From: Peter Tapsell, MP.

cc: 1. Gow ✓ 15/5

Confidential

HOUSE OF COMMONS
LONDON SWIA OAA

The Rt. Hon. Margaret Thatcher, MP,
10, Downing Street,
London, S.W.1.

13th May, 1981

Dear Prime Minister,

I had breakfast yesterday with Dr. Arthur Burns. Whenever I have an interesting conversation about economics, I Minute it to my senior business partners and I thought you might be interested to see a copy of the Minute I sent them on Dr. Burns' answers to my questions. Although his next engagement was with the Chancellor, I imagine that his natural courtesy and the, no doubt, different slant to their conversation would have emphasised different aspects of Dr. Burns' thinking.

It would appear that Reaganite policies are very similar to those which I have urged in my speeches when in Opposition and for the past two years (other than their reliance on excessively high interest rates which, if continued for any length of time, will wreck their programme also). I suspect that the Reaganite "sequence" was what you really had in mind but that it was thrown out of gear by the 1979 Budget and the failure of your Cabinet to achieve real cuts in current public expenditure during the early months of your Administration.

Like Mark Twain, I would not choose to start here - and we would not be "here" if any attention had been paid to my advice. If, however, this Parliament is not to be remembered simply as the hand-maiden to a neo-Marxist society, the most tremendous effort has got to be made now to get things into better shape and to reverse the rising trend of unemployment by mid-1982. That is why I have been making speeches about the economic situation with an increasing sense of urgency.

I have never suggested "printing money" as a solution to our problems (and was, in January 1973, along only with John Biffen and Jock Bruce-Gardyne, among the first Tory M.P's to draw public attention to this danger).

However, I am convinced that Dr. Burns' description of the Reaganite policy, of giving top priority to encouraging real investment by business and industry through a dramatic reduction in their tax burdens, is the right approach. We have increased their tax burdens, particularly when one takes Rates and National Insurance into account.

As I repeatedly said in my speeches when we were in Opposition, an expansion of business profits must be the first objective. These have been tremendously squeezed by our policies so far. The likely increase in profits from exceptionally low levels towards the end of this year (first publicly predicted, incidentally, by my commercial firm) will be transient, due to special factors, and not of a kind or on a scale calculated to stimulate real investment in the economic climate that will then prevail.

In this context, the special levy on bank profits is profoundly unwise, both economically and psychologically.

I enclose a copy of a Lecture I gave last February in which I expand on some of these thoughts.

I am sorry to burden you with this, but there really is not much point in being in public life if one does not try to make a contribution to the main issue of the day.

Please do not trouble to acknowledge this.

Yours Sincerely,

Peter Tapsell

Confidential

A.B. to P.T: 12th May, 1981

(1) Tension between Central Banks and Governments tends to be endemic in any advanced economy, but the present degree of tension between the U.S.Federal Reserve Board and the Reagan Administration is exceptional in degree and intensity both personally and theologically.

(2) For the first time in its history, the Fed is under attack from "the Right" and not from "the Left".

(3) This is due to a fundamental difference of view between monetarists (everywhere) and Central Bankers (everywhere) about (a) the duties of a Central Bank and (b) the practicality of controlling the monetary aggregates.

(4) Monetarists (necessarily) believe that the sole function of a Central Bank is to control the money supply. Other matters (e.g. interest rates, exchange rates, etc) should be wholly left to Governments or to "the market." Central Bankers (including the Fed) reject this view as simplistic, impractical, and unhistoric. They take the view that there is a complex inter-relation of factors (including the money supply), which influence each other, all of which must necessarily and properly be of concern to a Central Bank.

(5) Most (although not all) of the monetarists in the Reagan Administration are angry that U.S.interest rates have risen to such high levels.They blame this on the Fed's failure to control MIB in recent weeks.

(6) Every experienced Central Banker in the world will tell you that it is impossible to control the monetary aggregates "short-term" (i.e. under a six-month period). It is difficult even to measure them. Over a period of more than six months a Central Bank would hope to be able to influence the rate of growth of the money supply very considerably. Monetarists (e.g. the Reagan Administration), who call for precise short-term control of the money supply (as evidenced by the monthly indices) are asking for the impossible. Political policies based on such short-term expectations will only succeed by chance. Hence the great volatility of U.S. interest rates, largely caused by past monetarist "brain-washing" of the markets about the significance of the short-term indices.

