10a

FROM: E P KEMP
22 JANUARY 1982

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State (C)
Minister of State (L)
Sir Douglas Wass
Mr Burns
Sir Kenneth Couzens
Sir Anthony Rawlinson
Mr Ryrie
Mr Byatt
Mr Barratt
Mr Middleton
Mr Quinlan
Mr Battishill
Mr Cassell
Mr Evans
Mr Monger
Mr Mountfield
Mr Allen
Mrs Gilmore
Mr Norgrove
Mr Bush
Mr Ridley
Mr Harris

CABINET 28 JANUARY - ECONOMIC STRATEGY - BRIEF

The paper Cabinet will discuss on 28 January is your own. At the time of dictating this brief it is still undergoing some last minute changes, but we thought it bette: to get this brief forward to you before the weekend so you can consider it and discuss it with us if need be well before next Thursday.

2. The Cabinet discussion on 28 January represents the third in the series of "macro-economic discussions", and is arguably by far the most important. Amongst other things, it seeks to fulfil what appears to be the general wish of Cabinet colleagues that they should to some extent at least be taken into the Budget-making process. Discussion will be difficult, not helped by the fact that the Press appears to be well aware that it is taking place, and you and the

Chief Secretary will, that same afternoon and evening, be speaking in the House in the Debate on economic strategy.

Objectives

3. Your objectives in respect of your pre-Budget paper are, in broad terms, fourfold :-

a. To seek your colleagues' views on the general stance of fiscal policy for 1982-83 - that is, in plain language, to ascertain what they think if not about the sort of absolute PSBR level which might be sought for 1982-83, at least various levels of tax "give away" which might be possible.

b. To ascertain your colleagues' views on how any "give away" might be distributed eg as between measures benefiting the personal sector and measures benefiting company sector.

c. To avoid any firm commitment to being bound to any view taken, your furthest position being an agreement that you would take account of the views expressed subject always to reserving your right to modifying your position if circumstances required it before the Budget.

d. To avoid any request for further collective consultation in the period in the run up to the Budget (obviously apart from bilateral consultation on particular points with individual colleagues).

Speaking Notes

4. I attach flags A and B speaking notes which you may like to use in connection with objectives (a) and (b) above. Although these are not independent of each other (because one way to use any slack for the benefit of industry is not to go for any tax reduction at all but simply keep the PSBR lower than it would otherwise be, thus help keep interest rates lower than they would otherwise be)

it seems preferable if possible to try to arrange the discussion so that (a) and (b) - considerations relating to the PSBR and size of total tax relief, on the one hand, and how any such tax relief might be distributed, on the other - should be kept separate in peoples' minds. Flag C is the index to a bundle of separate notes, mostly defensive, on the large number of points which may come up in discussion.

The principal arguments - the size of the PSBR and any reliefs

5. Your paper discusses your views on next year's PSBR. You argue that for reasons of market confidence, which translates itself primarily into the need to try to keep interest rates down, the upper end is about £9 billion. From the point of view of interest rates etc, a lower figure would however be preferable - you quote £7-£8 billion, but you point out that this would not give any room for tax reductions and the political difficulties are obvious. For any given level of PSBR, of course, the size of the tax reductions that are possible depends on what the economic forecast shows the PSBR to come out to on the basis of conventional revalorisation. As your paper says, the provisional figure we have is rather less than £9 billion. It looks as though, therefore, a PSBR of £9 billion would certainly give some room for tax reductions over and above the revalorisation assumed (which itself involves a give away of a net £300 million or thereabouts in 1982-83). A forecast of £8 billion would give scope for real reductions over and above revalorisation of £1 billion, on the basis of a £9 billion PSBR, or about £1.3* billion in cash terms. On the other hand on the basis of the lower end of your PSBR range no real scope for reduction would be possible at all.

6. Arguments you may like to use include the following :-

a. To go further than £9 billion takes unacceptable risks on interest rates, and would also involve going above the figure mentioned for 1982-83 in last year's MTFS, which is also the figure that has got into some public circulation.

---

*This is a mongrel figure comprising PSBR cost (£1 bn) and revenue cost £0.3 bn). Because of feedback, revenue costs are bigger than PSBR costs for any given decision. Presentationally, it is likely that any "give away" will be measured and described on the bigger revenue costs basis.

b. To stay within the £9 billion shows consistency, while to go above it could imply in the eyes of the markets an undesirable step towards relaxation.

c. In any case regardless of the forecast there is a limit to the amount of "give away" that can be contemplated. At some stage it would have to be retained and used to help on the interest rate front. It is a matter for judgment what this limit is (and there will no doubt be those around the table who will argue that there is a downward limit as well as an upward one). The point is that the size of the tax reductions given (whether over and above revalorisation or including the cost of revalorisation) will be taken by many as a measure of the "stimulus" (or, misleadingly, "reflation") which you are apply to the economy, and these people will compare this figure with the various other figures which others have been clamouring for. The competing packages are a mixed bag, not always fully or accurately costed. But it is surely the case that if you started getting above say £1½ billion real or £2 billion cash,* then the figure starts to look comparable with some of these alternative suggestions, and, in the eyes of the markets and politically, the Government could be thought to be getting into "U-turn" country. So something of this order must be the upper limit.

