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Since I shall not be visiting London until mid January, I thought it might be useful to set out some thoughts on the present fiscal and monetary conditions.

Fiscal conditions are still perceived by the market to be still suspiciously loose - at least in terms of their expectations. Towards the end of last year the market-rightly spotted the doubling of the rate of growth of public spending in real terms in 1984-85 (excluding special sales of assets), and although the Autumn Statement shows a slight decline in the level for 1985-86 and holding thereafter, we have had enough experience with over-runs, especially by the local authorities and demand driven programmes, to take such forecasts with a grain of salt. The political pressure for, and economic sense of, substantial tax cuts suggest that the public sector's financial deficit is unlikely to be further reduced even as a fraction of GDP.

Note: there is a very good case for judging our fiscal stance in terms of the financial deficit rather than the PSBR. The financial deficit does not count special disposals of assets as though it were a revenue receipt or expenditure reduction. It regards the disposal correctly as a transfer only.

Monetary conditions are clearly rather tight relative to the experience of the past four years or so, and relatively to what the market expects in the future. The evidence is, first the slow rate of growth - indeed

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over the past months the virtual stagnation - of Mo. Secondly there is a sharp downward slope in the yield curve. Short interest rates are about 11.5 per cent, whereas the yield on long term gilts is less than 10 per cent. This is the opposite of normal' conditions where the short term interest rate is usually about 1 or 2 per centage points less than the long rate. (In the United States shorts are about 7.5 whereas longs are 10.). This implies that people expect short interest rates on sterling financial assets to fall in the near future to levels well below the existing long rates, and a 'normal' sustainable pattern of long rates paying a reward of 1 or 2 per cent above short rates for the illiquidity of being in long assets. Thirdly, and much more dubious evidence, the exchange rate has remained relatively strong and still above all the purchasing power parity calculations of the pundits.

A Regan-Volker Policy ?

The combination of a tight monetary and loosish fiscal policy combined with substantial tax cuts looks superficially like the United States policy since the 1981 measures. But, apart from the sheer magnitudes involved, appearances are deceptive. The greater-than-normal upward slope of the US yield curve suggests that people expect that interest rates will remain high or increase (and the opposite is true in Britain). Such expectations are a consequence of views about the continuation of the deficit and about the likely monetary reaction to an outbreak of further inflation. Indeed we have no need to hit inflation hard with an associated appreciation of the currency by manipulating a tight monetary policy. Our inflation is already circa 5 per cent.

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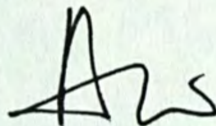
Stable Prices Ahead ?

If monetary growth (Mo) is held at its present level (i.e. virtually zero) for a period of two or three years, then it is likely that inflation will fall to about zero before the end of the 1980s and perhaps even by 1988.. At last we shall have price stability ! You may think, however, that it is best to approach such a nirvana rather more gradually and ease monetary policy in 1986 as suggested in our target for Mo. I would lean towards the latter policy and combine it with whatever can be done to tighten controls on public spending so that we avoid embarassments similar to those of December 84 to January 85. But I know that is easier said than done.



Alan Walters