(7) "Monetarism" might very well have worked in the 1960's, when the modern theories associated with that school of thought were evolved, but, because most monetarists are academics, they do not appreciate the technological revolution which has occurred in money markets in the past ten years. New "forms" of "money" are being created almost weekly (Central Bankers spend much time discussing whether a particular new instrument should be classified as "money" or not). Hence the repeated failures of the indices (MIB in U.S; Sterling M3 in U.K, etc), to measure changes in the money supply over the short-term with any degree of accuracy, and of the Central Banks to control them. In this sense, "monetarism" is a conservative, static and increasingly impractical theory about a dynamic, expansionist and increasingly innovative technology.

(8) Almost all the "experts" in U.S., whatever their economic standpoint, view the monetarist experiment in the U.K. as having been a failure so far.

(9) Nevertheless, many of them still have high hopes that they can avoid the British mistakes and that the Reaganite economic policies can be made to work. Although "the Right" in both U.S. and U.K. use the same political rhetoric about their economic policies, the Reaganites intend their policies fundamentally to differ from those of the U.K. in the following four vital respects (among others):

(10) First difference: Top priority will be given to reducing current public expenditure at once.

(11) Second difference: The otherwise deflationary effect of reducing current public expenditure will be off-set by real cuts in the overall burden of taxation. (From the U.S. it looks as though U.K. taxation has been restructured but not reduced).

(12) Third difference: The cuts in public expenditure will precede the cuts in taxation. The taxation reductions are aimed to be very modest in Year One but growing steadily in size in each fiscal year Two - Five.

(13) Fourth difference: Cuts in taxation will be concentrated on the business sector and not on the private individual. The over-riding aim is to increase business profits and so investment and thus

employment and demand (instead of the reverse policy sequence so often attempted in the past).

(14) It is hoped that the increase in business profits, investment and activity in U.S.A. resulting from the tax cuts will offset the loss in overall revenue to the U.S.Treasury resulting from the reductions in taxation of businesses.

(15) It is clear that these fiscal policies cannot hope to succeed (and then will be reversed by a successor Administration) unless they continue to enjoy public support.

(16) This primarily depends upon them not producing a large increase in unemployment (as the French Presidential election has demonstrated). It is hoped that the Reaganite economic programme will positively reduce unemployment levels at a fairly early stage of its implementation.

13th May, 1981. P.H.B.T.

Release Time: 13.00 hours
Tuesday, 24th February, 1981.

Mr. Peter Tapsell, Conservative M.P. for Horncastle (Lincs), lecturing to The Economists Society at The City University, Northampton Square, E.C.1. on Tuesday 24th February 1981, said:

Title of Lecture:

"British Economic Policy: what changes are needed?"

Few speech-writers have made a greater economic impact with a single sentence than Mr. Peter Jay. Ever since he inserted that phrase, in his father-in-law's speech to a Labour Party Conference, it has been the accepted wisdom, across a wide spectrum of political thought, that we cannot spend our way out of either inflation or slump. Yet even so brilliant a man as Mr. Peter Jay cannot be expected to encapsulate all economic truth in a single statement. The need to distinguish between "cost push" inflation and "demand-pull" inflation remains, as Mr. Peter Jay's own distinguished father never tires of reminding the House of Commons.

The inflation from which we have been suffering has clearly been of the "cost-push" variety, the original push coming from the rise in the international price of oil, but gathering many "fellow-pushers" along the way. It has increasingly seemed to me, however, that many of the measures, other than the vital curbing of the free-for-all wages scramble, which have been taken to combat inflation have been directed at the "demand-pull" variety. Some of these have naturally proved counter-productive.

You may not be able to spend your way out of deflation but you can only expand your way out of inflation, as the trend of the cost of living index in 1982 is likely to prove.

There are also considerable political difficulties about perpetually cutting public expenditure in a declining economy, as the most puritan members of, for example, the Lincolnshire County Council would, I think, be ready to testify.

We are far more likely to achieve a lastingly stable currency in a situation of rising productivity and falling unit-costs than in one of falling productivity and rising unit-costs. It was this latter situation which prompted the Bank of England recently to draw attention to the unprecedented decline of our competitive position in the world during 1980.

The remarkable buoyancy of our exports, the surplus on our balance of payments and the strength of our exchange rate may seem to belie that reality today, but we would be foolish to ignore the danger-signals. In economics, there seems to be a time-lag of about two years between cause and effect. Little that we do in this field now will have much effect before 1983, or even 1984. The ominous decline in our imports of raw materials, the continued fall in real investment in manufacturing, the remorseless squeeze on the profit margins of almost all businesses, great and small, both industrial and agricultural, outside the financial sector, <u>must</u> be arrested quickly, if our national situation in 1984 is not indeed to become Orwellian.

We can, in this small island, with our, at present, open trading system, only hope to control limited aspects of the inflationary forces at work in our economy. Of these, as I have stressed continually in speeches since 1969, the most important - and infinitely the most important - is wages. Yet it is perhaps still controversial to say, as I do, that wages are an even more important factor in inflation than public expenditure.