d. Finally it is necessary to keep an eye on the Budget for 1983 - perhaps the last of this Parliament; real reductions greater than around £1½ billion start to eat dangerously into possible slack for next year, the more so because any estimate now of next year's slack must be particularly tentative and at risk notably on the possibility of the 1983-84 public expenditure figures not holding. It would obviously be very desirable to have something in hand for 1983-84, and per contra very undesirable to risk being forced in that Budget either to have to increase taxes or take risks on interest rates; this points to some restraint now.

* See footnote to p.3.

These arguments point to sticking to a PSBR not bigger than £9 billion, and real tax reductions not more than, say, £1½ billion (cash equivalent about £1.8 billion).*

The principal arguments - how any reductions might be distributed (b) above.

7. Your paper spells out the broad possibilities. Briefly, the main choice lies between helping in the first place individuals (either through measures which directly affect prices or measures which reduce income tax) or companies. Immediately, operating on tax thresholds does best for individuals while operating on eg NIS or corporation tax does best for companies, with operating on the indirect taxes benefiting both (and of course, in a big sort of way, the RPI). But as Annex 4 of your paper shows, when the second round effects are taken into account this is not so obvious; money given to individuals works through and helps companies, while each of the alternative approaches gives very much the same result as far as GDP and unemployment. Another strand is the effect on wage bargaining, where while opinions can vary, reduction in direct tax should help while reduction in NIS might work in the opposite direction. And as well as economic, the arguments here are to a great extent political; for instance has the time now come to try to put right at least to some extent the way in which the burden of taxation on the individual has increased since the Election, contrary to the Manifesto promise; or would this be seen as "irresponsible" so that the main benefit should be overtly and in the first instance directed towards companies? Your colleagues will no doubt have a number of views on all this.

8. Some of your colleagues may make a case for more detailed perhaps cheaper measures - for instance enterprise, industrial, "caring", and so on packages. You could say that certainly you would hope that if there is to be an overall relief some amounts could be reserved for worthy less expensive causes (an example in your own field might be some relief in capital taxes). Obviously, however, to the extent this was done what could be done elsewhere would be that much less. Without actually soliciting a flood of Budget representations from your colleagues, you may like to say that if any individual Minister has ideas, you will be glad to know of them as quickly as possible.

* See footnote to p.3.

9. There may be some suggestions that some of any fiscal adjustment should be taken out by way of additional public expenditure. You will want to oppose this strongly. Detailed briefs J and K below gives some arguments. In short, the public expenditure decisions were taken, and so far as possible the books were closed, in December, and announcement made. To re-open them with second thoughts on policy would look feeble and indecisive. In addition, this Government was not elected to increase public expenditure; the December statement already had to add £5 billion for next year to the plans, and it is most undesirable to go any further in the wrong direction. And finally, in terms of the Government's longer-term strategy public expenditure measures are, economically speaking, not the best way of getting inflation down and output up; they are (and would be seen as) of the nature of short-term expediency.

The Annexes to your paper

10. These are largely background, and should not cause much comment. Annex 1 however, does give an interesting - and generally encouraging - picture of how the economy is evolving.

Summary

11. As I say, your principal objective is to get your colleagues' acquiescence of your working to a PSBR of not more than £9 billion in 1982-83. It seems reasonable to hope that you would succeed, given the prospect you can hold out of associating this with some real tax reductions. In a sense this is a situation which gives everyone a prize. Seen from the City, a PSBR of £9 billion should represent a continuation of existing policies and should not damage confidence too much. Seen domestically, there are real tax reductions in prospect, which will not be unpopular. How such a position is eventually presented eg in the Budget speech may need some adroitness. But the argument you might be able to adopt is that this is not in fact "reflation", assuming one defines reflation as going for a PSBR beyond what can reasonably be afforded, on a sort of "dash for growth" argument. The Borrowing Requirement remains at a responsible level, and the tax reductions available are the first fruits of the Government's economic strategy over the last 2½ years.

