps are being taken to put this issue beyond doubt).

19. The possibility of securing additional revenue through higher employees' national insurance contributions was discussed; the point was made that if the additional revenue were to be secured from the beginning of 1981-82, a decision would be needed in late November, and an announcement in early December, so as to leave time for the necessary legislation to be enacted. A number of ways of presenting the change were mentioned; one possibility would be to propose an increase in that part of the contribution which went to help finance the NHS, on the ground that the health service was being protected from expenditure reductions. An alternative possibility might be to reduce the Treasury supplement to the National Insurance Fund, so precipitating a need for additional revenue direct from employees. The Chancellor suggested that those still in employment might be told that their higher national insurance contributions should be seen as their contribution towards helping those for whom employment was no longer available.

20. In further discussion it was suggested that not fully indexing the income tax system in 1981 might be a better way of securing additional revenue; higher national insurance contributions would be clearly seen by everyone as practically indistinguishable from an increase in income tax. It was noted, however, that higher national insurance revenue from the start of the next financial year could help to smooth out the profile

of the PSBR, while the possibility could not be excluded at this stage that we might need both to secure additional revenue from this source and to increase the real burden of income tax. The Chancellor authorised consultation with DHSS on a restricted need to know basis about the possible options for raising additional revenue through employees' contributions; it would be useful, in order to minimise the dangers of damaging leaks, if the consultations were to emphasise the Government's interest in structural changes in the contribution system, rather than concentrate attention on what would be seen as conjunctural changes in tax rates.

Further papers for the Prime Minister

21. It was noted that the Treasury were preparing three main papers, which would eventually be submitted to the Prime Minister for discussion at her meeting on 13 October. These covered

(i) an analysis of the underlying monetary situation;

(ii) possible options for changes in techniques of monetary control; and

(iii) the roll-forward of the monetary target.

A separate paper was being prepared providing a post-mortem analysis of recent developments. It might be useful for this paper to be sent to the Prime Minister well in advance of the others around the beginning of October; a draft would be available for the Chancellor on 26 September. In addition to these papers about the domestic monetary scene, a further paper was in course of preparation about possible means of influencing capital flows and the exchange rate, following the discussion with the Prime Minister on 18 September.

TREASURY AND CIVIL SERVICE COMMITTEE

22. There was a brief discussion who of the possibility of the Treasury being asked to give evidence to the Treasury Committee before Parliament reassembled. Mr Unwin reported that the Prime Minister was considering whether to try to intervene with Mr du Cann. The Chancellor said he would consider this possibility further himself but in the meantime agreed that there should be no question of Ministers appearing before the Committee before Parliament reassembled but that, if invited, officials would have to do so.

PSJ

11 A J WIGGINS
23 September

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