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01-233 3000

PRIME MINISTER

THE MONETARY OUTLOOK AND THE CIVIL SERVICE STRIKE

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I attach the report prepared by Treasury officials on the Monetary Outlook and the Financial Effects of the Civil Service strike promised in my private secretary's letter of 11 May about the central government borrowing requirement in calendar April.

2. The salient points, subject to the inevitable uncertainties of all such forecasts which are compounded by the strike, are:

(a) £M3 figures are likely to rise by 2 per cent or more in each of the next 2 or 3 banking months. (The M1 figures rise a good deal faster, at least in the early part of the period.) As the table in paragraph 4 of the note shows, these increases will have been swollen by the estimated strike effect of nearly 1½ per cent a month. But even without that the underlying growth in £M3, over the first 5 months of the new target period may exceed the target range. The unexpected strength of bank lending seems to be the main factor behind this;

(b) the monthly effect of the strike on revenue will remain at about £1¼-1½ billion, if, as we expect, we continue to get about three quarters of the forecast revenue paid in;

(c) officials have not been able to identify ways of stepping up the flow of revenue without

Prime Minister ✓
Alan Cudde endorses the proposition that we finance the tax short-fall by reducing the Bank's holdings of Treasury bills and, if necessary, increasing the issue of bills. He draws the fairly obvious conclusion that there is no scope for an early cut in M.L.R.

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jeopardising the (much larger) existing flow. They have also considered whether any special funding device could contribute usefully towards containing the effects of the strike on £M. I endorse their conclusion (discussed more fully in the Annex to the attached paper) that transactions in bills are the appropriate way of responding to the situation;

(d) I have on balance decided to approve the proposal that the Inland Revenue should open an account with Giro into which uncleared cheques would be paid. Even though the money is not likely to reach central government during the strike, it would be helpful that the liquidity of the private sector will be reduced as a result. (See paragraphs 12-15 of the note.)

(e) Over 80 per cent of the missing revenue is not in the form of uncleared cheques but has simply not been paid. This means that it will take longer to unwind the financial effects of the strike than has been assumed for the purpose of the forecast. This will ease money market problems but lengthen the uncertainty about interpreting monetary statistics.

3. The prospect is thus not a comfortable one. But I do not think it is unmanageable and I am sure we should maintain the line that the strike is not putting the economic strategy at risk.

A handwritten signature in black ink, appearing to be 'G.H.'.

(G.H.)

13 May 1981

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1. MR MIDDLETON
3. CHANCELLOR
2. Mr Ryrie

- cc Chief Secretary
Financial Secretary
Minister of State (L)
Minister of State (C)
Sir Douglas Wass
Mr Ryrie
Mr Burns
Sir K Couzens
Mr Britton
Miss Brown
Mr Collinson
Mr Pirie
Mr Turnbull
Mrs Lomax
Mr Ingham
Sir D Lovelock - C&EX (Personal)
Sir L Airey - IR (Personal)
Mr Fforde - B/E

This note has been prepared in a form which could be sent to the Prime Minister. We promised her a full report when sending the C9BR figures over yesterday

Burns

THE MONETARY OUTLOOK AND THE FINANCIAL EFFECTS OF THE CIVIL SERVICE STRIKE

This note reports the outcome of Mr Ryrie's meeting with the Bank about the monetary outlook for the next 3 months and of a meeting of Mr Middleton's group of officials concerned with the financial effects of the strike.

Monetary Prospects: May-July

2. The £M3 figures for banking April, the first to be published since the strike, were published last week. The Press generally accepted official briefing that although the recorded growth was about 2%, the underlying growth, ignoring the strike effect was about $\frac{1}{2}$ %. This would place the growth of £M3 over the past 6 months at just over 8% at annual rate (using the new seasonal adjustments). Nevertheless, this did not entirely reassure the markets.

3. The prospects for the next 3 months are naturally dominated by the effects of the Civil Service dispute. Trying to disentangle

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the underlying position from the likely published figures is a difficult exercise requiring a large number of assumptions about the size of the effect on the CGBR and the way companies respond to the improvement in their liquidity. Through it all we reached the following conclusions.

- i. There appears to be some deterioration in the underlying prospect, with growth over the next 3 months averaging $1\frac{1}{4}\%$, and with the figure for May being around $1\frac{1}{2}\%$. Although we had always expected £M3 to grow rather faster in the first half of the target period (and considered including a statement to that effect in the Budget Speech), the position is nevertheless worrying.
- ii. We had no direct way of estimating the CGBR at present and it is being projected forward in line with the forecast. The degree of front loading is expected to be as great as it turned out to be last year.

