51

MR MIDDLETON

cc Mr Britton
Mr Evans
Mr Monck
Mrs Lomax
Mr Turnbull
Mr Davies
Mr Shields

MLR IN THE BUDGET

Sir Douglas Wass is of course right to be sceptical of the forecasters' ability to predict the appropriate level of interest rates to within a point. He is also right to suggest that on grounds other than presentational and political ones a 1 point cut in MLR would seem to be preferable to a larger cut.

2. In this context you may be interested in the following points which derive from the forecast:

(i) We would expect an immediate cut of 2 points in MLR to imply growth in £M3 in the first six months of 1981-82 of around 11% at an annual rate.

(ii) Stephen Davies has done a simulation based on the forecast which, taken literally, suggests that in order to achieve smooth growth at the centre of the target range throughout the year it would be necessary to keep MLR up at 13½% in 1981 Q2 and only reduce it to 12% or below sometime during 1981 Q4.

3. Quarterly paths of monetary variables are even more difficult to predict than annual totals or averages. But for what it is worth - and remember all the criticism we received last year for not paying sufficient attention to timing during the year - the forecast clearly points to only a small (less than 2 point) MLR cut in the Budget.

CJR.

C J RILEY
3 March 1981

151/3

3/3/81

60

Mr Riley

cc Mr Britton
Mr Evans
Mr Monck
Mrs Lomax
Mr Turnbull
Mr Davies
Mr Shields

MLR IN THE BUDGET

I do not think that there is any disagreement with the point you make in the first paragraph of your minute of 3 March. But just as Sir Douglas Wass is sceptical about the forecasters' ability to predict the appropriate level of interest rates to within a point, I am sceptical about your ability to forecast the smoothness of monetary growth. For example, in assessing the smoothness or otherwise of the growth of £M3 in relation to the various possible changes in interest rates, what assumption have you made about the effect on confidence of the Budget taken as a whole and of the introduction of indexed gilts? Moreover, in relation to Stephen Davies' simulation, have you assumed that the path of the PSBR in the forecast this year is likely to be a more reliable guide than it was last year, and if so why?

P E MIDDLETON
3 March 1981

369/81

53

MR MIDDLETON

PwP

cc Mr Britton
Mr Evans
Mr Monck
Mrs Lomax
Mr Turnbull
Mr Davies
Mr Shields

MLR IN THE BUDGET

Thank you for your lightning riposte to my minute. I share your scepticism about our ability to forecast accurately the smoothness of monetary growth, which is why I prefaced my conclusion with the words "for what it is worth"! But we were exhorted after last summer's monetary debacle to look more carefully at quarter-by-quarter movements because of the implications for policy.

2. The answers to your other questions are as follows:

(i) Confidence effects of the Budget. We have assumed that market operators foresee the full effects on interest rates suggested by demand for money considerations and that these are brought forward substantially (i.e. greater than 50%) into the level of interest rates immediately. As the impact on the demand for money comes through the effect on interest rates builds up. The post-Budget forecast assumes that the market expects on balance the monetary target to be achieved.

(ii) Indexed Gilts. As in the analysis done last year we have assumed a neutral impact on confidence. Investors are assumed not to accept the "road to ruin" argument, nor to improve their inflationary expectations significantly because of the Government's evident confidence in its ability to bring inflation down.

22/3

36/7/81

(iii) Forecast path of the PSBR. We think that the forecast path of the PSBR should be a more reliable guide to the outturn than last year - though still doubtless very wrong in an unpredictable way - because we (and Accounts, GE etc) have paid more attention to trying to get it right. Assuming all the work done since last year's events has had some value, the forecast ought to be better this time, though of course one should not claim that any improvement will be all that large in relation to the margins of error involved.

CJR

C J RILEY
4 March 1981