I very much welcome the move away from an excessive preoccupation with misleading, unreliable and largely uncontrollable money statistics, back towards a concentration on the real world of investment, profits, jobs and wages. These are what ultimately determine the level of prices. To that extent, monetarism is very definitely not enough; surely we can now all agree upon that?

I have never questioned that the money supply has an important role to play, whether it be sterling M3 recording excessive expansion, or retail M1 indicating an unduly rigorous restraint. My own guess - it cannot be more - is that M1 has been nearer to the truth and that much of the "breast-beating" in the technical financial press about the "missing of monetary targets" has been greatly over-done, providing an irritating diversion by academic theorists, in and out of Government, from the problems of the real world, now crowding in upon us.

In any case, whatever the truth about "the money supply," everyone practically engaged in industry and agriculture knows that there has, in reality, been a tightness in the conditions in which money can be borrowed. If it had been any tighter, our general national situation would today have been worse. Whether it be by luck or good judgement, it may be that monetary control has turned out about right for 1980, although too tight for the corporate sector.

Certainly, no one can fairly accuse the authorities of pursuing their policies with an excessive dogmatism. On the contrary, there has been a spirited lack of consistency to them which fully deserves the accolade "pragmatic".

Just as the money supply has an important place in the economic scheme of things, so has public expenditure. But as with the money supply, so with public expenditure you have first to define what you mean by public expenditure; secondly to differentiate between different types of public expenditure; and, thirdly, to be sure that you are able to control each type separately, if it is to be a helpful economic tool.

The first differentiation has to be between capital and current expenditure. Capital expenditure - "the seed corn" - has, as far as possible to be maintained, particularly in a slump, while current expenditure should be cut when new wealth-production is falling. So far, the approach to public expenditure has tended to be the other way round. I hope that the Budget on 10th March will start to put that right.

Secondly, we must avoid an oversimplification, in a mixed economy, of the differentiation between expenditure in the public and private sectors. Some forms of expenditure in the public sector - on defence, on telecommunications, on roads and railways, on housing for example - can be very helpful to the private sectors of industry and business. Far from "crowding out" the private sector, such expenditure - judiciously chosen - can infuse vitally needed life-blood into the private sector and into the whole free-enterprise system.

"Supply" economists should not disregard"demand". The underutilisation of our equipment and manpower surely demonstrates that there is an imbalance in the economy which needs to be remedied - an imbalance between the public and the private sectors certainly; an imbalance between the personal and the business sectors also; but, above all, an imbalance between supply and demand overall. Because of the international dimension of the inflationary problem - our domestic prices situation is far better than the misleading year-on-year statistics suggest - that imbalance can only be restored by expansion in certain sectors under our national control, top priority being given to high technology and high value-added industries, where possible.

A good deal of over-simplified nonsense is talked about the PSBR. This figure - another unreliable statistic with a recognised forecasting error of some billions of pounds either way - should not, anyhow,be discussed in isolation. It has to be put in the context of the stage of the economic cycle, the volume of personal savings, the movements of funds across the exchanges, the balance of payments and the likely trend of bank lending to the business and personal sectors of the economy. If,as now, all those tend to be counter-balancing forces, an attempt to suppress a rising PSBR during a period of deep recession can be positively undesirable. Those who clamour in a generalised way for cuts in the PSBR should give more thought to its likely practical effect on investment demand.

What is most urgently needed now is a clearly defined industrial strategy combined with lower interest rates and a lower exchange rate. Let me at once try to counter three of the parrot-cries which that statement always provokes from those who prefer to think in slogans.

First, there is the argument that we cannot "spend our way out" of the increasingly vicious downward economic spiral into which we have become trapped. This is only partially true. It is no more, and no less, true than to say that we could "under-spend our way" into a ruinous slump. There is always a balance to be struck in these matters. It is often a most difficult judgement where that balance is correctly to be found. The point of balance will constantly change as the situation develops. That is what politicians are for.

The desirability or undesirability of expenditure largely depends on the form it takes. Why should the Devil have all the best tunes? Why - deliberately to take the most extreme example of modern history - was Hitler able to expand the German economy out of a much worse economic and social background in the three years after 1933, and before he had crossed a foreign frontier, without provoking a return of ruinous inflation? Few historical analogies are ever remotely exact, but these are questions which deserve study. Are we so sure that we cannot find a decent and peace-loving method of economic expansion within our own fine national traditions - the more particularly since the threatening international situation urgently calls for a massive rearmament programme? Indeed, that is one of the points which President Reagan will be making to Mrs. Thatcher in Washington.