(iii) The main cause for concern is bank lending. Successive monthly exercises have raised the estimate of the underlying rate from £450 million per month to £600 million. At this level it is difficult but not impossible to achieve the monetary target without overfunding and reducing bank liquidity. Were it not for the dispute this might indeed have been taking place. There are no signs as yet of the hoped for weakening of lending to persons. The next quarterly survey - to mid May - will be available in June and we will need to examine these figures carefully.

(iv) Although National Savings are doing well - probably unsustainably so sales of gilts have been disappointing in May. The short tap has been reactivated but yields had to rise considerably to bring that about. Built into the forecasts are some fairly ambitious figures for gilt sales which it will not be easy to achieve in adverse circumstances.

4. Whatever our view of the underlying position, the actual monetary figures will attract attention. The table below shows the estimated effect of the dispute on the CGBR and £M3. It is constructed on the assumption that the strike ends in June and is unwound in July. (This is not necessarily the most realistic assumption but it allows one to look at the prospects over the period excluding the effects of the dispute.)

	<u>Banking Months</u>				
£ billion	<u>Mar</u>	<u>April</u>	<u>May</u>	<u>June</u>	<u>July</u>
CGBR underlying s.a.	635	575	1375	840	730
Strike effect	200	1350	1410	1320	-4280
Actual CGBR	835	1925	2785	2160	-3550
Per cent					
Increase in £M3, underlying	0.6	0.7	1.4	0.6	1.6
Strike effect	0.2	1.3	1.4	1.4	-4.1
Actual increase	0.8	2.0	2.8	2.0	-2.5

5. The actual £M3 figure for May could be between 2½-3 per cent and June around 2 per cent. In addition to the monetary statistics, there will be a cumulative CGBR, not seasonally adjusted, of around £10 billion. Such figures are likely to cause increasing concern in the Press and the markets, particularly as it will become increasingly apparent that we have no independent source of information for the underlying figures: we could be understating them if the Budget forecasts of revenue were optimistic. As an independent cross-check we can use statistics for earnings, employment and retail sales. We do not get these promptly enough to be of much use yet, though if anything they suggest the Budget forecasts of revenue might be a little on the low side.

6. The discovery that only a small part of the uncollected tax is in the form of uncleared cheques is worrying. It could cast doubt on the estimates of the strike effect, it could imply greater freedom for companies to deploy the funds and it could slow the process of unwinding.

Funding and unwinding the effects of the strike

7. Officials have considered whether the funding arrangements should be changed in response to the effects of the strike and whether there should be any changes in our methods of operating in the money markets both to cope with increasing bank liquidity and to improve the prospects of unwinding the strike smoothly. The arguments are set out in the attached Annex. It concludes that there is not much prospect of being able to sell additional gilts or National Savings and ^{that} to offer a special interest bearing instrument for companies to hold would encourage and sanction non payment of tax. The effects of the strike should* continue to run down the Bank's holdings and then by issuing Treasury bills. When the strike is unwound the Bank will buy back the bills, though it is possible that there could be pressure on bank liquidity.

* be financed in the bill markets first by

Bringing in More Revenue

8. Customs and Excise see the possibility of some slippage in deferred duties after May but both departments agree that the best working assumption for the next few months is that the proportion of forecast revenue being paid in will remain at about three quarters overall, with the Inland Revenue achieving slightly less than that figure, and the Customs and Excise slightly more. The strike effect on revenue and the CGBR is likely to remain about £1 $\frac{1}{4}$ -1 $\frac{1}{2}$ billion per month.

9. The Revenue departments have no way of knowing which taxpayers have failed to pay, though they know that they are predominantly small payers*. But in any case, few enforcement staff are available to chase up overdue payments and those that are lack their normal computer information. There is therefore no scope for stepping up enforcement activity. However the Revenue hope to be able to cash the large cheques at present in their offices (see paragraph 17 below). Those should bring in over £100 million.

10. An alternative would be to draw more attention to the mean of payment still available; ie through the banking system and Giro. But the clearers have advised that a change from the present low-key approach may be interpreted as a hostile action by their own staff many of whom have still not accepted their employers' pay offer, and so jeopardise the payments, mainly by large payers, now made via the banking system which are crucial to the success of the present arrangements. (There has already been some blacking of the payments through this route in some of the Northern Irish banks.) Similarly, the Giro, whose staff are members of the civil service unions, consider it essential to maintain a low profile if present revenue flows are to continue (though a small step in Giro's case is discussed below). We conclude that this option must be ruled out at least until the outcome of the ballot by BIFU, and its aftermath are known. BIFU is on the look out for an excuse for escalating its industrial action.

* and that some taxpayers are netting off VAT repayments due from the payments that are being made.

