E. R.

cc Mr. Wolfson   PEPPER
Mr. Ryder
Mr. Hoskyn

NOTE FOR THE RECORD

The Prime Minister met Mr. Gordon Pepper here at No. 10 at 1030 this morning. Mr. Pepper had earlier sent the Prime Minister the attached note on the budget, and the discussion centred around it. The main points to emerge were as follows:

(i) The Prime Minister questioned Mr. Pepper's assessment that the Government could concentrate on getting the public sector balance right in year two, doing relatively little in year one. Sophisticated people might understand this approach, but there was a widespread expectation - and she thought this included many people in the City - of major action in the present financial year. But she well understood that this would require some very tough decisions - particularly on the public expenditure side.

(ii) Mr. Pepper said that he fully accepted the Prime Minister's approach provided it were politically feasible. The prospects as he saw them and the difficulties in making major public expenditure cuts this year made him doubtful whether it was possible to go quite as far in the first year as the Prime Minister was hoping for. The money supply was already growing well above the existing 8-12% target - the latest published figure for M3 showed growth at 12½% on an annual basis, but taking into account distortions in the system he thought the real figure was higher; and on a more narrow definition (M1) money supply was growing at nearer 16%. The money supply would continue to be under pressure in his view. Even without any indirect tax increases in the budget, the RPI would rise about 12% by the end of the year, and real growth in the economy was not slowing as fast as forecasters had anticipated. Hence, the growth of GDP in nominal terms would be higher than 12%, and higher still to the extent that it included indirect tax increases. Accordingly, the demand for money was likely to remain very buoyant. In addition, he was forecasting a substantial inflow across the exchanges from abroad (perhaps to the order of £1b over the next 12 months), and this was likely to fuel the money supply. Against this background, the City would be looking closely at the public sector financial deficit (as opposed to the PSBR); and therefore it was essential not to rely too much on sales of assets as a budgetary panacea. It was essential to get the growth of money supply down, and to achieve this the budget arithmetic must look right. To the extent

/ that it was

that it was not possible to get the PSBR and the PSFD down, it was all the more important that there should be a clear statement on the Government's intentions for cutting public expenditure in subsequent years.

(iii) There was some discussion of Mr. Pepper's view that it would be unwise to put more than 2% on the RPI in the budget (this effectively meant that indirect tax increases would have to be confined to VAT at 12½%, or some combination of a lower VAT increase and some increases in excise duties). Mr. Pepper said that this was essentially a political judgement: his own feeling was that anything more than 2% on the RPI would result in reopening the existing pay settlements and cause great difficulty in the next pay round.

(iv) Mr. Pepper pointed out that sales of assets, if they were to affect the money supply, would have to be to UK residents. Therefore, there should not be a repeat of the BP offer in New York. In addition, it was important to select assets which the City would have no difficulty in valuing. One idea which he would like to see considered was the sale of commercial properties currently owned by the new town development corporations. One or more property company could be formed to take over this property, and then sell it to the institutions. The institutions would readily take up property offered in this way, and it would help dampen the property boom. The Prime Minister asked that this be looked into, but pointed out that legislation would be needed.

(v) The Prime Minister asked Mr. Pepper about his ideas on the monetary base method of controlling the money supply. Mr. Pepper said that the bank had been studying this approach, but had been very slow to produce anything. They had planned to have an article on it in the June Bulletin, but this had been held up because of the election. The monetary base method was in his view a far better system than the present one, and he hoped it would be looked at quickly by the Treasury. The Prime Minister asked me to pursue this, though she also said that the Chancellor would be too busy to give it his full consideration until after the budget. She also expressed concern that, notwithstanding the possible merits of the monetary base method, the Government might be criticised for introducing sudden changes in the banking system. She remembered too well the introduction of Competition and Credit in 1971 and the aftermath.

18 May 1979

TL

Prime Minister

To see

AJ
Duty Clerk
16.5.

BOW BELLS HOUSE (6th FLOOR),
BREAD STREET, LONDON, EC4M 9EL
Telephone: 01-236 2040

16th May, 1979

Miss Caroline Stephens,
10, Downing Street,
London S.W.1.

Dear Caroline

Having spent an hour or so with Mrs Thatcher before the last four Budgets, I have jotted down on paper some of the points I would be making if she had time to see me before this Budget and about which I feel strongly. I am also sending a copy to Adam Ridley. I am available for any comment until Monday afternoon; at present I am planning to spend the remainder of next week in the U.S.

Yours
Gordon.

G.T. Pepper

enc.

ASSESSING THE BUDGET

English Sickness

In order to have a realistic chance of curing English Sickness the new Conservative Government must act quickly and decisively, for at least four reasons:

(i) Increasing benefits from North Sea oil provide some of the "give" needed to turn the vicious circle from which the U.K. has been suffering into a virtuous circle. The benefits from North Sea oil will increase rapidly for only a few years.

(ii) Reducing inflation now has high priority. The lesson that rising inflation destroys employment has been learnt. Inflation is caused by too much money chasing too few goods. Reducing the supply of money is the technically easy part of the solution. Increasing the supply of goods is the more difficult part.

Action on the supply side of the economy must be taken quickly if there is to be a clear response before the next election. The real economy has many rigidities and, because of these, supply side measures will probably take at least three years to work. Therefore, such measures are urgent.