Secondly, it will be said that it is difficult for Governments and Civil Servants to "pick winners." I accept that. It is difficult. But surely it is preferable to have a declared industrial policy which tries to pick winners, rather than an undeclared one which, in practice, concentrates almost exclusively on backing known losers? By having no industrial policy we get the worst of both worlds. Public expenditure is not controlled but it is spent - in huge amounts - in the wrong areas. The political pressures which bring this about, in piece-meal fashion, would be easier to resist if there was a positive alternative industrial strategy, attracting as it soon would the support of the vested interests of Unions and of management and of the City.

Thirdly, it will be argued by some self-styled "monetarists" or "free-marketeers" that all this is too "interventionist" by half. I would remind them - disregarding Japan if it is argued that our traditions are so different - that the Barre Plan for France, which originally attracted them as much as the Joseph Plan for Britain once attracted the Reaganites, has always had a strongly "interventionist" side to it - and M.Barre and his closest advisers will tell you that it was the most important aspect of his Plan. Massive French Governmental support - financial, fiscal, technical, and in terms of key personnel - has been put behind carefully selected sectors of French economic activity, judged by that very entrepreneurial Government to hold the key to future French prosperity: for example, Biomass, Micro-chip, Computers, Atomic Energy and Food Production.

There will be a massive upsurge in the tax revenues from our North Sea oil between now and 1984. The big increase is still to come. It may go up from around £4 Billion this year to £15 Billion by 1984. It would be unforgivable if this extra national income were to be mainly spent on uneconomic wages in the nationalised industries, on unemployment benefit to those thrown out of work in private enterprise business and on imports of luxury foreign consumer goods,and food,which we ought to be producing here in Britain.

The oil revenues - not vast in relation to our G.D.P. but still a significant bonus - ought mainly to be spent to reduce the national debt, to lower taxation, to modernise the infrastructure of our economy, and to equip the growth industries of this country to compete internationally. Only a Government can ensure that such things happen, as the Germans, the French and the Japanese well understand. The belief that the "free market", left to itself, will achieve these ends is sheer mysticism. Nothing makes a Pension Fund manager pale so quickly as the mere mention of the words "Research and Development" - yet it is to "R and D" that the Japanese"beehive"of Government/Industry/Banks gives the highest priority.

As my last example, I will quote food production - because I represent an agricultural constituency in Parliament and because I think it generally illuminates my argument. The French Government is pouring large sums of their taxpayers money into their agriculture with the declared aim of turning France into the larder for Europe. Here, in Britain, farm incomes in the past year have fallen in real terms by 24%. Our agricultural production is declining,while its costs are rising. Investment is drying up. Hardly anyone in Lincolnshire will be buying a new farm tractor this year, or any other expensive piece of agricultural equipment,if they can avoid doing so. Yet Agriculture is Britain's largest and most efficient industry. Our land is among the best in the world. Our productivity has steadily risen over many years. Our capital investment per acre and per worker is exceptionally high. Labour relations on the farms are excellent. The tax climate is already favourable. Pension Fund managers regard this industry with a kindly eye. The food is wanted and needed. The scope for import substitution is still huge. Why then are we allowing our international competitive position in Agriculture to be weakened by the more activist support given to their farmers by the French Government, in the form of free grants and cheap credit and obstruction of imports?

Our comparative inertia in this, as in so many other spheres, is disguised under a variety of foreign-sounding pseudonyms - "Communataire", "Internationalist", "Monetarist", "Laisser Faire", and so on. Whatever guise the excuse takes, the practical result is that we fight our own national corner less fiercely and less effectively than most of our overseas rivals.

This applies right across the board. I recently asked a foreign car manufactuer how it was that his not very efficient country was so little penetrated by Japanese motorcars? "Because", he said, "we make the documentation as difficult as possible for them". Here in Britain, by contrast, we are like the woman in the hayfield who lay on her back and shouted "Rape, Rape, Rape" all summer long. The City of London, our overseas trading companies, our advertising industry, our retail network, our political philosophers, our economic pundits and public taste all encourage the maximum possible import penetration of our markets. We must be the first modern economy in the world deliberately to "export employment"to our overseas competitors, and,if we are not careful,huge amounts of our capital will soon follow it,stimulated by the prospect of a falling exchange rate and a near-Marxist Labour Government.

To avoid these and other horrors, we must have a British Industrial Strategy to which our tax policies, our fiscal policies, our energy pricing policies, our interest rate structures, our exchange rate and our "guidance" to the Banks on lending,are all subordinate and coordinated. Of course, such a Plan will not be an unqualified success. Nothing in life ever is. Yet in politics as in life, low aim not failure is the crime. Let us at least <u>aim</u> to get our Nation back to work. <u>That</u> might work too.

<u>ENDS</u>