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cc Mr. Lankester
Mr. Wolfson
Mr. Hoskyns
Mr. Duguid
Mr. Strauss

10 DOWNING STREET

1 April 1981

Dear Geoffrey,

NATIONALISED INDUSTRY FINANCING

My No. 10 colleagues and I were grateful for the opportunity to debate this issue with you and your officials on 30 March. We still seem to disagree on a number of points. I shall attempt to set these out below.

First of all, the problem we are trying to address is how to accommodate extra investment in profitable capital projects in nationalised industries. We know that there are difficulties about establishing the profitability of some projects - and that the judgment of the management of nationalised industries is not a sufficiently reliable guide. For example, I am dubious about the benefits claimed for large-scale railway electrification. You seemed sceptical yesterday about the value of extra telecommunications investment. However, Mr. Burgner's minute of 16 March shows that an economic case for essentially cost-reducing investment has been made to the satisfaction of your officials. (Bill Ryrie said that one of the convinced officials concerned was the most sceptical man in the Treasury!)

Everything else that follows in this letter assumes that a very strong economic justification for the extra investment has been made. It is important to establish this at the outset because we have no wish to see the floodgates open to NI investment regardless of its merits.

We are all agreed that the medium term goal is to privatise BT as much as possible and that any early steps in that direction are desirable. However, we are assuming here that this cannot be done in time to help solve the immediate problems.

Case 1: Assume 100% Crowding-Out

Let us assume that the extra capital investment does, as Peter Cropper argues, displace other investment of equivalent cost. Ideally, of course, we would all like to see it displacing other public sector investment - or, still better, public consumption. The one thing we all agreed on last night was that it would be highly desirable to re-order Government priorities - raising some categories of investment and reducing other categories of spending. Ideally there should be a "hit list" of disposable or at least

/deferrable spending.

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deferrable spending. However, as I understand it, your present political judgment is that there is no scope for this during 1981/82.

This means that the extra investment in, say, BT (which we accept is irrefutably in the public sector for the time being) will crowd out an equivalent amount of investment in the private sector. But since the marginal return on private sector investment is a good deal lower than for this project, there will have been a net gain.

This displacement of a low return by a highly profitable project is a "good thing". But I accept that there are three further arguments which might be advanced by the Treasury:

a. It would mean a net transfer from the private to the public sector - which is contrary to our broader objectives. I would not be concerned about this in a case, like BT, where we see medium-term prospects of privatisation.

b. There is a risk that the pressures on management and unions to strive for efficiency will be weakened. This danger is real. Disciplines on management are obviously needed, though we doubt whether it would be at all realistic to threaten the unions with withholding marginal cost-reducing investment.

c. The mechanism by which this project has displaced the other has, in theory, some monetary consequences. These are uncertain and probably negligible. It seems wrong in principle to us to make monetary objectives so paramount that we prefer to forgo the expected benefits from the extra investment, rather than risk a minor monetary consequence. The monetary consequences would be:

Either:

i. The extra spending counts towards the EFL and thus raises the PSBR (even if it comes off the contingency reserve, there is a high chance that the reserve will be exhausted during the financial year that this project will simply ensure that other projects add to the PSBR). If the extra PSBR is financed through gilt sales, there may be upward pressure on interest rates. A slightly increased PSBR compromises the MTFS targets and may have psychological effects on the markets.

Or:

ii. If the project is financed by some device which modified rules regard as outside the EFL, then the PSBR would be unaffected. However, to a greater or lesser extent, the funds would be met by Bank lending which would increase M_3. If, per contra, the funds were provided by loans, such as bonds, which do not affect M_3, then they would compete with gilts - driving up interest rates. But the crowding out will be of inferior projects.

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/Case 2:

Case 2: Assume less than 100% Crowding-Out

If the investment does not crowd out other private sector projects, then it will constitute a net addition to demand with more serious monetary consequences.

However, it is as unlikely that there will be 100% as 0% crowding-out. With unemployed resources at their present level it is likely that, if the project is financed by a PSBR increase, or additional bank lending through lease back, there would be some additional demand. This would have expansionary effects. If we take a rather high figure and suppose that 75% of the project costs is additional and only 25% is crowding-out, what are the consequences?

This depends. Suppose that we hire those who would otherwise have been unemployed in the West Midlands, etc and plant which would otherwise have been idle. Then it is easy to see that, provided it has no effect on wage settlements (and I know this is a big proviso), the fall in unemployment benefits (roughly 75% of the wage earnings net of tax and NIC) will give a matching reduction in the PSBR. The net effect on £M_3 will depend on the fraction of the wage bill in the project - but if the wage bill is less than 100% of the value added, the net effect on £M_3 is negative, both in the year of investment and much more negative in the subsequent years when the investment fructifies.

The critical issue is the effect of such additional demand on real wage settlements. If the new demand set off a round of higher wage settlements, higher unemployment and PSBR, then the issue is much more equivocal.

It is a matter of judgment, then, on the wage settlement issue whether the investment should be financed by allowing additional private borrowing from the banking system (through a lease back arrangement for example) or whether one should issue more gilts and so assume a 100% crowd-out.

We realise that the arguments that some additional expenditure may be accommodated without inflationary consequences is generally incorrect. That we accept. However, we also know the lessons of history. Friedman himself (in Friedman and Meiselman in Stabilization Studies CMC 1953(?)) pointed out that in the depths of the slump in 1931, the Keynesian model was superior to the monetary model (and it was the only period when this was the case). It is a moot point whether we are now in a similar situation. I do not think that the analogy is very close let alone perfect - after all we still have a 10 per cent or so underlying inflation compared with a plummeting price level in the USA in 1931. But in my judgment it is near enough for us to risk at least the very modest expansion in highly profitable investment of BT. On the above arguments we can hardly make an enormous mistake and we seem likely to generate very considerable benefits.

We still think there is a strong case for allowing demonstrably highly profitable investment to go ahead - even on the assumption that it crowds out other, less profitable investment in the private sector. We accept that it is not without risks, but these seem to be outweighed by the benefits.

Yours
Alan Walters

The Right Honourable Sir Geoffrey Howe, MP.