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10 DOWNING STREET

Prime Minister 2

An unhelpful article, drawing large conclusions from small foundations. It shows why the Chancellor is concerned about the presentation of macro-economic policy.

DAS
14/10.

[initials]

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THE LEX COLUMN

Rising damp at Mansion House

As Mr Lawson stands up to speak at the Mansion House dinner on Thursday, City analysts will be hoping for an explanation of the Government's recent monetary policy, if not a new set of monetary targets. Not only is sterling M3 embarrassingly wide of its target range; the Government has done precious little in the past three or four months to tempt it back.

Traditionally, the Bank of England has controlled a wayward £M3 by selling more gilts to the non-bank private sector than it needs to. Since the late summer, this tactic seems to have been dropped, with the effect that the PSBR has been seriously underfunded in the past two banking months. As a result, perhaps, the annualised growth rate of £M3 over the past six months has been 18½ per cent—more than twice the maximum officially approved rate.

Underfunding

The underfunding could, of course, be accidental — or at least not part of any great Treasury plan. Perhaps the Bank wants to see some natural wastage on the holdings of commercial bills it has built up as a result of past overfunding. But the bill mountain is an irritant at worse; a mere molehill compared with inflation. So it would be odd for the Government to allow broad money to grow this fast purely to reduce friction in the money markets.

It could instead be a policy of creeping reflation. That may not be as direct as spending money on the sewers, but expanding real monetary growth will eventually inject spending power into the economy; and by encouraging spending by private individuals and institutions rather than the State, it suits the Government's book.

After the sharp rise in interest rates—and later, the exchange rate—at the beginning of the year, Mr Lawson may well have been worried that the economy would run out of steam in the run-up to the next election. Now that the exchange rate seems to have found its niche at a more sensible level against the dollar, perhaps he is turning his mind to the creation of jobs through stimulating the economy.

The Government's attitude to public sector pay seems to confirm a more reflationary stance.

Its target for pay rises is supposedly 3 per cent, but an offer of 8 per cent has been made to local authority manual workers, and other employees, such as policemen and firemen, should be winning awards of 7 to 8 per cent. Public sector earnings have fallen well behind the private sector and the Government seems relatively happy to allow catch-up settlements this year.

All this will boost public spending, though at least some can be delayed until after next year's budget. Meanwhile, the Government may have to scratch around to find the £2bn to £3bn it wants for tax cuts. Oil revenues are now likely to be around £3bn less than was projected earlier this year, and higher-than-expected revenues from income and corporation tax will probably take up only £1bn of the shortfall. On the spending side, there could easily be an overshoot of up to £3bn.

The Government can be perfectly justified in dipping into the contingency reserve to help balance its books—after all, it earned more than it expected from oil last year and used the money to replenish its reserves for just such a rainy day. But the rest may have to be found from asset sales, which could rise from a projected £2bn to as much as £3.5bn. If the Government is easing the pressure on the gilt market by underfunding, maybe the plan is to ensure that institutions have enough money to mop up a heavy flow of privatisations in the equity market.

It may seem rather premature to be speculating about pre-election reflation. But on the assumption that the date is to be Autumn 1987 and that reducing unemployment is the Government's top priority, now is probably the time to start. Creating jobs through economic growth rather than specific programmes is a time-consuming process and a two-year lag does not seem excessive.

But the Chancellor's main constraint must be inflation. Having promised so often to keep inflation under control, it would be extremely embarrassing to go into the next election with a rate no lower than today's. Yet with money and wages growing so fast, he may have a hard task on his hands.

Wage settlements have shown no sign of slowing, even though inflation will moderate in the short term once the effects of the weak pound and high mortgage rates have washed through the system. Corporate profitability is high and the share of wages in national income since 1982 (when unemployment more or less stabilised) has been falling at the expense of profits. So private sector employees are trying to win back what they have lost to their employers, while the public sector wants to catch up with the private sector.

Earlier this year, the Government seemed to be using the twin weapons of high interest and exchange rates to concentrate companies' minds for the wage round. Employers were presumably supposed to threaten more redundancies in order to keep wage costs in check. But now that sterling has fallen against the D-Mark, the margin pressure has lessened, and with it the reluctance to pass wage increases on in higher prices. The Government must hope to be bailed out by lower import and commodity costs, which could again allow companies to grant higher wage settlements without raising prices or eating into profit margins.

Room for error

When Mr Lawson sits down for his coffee and brandy, he can at least console himself with the fact that he has some room for error. Though boosting employment takes a long time, controlling inflation is a quicker thing altogether. If the worst happens and prices take off in a year's time, he can at least try to bring down inflation by tightening the monetary reins; and any adverse effect on jobs might not come through until after the election.