11. However, officials did consider that a carefully presented Ministerial appeal to those employers who have not yet paid might be worth considering. Such an appeal might be made as a minor part of a statement by the Prime Minister or Chancellor which would be mainly designed to underline the success of the present arrangements (without encouraging the unions to further disruption) and would carefully avoid explicit reference to the alternative methods of payment available. We shall be considering this further with the Revenue departments.

Girobank

12. There is a special problem relating to Girobank on which we seek a decision from Ministers. The flow of revenue by credit transfer through Giro presents no difficulties; some £200 million per month reaches each of the Revenue departments by this route. But a number of cheques made payable to the Inland Revenue are mistakenly sent to the Giro. In normal circumstances these would be forwarded to Inland Revenue at Worthing, but the Giro unions (ie the civil service unions) have blocked this arrangement for the duration of the strike.

13. Although initially the amounts involved were small, some 200 cheques worth £45-50 million are now stuck with Giro, and the amount could rise quite sharply, particularly after the next PAYE payments due on 19 May. The Inland Revenue have up to now accepted this because Giro management consider that if some special means of getting these cheques to Inland Revenue were adopted, the much larger monthly flow of £200 million through Giro credit transfer would be at risk. But if the cheques are not cleared in some way, the senders of the cheques may not bother to make further tax payments. Inland Revenue have therefore asked the Treasury to agree that Giro should open an account on their behalf into which the cheques could be paid and then block the account until the end of the strike. Giro consider that the unions are likely go along with this. The Inland Revenue have copied their letter to Exchequer and Audit who will also see our reply.

14. The proposal would not change the £M3 statistics compared with the present arrangements because the sums represented by the cleared cheques would be shifted from one (private) part of the banking system to another (public) part. But it would have the advantage of reducing the liquidity of the private sector; and to the extent that Giro invested this money in the public sector, less interest would be paid to the private sector. Giro think a formal agreement to pay interest on the blocked account may provoke the unions unnecessarily at present; but they would accept eventual payment in some form. Treasury officials consider that it would not be right for the Treasury simply to authorise the opening of a blocked account. But we have to recognise that if we authorise the opening of a new account it is in practice likely to be blocked.

15. This raises presentational difficulties, which might be exploited by the unions if the amounts involved grow significantly. But there are also problems with the alternative. If no action is taken, the unions will have just as much presentational leverage while the Government will not gain anything at all. If the Revenue or the Treasury were to insist that these cheques should be forwarded to Inland Revenue the present arrangements for obtaining revenue through the Giro would be put at risk. On balance, we would therefore recommend agreement to the opening of a Giro account on behalf of Inland Revenue; we would not give approval to the proposal that it should be blocked but recognise the probability that it would in practice be blocked and make it a condition that if that happens, payment of interest or equivalent financial compensation in lieu of interest will be obtained from Giro.

Recovery at the End of the Strike

16. It was originally thought that following a return to normal working, very large payments of tax would be made extremely rapidly, which might create a serious shortage in the money markets. However, we now think the period of unwinding the financial effects of the strike

may be extended. This will ease money market problems but lengthen the period of exceptional uncertainty about interpreting money statistics.

17. The Inland Revenue have reviewed their estimate of the breakdown of revenue not received between that in the form of low denomination cheques which it has not been possible to clear and that which employers have failed to pay. It is now reckoned that there are nearly 500,000 cheques awaiting clearance worth perhaps £300 million. Most of the shortfall in tax receipts is therefore in the form of tax not paid - some 80% or so of the shortfall.

18. This could have serious implications for recovery time, particularly since both Revenue departments face the prospect of an overtime ban by staff returning to work which may be imposed for the same period as the strike. If recovery staff are needed for collection of unpaid revenue, the backlog is likely to take some considerable time to clear, since enforcement staff are normally fully occupied at this time of the year in the processing of employees' deduction cards. Some 37 million of these are annually processed by the Inland Revenue and the DHSS before being sent on to local tax offices to ensure the correct payment of tax during the forthcoming tax year. This operation has also been blocked for the duration of the strike; instead of 2 million cards sent weekly to DHSS at this time of year, only 250,000 in all have gone since 5 April.

19. The Revenue departments will have to deal with many problems at the end of the strike including returned cheques and Payable Orders and cheques which cannot be cleared; and the repayment of VAT. Both departments are now considering what their priorities should be during the recovery period, and will consult Ministers about the various options in due course. Relevant factors will include the general economic conditions at the time and the CGBR position and the markets' expectation of an early return to normal of the money supply figures.

20. The Revenue departments presently reckon that for a return to work at the end of June recovery* would take place during the following

* In the sense that the bulk of the missing revenue would be recovered during the following quarter.

quarter. However, the Paymaster General's Office consider that they are already at the point beyond which "recovery" for the period of the strike looks extremely remote; a strike lasting until June would eliminate all prospect for recovery of fraudulent payments made during the dispute.