12. You may wish to discuss this brief with us.

EPK

E P KEMP

LIST OF BRIEFS

BRIEF

A. RECENT ECONOMIC SITUATION

B. THE FORECAST

C. READY RECKONERS

D. UNEMPLOYMENT AND OUTPUT PROSPECTS

E. INFLATION

F. PRODUCTIVITY

G. PAY

H. EXCHANGE RATE AND COMPETITIVENESS

I. MONETARY POLICY

J. PUBLIC EXPENDITURE

K. PARTICULAR ITEMS OF PUBLIC EXPENDITURE

L. TAXATION

M. (i) PSBR

M. (ii) WHY DOES A £9 BILLION PSBR LEAVE ROOM FOR TAX CUTS, DESPITE A P/E PLANNING TOTAL OF £115 BILLION?

N. (i) WHY REFLATION NOT SENSIBLE

N. (ii) TAX CUT/INTEREST RATE TRADEOFF

N. (iii) MISUNDERSTANDINGS WHICH AROSE ON 20 OCTOBER

N. (iv) SUMMARY OF REFLATIONARY PACKAGES

N. (v) BANK OF ENGLAND AND CBI VIEWS

O. OTHER COUNTRIES' POLICIES

P. WHY INFLATION MUST BE CONTROLLED

Q. "NATIONAL CASH LIMIT" AND CROWDING OUT

R. EFFECT OF TAX CHANGES ON DISPOSABLE INCOME

RECENT ECONOMIC SITUATION [See also Annex 1 of the Cabinet Paper]

Positive

(i) Evidence points to turning point in 1H 1981 - clearly shown by CSO cyclical indicators and consensus of independent forecasters.

(ii) Output now rising - total up $\frac{2}{3}$ per cent in 3Q over 2Q 1981. Manufacturing and construction output up $2\frac{1}{2}$ per cent. Destocking much reduced.

(iii) Exports held up well under difficult conditions of sluggish world trade and earlier losses in competitiveness. In 3 months to November non-oil exports some 4 per cent up on average 1980 level.

(iv) Current account remains in surplus.

(v) Labour market indicators improving.

- average hours worked increased during 1981 (4 per cent) as short time sharply cut (down by $\frac{3}{4}$) and overtime recovered.
- total hours worked stabilised (employment continues to decline).
- vacancies picked up during 2H 1981 (from very low level).
- unemployment increasing much less slowly - only about $\frac{1}{3}$ of a year earlier (4Q 1980, 115,000 pm cf 4Q 1981 36,000 pm - 43,000 pm allowing for new benefit arrangements for over 60s)

Defensive

Unemployment continues to rise - rate of increase much reduced, other labour market indicators improving. See also briefing (to be provided) on January figures.

November manufacturing output disappointing - smooth monthly profile unlikely. Allowing for BL and Ford disputes index remained above September level.

Imports increased very rapidly - but from a very depressed level. Reflects slower destocking and recovery in output.

Investment weak - No further decline since Q1 1981. Fall concentrated in housing. Plant and machinery investment held up. 10 per cent higher in 1H 1981 than two years earlier.

BRIEF B

THE FORECAST

(i) Latest Treasury forecast sent to Chancellor on 26 January.

(ii) Based on conventional assumptions about tax indexation in the 1982 Budget; and on sticking to public expenditure totals.

(iii) Summary of forecast attached - NOT FOR USE.

(iv) In general, forecast is close to published Industry Act Forecast, and to interim Treasury forecast of 7 January.

Main points of forecast

(i) Recovery continues in 1982, and should strengthen in 1983.

(ii) Growth of exports - which performed appreciably better than expected in 1981 - should help to sustain economic recovery, as well as end of de-stocking. Current account still in large surplus.

(iii) Inflation lower in 1982, and again in 1983 which should see single figure rate.

(iv) Path of interest rates depends partly on US rates - but the prospect of a falling PSBR and falling inflation suggest possibilities of falls in interest rates, consistently with rates of monetary growth significantly below those in past two years.

	Industry Act Forecast	Latest Treasury Internal Forecast
Output, per cent change between 1981 and 1982	+ 1	+ 1¼
Inflation, per cent change between end 1981 and 1982	+10	+ 9½-10
Current Account, balance of payments, £bn	+ 3	+ 4

READY RECKONERS

Annex 4 shows effects of illustrative tax changes, each of which increase PSBR by £1bn in 1982/83.

Changes are:-

Category (1):- no revalorisation of specific duties (incl VED on cars) (NB Not VAT).

Category (2):- Personal allowances: an increase of 10 per cent points (above full revalorisation allowed for in forecast).

Category (3):- Cut in National Insurance Surcharge of approx 2 per cent points (implemented from July 1982).

2. These are extreme cases prepared to bring out the various effects, not proposed Budget packages.

3. Table assumes no change in interest rates: so money supply is about ¾-1% higher than with £7-8bn PSBR. If interest rates were higher with £9 billion PSBR (so monetary growth was the same as with PSBR of £7-8 billion) tax cuts would have much less effect on output (and none at all after 2-3 years).

4. Lower specific duties (category (1)) is best for inflation. Higher personal allowances may help reduce wage pressures. Lower NIS may be partly passed on in lower prices: but could also leak into higher wages.

5. NIS does most to help companies: but all tax cuts boost company incomes indirectly. Lower NIS also indirectly boosts real personal disposable incomes.

6. Tax cuts have similar effects on output and employment (though not inflation) taking account of second round effects.

UNEMPLOYMENT AND OUTPUT PROSPECTS BRIEF D

Factual: Recent developments and immediate prospects

1. Output. Bottom of recession passed in first half of 1981. Sure signs of recovery seen in last six months:

- manufacturing output grew by over 2 per cent in the third quarter and GDP by ½ per cent:

- short-time working dropped dramatically: October level less than one-quarter that of January 1981.