Cuts in direct taxation are an important supply side measure. Accordingly, significant cuts should be included in the coming budget and more substantial ones should be promised later.

(iii) The longer the private sector of the economy is throttled, the less will be its powers of recuperation.

(iv) Many people fear that the longer the new Government waits, the greater will be the chance that it will become overwhelmed with the problems of day-to-day government.

Public Expenditure (excluding financial items of a capital nature)

It is administratively very difficult to effect cuts in public expenditure quickly. For example, the private sector needs time to offer the services being withdrawn by the public sector. However, substantial cuts in public expenditure can certainly be achieved starting in 1980/1. Within four years it should definitely be possible to reduce public expenditure by at least 5% of GDP, but the decisions need to be taken in the next six months.

P.S.B.R.

The forecast for the PSBR in 1979/80 before the budget changes is now one of at least £10bn. This is some £2bn. higher than had been hoped. An important reason for the increase is public sector pay rising relative to private sector pay. Another reason is that, with the Budget in June, some three months of additional revenue from higher indirect taxation have been lost.

The PSBR in 1979/80 will be further increased if direct taxes are cut at once but public expenditure cannot be cut substantially until 1980/1.

The PSBR in 1979/80 can be reduced by only a small amount through higher indirect taxes without risking a big increase in inflation. Inflation is already rising from its current rate of 10% and will be increased further by the removal of subsidies and price restraints. If the retail price index is raised by more than 2% by increases in indirect taxes which are announced by the Budget, there will be a serious risk of wage settlements being reopened and of much higher inflation. In short, the budget must not increase the retail price index by more than 2% and even this may be too much. (Note - the higher inflation, the more difficult it will be to achieve the monetary targets and the less the room for real growth).

The second way of reducing the PSBR is by financial transactions of a capital nature - e.g. the sale of B.P. and less money for the National Enterprise Board. However, there is a serious danger that commentators will consider these financial transactions to be cosmetic.

Although the PSBR receives more publicity between budgets, most serious commentators, e.g. Samuel Brittan, concentrate on the PSFD when assessing the main budget. The PSFD includes the current account of the public sector and real capital spending, i.e. capital formation and stock building, but excludes capital transactions of a financial nature. Similarly, commentators such as Peter Jay and Wynne Godley have always adjusted public expenditure for financial items, e.g. the sale of B.P. in 1977, export & shipbuilding credits and investment grants.

Commentators are bound to pay considerable attention to a PSFD running at a substantially higher rate in 1979/80 than 1978/79. Given what happened in 1972 and 1973 during the last Conservative Government, reaction could be hostile if the underlying strategy is not clearly explained and justified.

A Solution

In the Budget we will be looking for guarantees of :-

(i) really substantial reductions in public expenditure within two years

and (ii) strict control of the money supply in the interim period.

Subject to being completely satisfied about these two factors, the PSBR/PSFD in the short run is of only minor importance. There is a short term cash flow problem which needs financing.

The Financing Problem

Labour has already issued too many long-dated fixed-rate gilt-edged stock. Therefore, other types of debt must also be sold. It is too dangerous to issue a lot of short-dated debt in the absence of a monetary base system of control, which probably cannot be introduced in time. Therefore, some equity type debt should be sold.

Sales of B.P. etc. are entirely appropriate in the circumstances (and accord with the philosophy of reducing the public sector). However, they must be sold to the non-bank private sector if the money supply is to be controlled. This is in contrast to 1977 when one of the objectives was to increase the U.K.'s foreign currency reserves and, therefore, half of the underwriting of the sale of B.P. at that time took place in New York. The London market will probably be capable of absorbing only part of B.P. in one go and at a realistic price. Publicly owned assets ought not to be sold at knock down prices (the Financial Times for one has promised criticism if this occurs). A substantial financing problem will probably remain. A solution of last resort would be a one-off issue of an index-linked gilt-edged stock. It might be the only way of getting the sums to add up in 1979/80.

The Guarantees

There remains the crucial question of the two guarantees. Is it possible to give them and, if so, how?

The Budget date of 12th June is too soon for the details of the cuts in public expenditure to be available. It is just possible that sufficient information about the outline of the cuts can be given which, together with a most categoric political commitment, would satisfy people. The other and less risky approach is to announce the cuts in direct taxation in the June Budget but not to legislate for them until the details of public expenditure have been worked out and announced in the late summer.

As far as a guarantee of strict monetary control is concerned, words (i.e. targets) will not be enough. The first rule of all watchers of Central Banks is to ignore what a Central Banker says but watch what the Bank does. During the latter part of Mr. Healey's Chancellorship, financial measures to control excessive monetary growth may have been delayed but when they were taken they were reasonably decisive, viz the increases in MLR to 12½% in November 1978 and 14% in February 1979. Sir Geoffrey may, unfortunately, have to demonstrate early on that he, too, is capable of tough action, i.e. that he is not a William Miller. An announcement that the Government is urgently investigating the possibility of moving to a monetary base method of control would also help. Further, the one-off issue of an index-linked gilt-edged stock would convince many people that the money supply will indeed be controlled.

Gordon Pepper

Gordon Pepper
16th May, 1979