Presentation

21. In the further briefing for Ministers that we shall be preparing, we shall be recommending that the present line - that the strike is not threatening the economic strategy - should be maintained. When the money figures for banking May are published in June we shall consider whether further special briefing of the Press would be useful.

Conclusions

22. We have no reason at present to expect the monthly effect of the strike on revenue to rise from its present level of £1 $\frac{1}{4}$ -1 $\frac{1}{2}$ billion, though a deterioration remains possible.

23. The high underlying CGBR figure for banking May means that both the recorded and the underlying £M3 figures to be announced on 7 June will be uncomfortably high. The prospect is that over the first 5 months of the new target period, underlying monetary growth may exceed the target range. The main factor behind this appears to be the strength of bank lending. All this will add to the anxieties about the absence of any direct independent source of information about the "underlying" revenue flow, as the cumulative CGBR rises, perhaps to £10 billion by the end of June.

*not
seasonally
adjusted*

24. Despite these problems the Government should continue to maintain that the strike is not putting the economic strategy at risk.

25. We cannot identify any way of stepping up the flow of revenue without jeopardising the (much larger) existing flow. Nor do we see any special funding device which can reduce the effect of the strike on the £M3

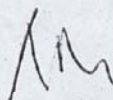
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figures. Relying on bills seems the appropriate response.

26. We recommend Ministers to agree that we should authorise the Inland Revenue to open an account with Giro on the basis in paragraph 15.

27. The recovery period now seems likely to be a long one. This will have some advantages for managing the money markets but will prolong the uncertainties about monetary growth.



N MONCK

12 May 1981

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FUNDING AND UNWINDING THE EFFECTS OF THE STRIKE

1. Hitherto the shortfall has been financed largely by reducing the Bank's holdings of bills which at a peak reached £3.5 billion out of a total of around £5 billion. So far the Bank's bill holdings have declined to around £2.3 billion. There will come a point when it will be necessary to increase the issue of Treasury bills. In monetary terms this is a continuum; there is no particular significance to be attached to the point at which we cease to finance the shortfall by running down assets and begin to issue new debt. Either way the shortfall adds to money except to the extent that there are offsets in bank lending and the externals. The Treasury Bill tender has remained at £100 million a week and the stock is historically very low. Thus there should be some scope for increased sales both within and outside the banking system.
2. One advantage of financing the shortfall via bills is that it provides the mechanism for unwinding. In order to offset the cash shortage created by the flood of tax payments, the Bank will buy back the large stock of bills in market hands.
3. However, there could be difficulties in unwinding the effects of the strike painlessly. First the sums involved could be very large - possibly over £5 billion of market assistance being required if the strike were unwound in July. Secondly, in underlying terms the liquidity of the banks may have been deteriorating with strong bank lending being matched by an overfunded PSBR.
4. What are the implications of trying to mop up the extra liquidity by more funding? The first point to consider is who has the money. In general this will be companies who in general are not large holders of public sector debt, rather than financial institutions. It is likely that these companies will want capital certain assets to match tax payments of a

predetermined amount, and assets of shortish maturity, as there is uncertainty about when the strike will be unwound. Gilts look a rather unsuitable outlet for the tax money. Thus there is a problem of habitat - the money is not accruing in the right place; and of assets - most debt instruments are unsuitable.

5. The case for accelerating the sale of gilts is weak. In present circumstances there are worries enough about achieving the "normal" funding programme. To raise more could require a very sharp adjustment of medium and long term interest rates. It is doubtful too whether National Savings could be pushed even harder at the moment.

6. An alternative might be to devise some new instrument which would be short term, reasonably capital certain, which could be sold to non-banks and surrendered when the tax is eventually paid. This would mean that the idle balances would not score as money but would be just over the definitional border. Why not market CTD's more actively? There are several difficulties here. First, CTD's cannot at present be used for PAYE for VAT or NI contributions. Secondly, interest on CTD's ceases to be paid on the due date; thus by definition they would not be useful in these circumstances. The PAC might ^{have} something to say about HMG overtly paying interest on tax due and encouraging non-payment though it is, of course, doing this indirectly. Thirdly, most of the natural customers for CTD's are the big companies from whom we are getting most of the tax due. If cheques can be collected and cleared in payment for CTD's, it could be done for the tax itself.

7. Thus there appears to be relatively little that can be done to increase funding either by more aggressive sale of existing instruments or by offer of new instruments. It will then be necessary to continue to operate in bills. When the Bank's holdings of commercial bills have depleted, it will be necessary to increase the Treasury Bill tender.

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When the strike effects are unwound, the Bank will provide assistance by buying back these bills. It will be difficult to complete this operation smoothly.

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