- destocking in the third quarter of 1981 only at one fifth of rate in first half.

Output likely to continue to rise (although moderately) through 1982 and show over 1 per cent increase year-on-year. Helped by recent improvements in productivity and competitiveness and the end of destocking, but unlikely to be very fast because of continued impact of high real interest rates and falls in real personal disposable income. Effects of strikes, cold weather etc should be short-lived.

2. Unemployment. Even taking account of January's figure, recent monthly increases in seasonally-adjusted unemployment have been much lower than at the end of 1980 or early 1981 - roughly half the rate of increase. But "wide" unemployment now just over 3 million. See table at end of brief for recent figures. Prospects are probably for some further increases in unemployment in the near future, but unemployment forecasts are notoriously uncertain.

Positive

3. Longer term prospects for unemployment. Much depends on our success in reducing inflation, as basis for sustained economic growth.

Need for restraint on wage demands and improved productivity.

4. Better output prospects in medium term. Growth of 1 per cent in 1982 should be followed by sustained growth in medium term:

- Better growth in the world economy.

- Falling nominal interest rates, resulting from control of the PSBR and decelerating inflation, to help investment.

- Falling wage and price inflation will improve our international competitiveness and hence trade performance.

- Falling inflation will mean that individuals will have to save less to maintain the real value of their savings and so they will spend more.

5. Lower PSBR in the medium term. Output growth will increase tax receipts and reduce expenditure on unemployment benefit, and improve the financial position of the nationalised industries. North Sea revenue will be rising fast. Therefore as long as we retain strict control of public expenditure there is the prospect of a fall in public sector borrowing in the medium term both in money terms, and as a share of national income. This will help to bring down nominal interest rates, further benefiting the PSBR.

Defensive

6. 3 million a critical figure. The magnitude of January's rise reflects abnormal weather in addition to the normal seasonal increase. Underlying rate of increase, once adjustment made for special factors, has not increased. Vacancies still improving.

7. Interest rates still too high. Interest rate increases last year were necessary to restrain monetary growth and protect the exchange rate to maintain progress in bringing down inflation. Reduction of inflation vital if we are to secure prospects for sustained long term growth.

8. <u>Forecasts of unemployment</u>? Forecasts notoriously unreliable. For purposes of public expenditure planning, GAD <u>assumed</u> a level of <u>GB</u> wholly unemployed of 2.9 million in 1981-82 and in 1982-83 and subsequent years.

9. <u>Output prospects still as gloomy as 1981 MTFS</u>? The 1981 FSBR projections of government receipts, expenditure and borrowing <u>assumed</u> an average output growth of ½% per annum for the whole period 1980 to 1985. Latest projections suggest just over 1 per cent growth in 1982 and perhaps stronger performance in 1983 and 1984. Given growth of nominal income - "the national cash limit" - prospects for output depend crucially on how fast prices, and more particularly earnings, decelerate.

Background Note H: UK Unemployment

Unemployment Levels

	Wholly Unemployed (excluding school leavers s.a.)		Total including school leavers ("wide") (unadjusted)	
	Millions	Percentage of working population	Millions	Percentage of working population
1980 December	2.14	(8.8)	2.2	(9.3)
1981 October	2.73	(11.3)	2.99	(12.4)
November	2.76	(11.4)	2.95	(12.4)
December	2.78	(11.5)	2.94	(12.2)
1982 January	2.83	(11.7)	3.07	(12.7)

Increase in Unemployment 1981-82

	(monthly averages) Thousands
Mid January to Mid April	75
Mid April to Mid July	43
Mid July to Mid October	49
Mid October to Mid January	33

Unemployment Projections

The assumptions used in recent projections have been as follows:

	GB unemployment including school leavers (millions)	
	Government Actuary's Report (December 1981)	PEWP (March 1981)
1982-83	2.9	2.7
1983-84	2.9	2.7

INFLATION

BRIEF E

Factual

1. Retail prices rose by 12 per cent in the year to December 1981 (the same as for the year to November).

2. January RPI may be adversely affected by the recent bad weather, but little change expected in 12 per cent inflation rate.

3. The outlook for early 1982 is for very little change in the annual rate of inflation. Later in the year it should drop below the 1981 trough (10.9 per cent). By 1982 Q4 the Industry Act Forecast looked to an annual rate of increase in the RPI of 10 per cent. A reduction to single-figure inflation is expected in 1983.

4. General government procurement prices are expected to grow by 9 per cent in financial year 1982-83, in line with the price factor used in planning expenditure.

Positive

1. Inflation on a rising trend when we took office. It has come down from 22 per cent in the early part of last year to around 12 per cent now. Recent months have been somewhat less encouraging, but downward trend will be renewed soon.

2. This has been achieved without prices and incomes policies and without building in a serious threat of a future explosion.

Defensive

1. The recent increases in inflation have been disappointing, but special factors (the mortgage rate increase, effects of sterling depreciation) have been unhelpful. There is a firm prospect of resumed progress soon.

BRIEF F

PRODUCTIVITY

1975 = 100

Factual	Output per head		Output per person hour
	Whole Economy	Manufacturing	Manufacturing
1979 Q2 (last cyclical peak)	111.4	108.6	111.1
1980 Q4 (cyclical trough)	108.1	103.1	106.9
1981 Q3	n/a *[Q2 = 110.1]	113.2	115.0
per cent change			
Q3 1981 on Q2 1979	[Q2 =-1.2]*	4.2	3.5
Q3 1981 on Q4 1980	[Q2 = 1.8]*	9.8 N.B.	7.6

*As output rose and employment fell in 3Q the 3Q figure will show a significant rise. The 2Q figures are therefore underestimates.

Positive

(i) Productivity increased sharply during 1981 especially in manufacturing. Previous cyclical peaks have been passed.

(ii) Widespread reports of strenuous efforts to improve efficiency perhaps now beginning to show up in the figures.

(iii) Productivity gain plus moderation in settlements have resulted in very little rise in manufacturers' unit wage costs - up only 4 per cent in year to September.

Defensive

Improvement is just cyclical bounceback

Normal for productivity to decline in recession as employment response lags - but decline less than previous experience indicated. Productivity now above previous 1979 cyclical peak.

BRIEF G

PAY

Factual

The cumulative average for private sector settlements monitored by the Department of Employment in the pay round so far has now fallen to just over 6½ per cent. The corresponding figure for the public sector is 12 per cent, but this is still dominated by the police settlement in September (13.2 per cent).

2. The cumulative average for the economy as a whole is just over 7 per cent. Just under 15 per cent of employees monitored by the Department have reached settlements.

3. The miners have accepted 7.4 per cent in earnings (presented as 9.3 per cent on basic rates), water workers 8.8 per cent, oil tanker drivers 8.1 per cent. Low settlements include national engineering agreement (5.1 per cent), British Leyland (4½-5 per cent), clothing industry (5 per cent), motor vehicle retail and repair (4½ per cent).

Positive

1. Clear deceleration in this pay round

Average level of settlements was 9 per cent in the last pay round. In this round 9 per cent is emerging as the upper end of the range, with settlements ranging down to 4 per cent and below. Few settlements in double figures.

2. Government objectives still intact

Even groups with most scope for damaging industrial action (miners, water workers, oil tanker drivers) are settling well within single figures, if rather on the high side. The 6.9 per cent offer to the local authority manuals was regrettable. But no reason why the Government should not continue to approach public service pay on the basis of the 4 per cent pay factor.

Defensive

1. Pay settlements higher than assumed?

Some are certainly higher than we would have wished. But no serious pay threat to the strategy at this stage. The need is to press hard for low settlements in the public services. CBI report that the bulk of settlements in manufacturing this round have been in the 4 to 6 per cent range.

2. Intolerable squeeze on living standards?

The great majority of settlements are well below the rate of inflation, and they are being voluntarily accepted by workforces. Much greater realism about the short-term prosepcts for living standards, and about the need to earn them. Personal living standards grew by 17½ per cent in the 3 years 1977-80: downward correction from this unsustainable level now inevitable, and little of it had occurred by the start of this pay round (less than 2 per cent down in first 9 months of 1981 compared with same period of 1980).

3. Incomes policy

A sharp deceleration was achieved in the last pay round (from 18 per cent settlements in the round before that to 9 per cent), and a further marked deceleration (to 6½ per cent so far in the private sector) is being achieved now. Doubtful whether incomes policy could have done any better even if the grave problems of norms, enforcement, public acceptability, and union acquiescence could have been overcome, quite apart from the economic distortion which would have resulted.

Brief H

EXCHANGE RATE AND COMPETITIVENESS

1. Why did the exchange rate fall so far in 1981?

Between January and October 1981 sterling fell by 23% against the dollar (from $2.40 to $1.84), by 14% against the deutschemark (from DM 4.82 to DM 4.15) and by 14% in effective terms (from 102 to 88). Reasons for decline include:

- fall in oil price
- high interest rates in US and latterly in Europe
- also perhaps some fear in the autumn of weakening of UK government resolve against inflation.

Since October sterling has staged a modest recovery and currently stands at $1.88 DM 4.33 and an effective rate of 91.2 . This recovery owes something to the rise in UK interest rates since September; but sterling has also benefited from evidence of the Government's continued resolve on economic policy; and more recently from the better industrial news (miners).

2. Support the rate by greater intervention rather than interest rates

Experience here and elsewhere shows intervention ineffective, except in very short-term. Can even attract speculation. Most effective support for the pound that the Government can offer is to show continued determination to cut inflation and pursue responsible econimic policies.

3. An exchange rate target/join EMS e.r.m

(Hard to adopt an independent target publicly without joining EMS e.r.m). Membership of the EMS is itself would not stabilise the exchange rate: exchange rate stability will only flow from the successful pursuit of counter-inflation policy. In addition:

- would put a European label on the prompt adjustments in interest rates and fiscal policy required whenever sterling came under pressure;
- some loss of the flexibility presently available to us of permitting the exchange rate to take part of the strain of international adjustment.

A balance of risks. But must doubt our ability to hold sterling to any target in some circumstances. Remember it is a petro-currency and responds to changing expectations in the oil markets - whether the price is rising or falling - by moving in a contrary direction to other currencies; and is an internationally traded currency, like the DM, and subject to market pressures of a different kind from the other EMS currencies, which find it easier to keep up (or down) with the DM.

4. Should exchange controls be reimposed?

Abolition of exchange contols an important part of policy of reducing bureaucracy and freeing the economy. Experience had shown that their effect on the exchange rate was very limited. In particular they could not prevent substantial pressure from changes in leading and lagging on trade payments or investment by non-residents. The abolition of exchange controls helped UK industry by allowing long pent-up outflows that helped keep the exchange rate lower than it would otherwise be at a time when it was subject to strong oil-related upward pressures.

5. Effect of fall in the exchange rate on the RPI?

Some 20% of a fall in the exchange rate may be reflected in the RPI within a year. On that basis the 10% fall in sterling's effective exchange rate in 1981 would add 2% to this year's RPI. Therefore it is important to maintain current policies to moderate growth of wages, public spending, and the money supply and to encourage improvements in productivity.

6. Fall in the exchange rate help exporters to regain cost competitiveness?

There is now some evidence that UK unit labour costs are rising more slowly than those of our competitors, due to faster growth in productivity and the more moderate growth in wages. This suggests competitiveness may be improving even before the 10 per cent fall in the effective exchange rate is allowed for. Most of the extensive loss of competitiveness suffered in 1979-80 was due to a failure by companies to contain their cost increases. Seeking further falls in the exchange rate will add to those costs. The only long term path to improved competitiveness is to continue to confine cost increases and improve productivity.

MONETARY POLICY BRIEF I

Factual - see attached table for details of monetary aggregates(1) and UK/international interest rates.

(i) Over the past year £M3 has grown by 13.5 per cent; M1 has grown by only 7.8 per cent; PSL2 has grown by 11.5 per cent. After allowing for effects of Civil Service strike, growth of £M3 is probably above the target range.

(ii) Bank lending has been growing very rapidly. Stock outstanding at mid-November was 22 per cent higher than a year earlier. Personal lending growing very rapidly, up 42 per cent on a year earlier.

(iii) At time of Budget, our interest rates were broadly in line with average for other industrial countries. As our rates fell and rates abroad rose, UK rates were up to 3 per cent lower. In Nov/Dec that was reversed, and our rates rose to be about 2½ per cent higher. Subsequently, US rates have risen while UK rates have fallen, leaving our rates now roughly 1½ per cent higher than the average for other industrial countries.

Positive

(i) Tough fiscal decisions in Budget enabled us to hold our interest rates below those abroad for much of summer, though as rates abroad rose we were not able to sustain the advantage. But without that tight Budget our rates could now be even higher.

(ii) An updated version of MTFS containing financial guidelines for money and the PSBR will be presented in Budget. Central theme of MTFS, that fiscal policy must be consistent with monetary policy, is gaining wide acceptance around the world.

Defensive

(i) Why did interest rates have to rise from their 1981 Budget levels
Immediate reasons were pressure on sterling and rapid growth of bank lending. But important to note that overseas rates had bee rising since the spring, and while Budget measures enabled us to prevent our rates being pulled up for some months, deterioration in domestic monetary conditions required a rise to keep the money supply under control.

(1) figures relate to the new monetary sector

(ii). Isn't it just exchange rates which are determining interest rates and if so why the concern about the PSBR?

No. Exchange rate is one factor to be taken into account along with domestic monetary situation, especially recent rapid growth in bank lending to the private sector. US rates not sole determinant of UK rates. Can have lower rates here if prospects for inflation improve and PSBR is contained.

(iii) What will be the monetary target for next year?

Am still considering the form and level of the financial guidelines in the MTFS. Essential to look at behaviour of different aggregates - so am considering the case for providing figures for several aggregates in addition to £M3. Too early to say what precise figures may be, but our latest work on velocity trends indicates that rather higher figures than in last MTFS may be consistent with maintaining downward pressure on inflation.

(iv) Don't the narrow aggregates give a better guide to monetary tightness?

Growth in narrow aggregates more affected than £M3 by fluctuation in interest rates (higher rates imply lower growth). In practice, interest rates are determined with reference to a range of indicators including the exchange rate.

(v) Isn't £M3 a misleading guide? (eg rise in bank lending for house purchase)

Aware of need to take account of structural changes which could inflate £M3 without adding to inflationary pressures. Extent to which lending for house purchase by banks represents substitution for lending by building societies is borne in mind in interpreting £M3. But indications are that some of bank lending has been additional, not just in substitution, and as such constitutes a risk to inflation.

(vi) Do we have a consistent framework for interest decisions?

Yes. Aim has been to exert steady downward pressure on monetary conditions and thus on inflationary pressures. Interest rates adjusted in the framework. As set out in 1981 Budget, interest rates are determined with reference to a range of financial indicators including the exchange rate.

(vii) MTFS and monetary targets discredited?

It is necessary to set our policy decisions in a medium term framework for operation of the economy. Essence of our approach is not so much in particular series of figures, but in assurance it gives of Government's determination to reduce inflation. Only in this way can we give wage bargainers the the right message.

(viii) Why not allow PSBR to rise, to accommodate tax cuts in the budget?

Effect of tax cuts on output would be largely offset by consequences of the rise in interest rates necessary to contain monetary growth - both the direct effect of raising industry's costs and the indirect loss of competitiveness due to rise in exchange rate.

(ix) What if we make room for tax cuts by allowing PSBR to rise, but keep interest rates fixed?

Rise in real output would be accompanied by rise in inflation resulting from rise in money supply and fall in exchange rate.

MONETARY POLICY

(i) Monetary growth (annual rate)

Per cent

	MO	M1	£M3	M3	PSL2
Change over:-					
Target period - Feb/Dec	2.9	8.6	15.3	19.9	12.1
Last 12 months - to Dec	4.8	7.8	13.5	19.2	11.5

(ii) International Interest rates (3 months)

	UK	US	Germany	France	Japan	Italy	Canadian	World Basket
Mar	12.6	14.5	13.8	12.7	7.9	18.6	16.9	13.8
April	12.3	15.2	13.2	13.1	6.8	20.0	17.3	13.8
May	12.4	18.0	13.1	16.3	7.2	20.1	18.6	15.8
June	12.7	17.0	13.1	19.0	7.4	20.6	19.2	15.9
July	13.8	17.6	12.9	17.7	7.2	21.0	19.4	15.9
Aug	14.2	17.8	12.9	17.5	7.2	21.2	21.9	16.0
Sept	14.9	16.5	12.4	18.0	7.3	21.4	20.2	15.5
Oct	16.4	15.0	11.7	16.9	7.1	21.2	18.8	14.4
Nov	15.0	12.0	11.1	15.5	7.1	21.4	16.4	12.7
Dec	15.6	12.9	10.8	15.3	6.6	21.0	15.9	12.9
25 Jan	14.8	14.6	10.2	15.2	6.4	21.6	15.2	13.2

We have announced a planning total of £115 billion for 1982-83 (the 2 December statement). We should stick as closely to this as possible. [By 28 January, we shall know what total has gone to Cabinet with the Public Expenditure White Paper: it could be £115.5 billion or even more.] To use up any room for manoeuvre by increasing public expenditure would be quite the wrong thing to do both economically and politically.

- Economically, our aim must be to help industry, while keeping costs down. This means reducing taxation, whether corporate or personal. To add to public expenditure might look like a good short term expedient. But it does nothing to cut costs. The whole experience of the UK, as in many other countries, is that the growth of public spending tends to weaken the industrial and commercial basis which pays for it. At best, extra public spending is likely to create jobs which are not sustainable; at worst it is likely to increase unemployment rather than to reduce it.

- Politically, this Government came into Office with the objective of reducing public expenditure, not of increasing it. The Government is already under attack from some of its supporters for failure to reduce public expenditure as promised and for repeated failures to adhere to the original reductions in plans. Extra public spending has vitiated our objectives on taxation. We should be criticised (by some) if not of by all if the total were increased further and substantially within 3 months of announcements of our plans. Certainly to add to them at this stage would not give the impression of an administration with no clear idea of where it is heading.

Defensive

Operationally, we have finalised the figures for 1982-83 for the White Paper - there is virtually no time left for changes. However, it would be possible to publish a slightly different figures in the FSBR to take account of late decisions. Governments have done so in the past. But it looks bad, against the political arguments stated above. We should stick to our published plans.

Background

If the Chancellor eventually decides to make small increases in spending in the Budget eg by spending more on the disabled rather than by the tax route, it should come out of the Contingency Reserve, rather than adding to the overall total. The public expenditure side would advise strongly against any such increases. The programmes for 1982-83 have been settled and were published in December subject to only such adjustments as would bring the total to £115bn. Additions are not only undesirable in themselves but would weaken our case against other spending departments (like the Home Office) where we are at present insisting on offsetting savings to any fresh bids. And of course charging such items to the Contingency Reserve, rather than to the fiscal adjustment, means that they have no reflationary effect since the forecast assumes that the Reserve is more or less fully spent.

Public Expenditure White Paper

Cabinet colleagues should have received from the Chief Secretary, before Cabinet, a draft of Part 1 of the PEWP. They might raise points on it, although the Chief Secretary will merely have asked for comments in writing.

Any general points raised could usefully be got out of the way on 28 January (the following Cabinet, 4 February, would be too late). But if specific points on individual Departments are raised, you are advised to suggest that they could best be dealt with in correspondence or bilateral discussion.

K

PARTICULAR ITEMS OF PUBLIC EXPENDITURE

1. Shortfall on unpledged benefits
2. Child Benefit
3. Energy price subsidies
4. Department of Industry expenditure proposals
5. Agriculture
6. Asset disposals
7. Construction

These briefs cover the major items of direct departmental interest which have been raised or may be raised by particular colleagues. Budget representations on more general matters relating to taxation etc are covered passim in your briefs. Minor items (workshops scheme and the like) are not Cabinet material. Indeed in principle departmental spending proposals should not be discussed tomorrow.

K. 1

THE SHORTFALL ON UNPLEDGED BENEFITS

Line to take

Cabinet agreed that we should not restore the 2 per cent shortfall on the unpledged benefits and Chancellor announced the decision on 2 December. No specific commitment given to review that decision though, because the November 1982 uprating will not be known until the Budget, impression given that Government will reconsider at Budget time. This a matter to be considered further between Chancellor and Secretary of State for Social Services.* The merits which led the Cabinet to decide not to restore shortfall are unchanged. The cost would be £180 million in a full year. The benefits are, for the most part, short-term and restoration of shortfall means very little since the population on benefit in November 1982 would be very different from that receiving the benefit in November 1980. Third, we expect those in work to take a cut in their living standards in the next financial year; we have already done more for those out of work by giving them a guarantee of price protection from November 1982 to November 1982. The case for doing more and restoring shortfall is thin.

Background

2 The shortfall in question is the amount by which the actual movement of prices from November 1980 to November 1981 (12 per cent) was below the forecast made at Budget time (10 per cent) on which the upratings for November 1981 were based. The actual upratings were 9 per cent because of the decision to take back 1 per cent over-provision in the previous uprating.

3 The cost of making good the 2 per cent shortfall is shown in the table below.

---

*We understand that Mr Fowler will be writing shortly, perhaps before Cabinet, to say that in his view it is not now practical to restore the shortfall. But DHSS think he is unlikely to copy his letter round.

	1982-83	Full year (1983-84)
Unemployment benefit	11	35
Sickness, injury and maternity allowance	5	10
Supplementary allowance		
- short-term rate	16	45
- long-term rate	6	15
Child benefit	25	65
Family Income Supplement	2	6
Mobility Allowance	2	4
	67	180

K. 2

CHILD BENEFIT

Line to take

Child benefit was treated in the PES discussions as an unpledged benefit. In other words it was assumed it would receive an uprating to cover the movement of prices from November 1981 to November 1982, but that there should be no attempt to restore any shortfall between last year's uprating and the movement of prices from November 1980 to November 1981. We all recognise however that the rate of child benefit has an importance in the Budgetary context as one of the components of family income. It is therefore proposed to discuss this further with the Secretary of State for Social Services in the Budget context.

Background

2 The rate of child benefit is £5.25 p.w. The increase announced last Budget was just over 10 per cent (in contrast to the 9 per cent increase for other benefits and the freezing of tax allowances). There will be a number of considerations in setting the rate payable from November 1982. They include the post-Budget expectation of price movements from November 1981 to November 1982; the actual increase in tax allowances decided on in the Budget (simple Rooker-Wise would be about 12 per cent - the price movement for the calendar year 1981); the political pressures (CPAG are pressing for at least 60p; a number of Conservative backbenchers take their tune from CPAG); and the fact that increases are usually to reasonably round numbers of £p. The attached table shows what the public expenditure impact of likely increases would be, and further material on the real value of child benefit etc is also attached.

Defensive

In the context of discussion on category (ii) measures as discussed in the main paper (giving the bulk of any fiscal relief by way of increase in income tax thresholds over and above straight Rooker/Wise) Treasury Ministers may be pressed for an undertaking that if they went down this path child benefit would also be increased as appropriate beyond straight revalorisation, in order to avoid the position of people with children falling behind those without children. Treasury Ministers will want to be cautious on this; increasing child benefit over the odds is an expensive business, and it could be argued that following last year, when the benefit went up although income tax allowances did not, some reversal this year would be only fair. But this Cabinet is not the place to settle this; Treasury Ministers may simply like to say that they will bear the point in mind when they consider the matter with the Secretary of State for Social Services in the Budget context.

CHILD BENEFIT

Rate	Increase		Public expenditure full year (compared with current programme)	Comment
£p	£p	%	£m	
5.50	25	4.8	-168	
5.75	50	9.5	- 18	The nearest to the PES assumption of 10%
5.80	55	10.5	+ 18	
5.85	60	11.4	+ 50	The CPAG "minimum"
5.90	65	12.3	+ 80	This would more than "restore shortfall" on the basis of a 10% price forecast. It would equal a "Rooker-Wise" provision on tax allowances
5.95	70	13.3	+115	
6.00	75	14.3	+150	