Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

12 January 1982

Michael Latham Esq., MP.
House of Commons
LONDON
SW1

Dear Michael

I must apologise first for not having answered sooner your thoughtful letter of 18 September. My original intention was to let you have something shortly after the pre-Christmas Statement. In the event a variety of pressures caused a further delay which I hope you will pardon. I have a number of comments on the central points you made to me.

You observed on page 2 that the December 1980 announcements and the 1981 Budget were "intentionally deflationary". I can agree that they were both intended to keep the PSBR on a declining path over the medium term. But it is not fair to characterise either set of decisions as being intended to reduce the level of economic activity. Particularly since the end of the Bretton Woods system of fixed exchange rates, the level of and changes in the PSBR have not been a good indicator of the influence of fiscal policy on output, whatever may be alleged by more Keynesian economists. Indeed the PSBR can well be too large, in which case reducing it can be an expansionary measure. Our own experience between 1975 and 1978 illustrates this well. Denis Healey cut the PSBR from over 11 per cent of GDP in 1975 to under 5 per cent in 1977. This "savage deflation" as conventionally measured was accompanied by an 8½ per cent growth in GDP over 1976-8, and a major economic upswing.

One of the routes by which a lower PSBR helps recovery is by permitting lower interest rates than one would otherwise have. As you point out yourself at the end of page 3 of your letter, rising interest rates tend to bring revival to a halt and demoralise industry. I suspect that the economy's sensitivity to interest rate changes has increased considerably in recent years, is not adequately acknowledged by many economic forecasters, and is particularly marked when rates are high to begin with. So I remain as committed to getting interest rates down as I was at the time of the last Budget - and as you are.

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It is, I know, commonly alleged that the interest rates increases of September and October were deliberately engineered by the authorities. This is understandable given the way such changes may have to be made under the new system of monetary control. But in truth these changes were not the avoidable exercise of discretion that they appeared to be. The story really began with the November 1980 measures, and the 1981 Budget. The decisive action we took in late 1980, the PSBR target we went for in the Budget and the firmness of the measures taken to secure it succeeded in their declared goal of laying a foundation for lower interest rates. It is now clear that these lower interest rates came just as we hoped, at the right moment to encourage and reinforce the first stages of economic expansion.

.... However, as the enclosed chart of short-term interest rates here and overseas shows, we were faced with an unsympathetic world environment. Continental interest rates began moving up in February 1981, and US rates moved up very sharply indeed between March and May. The gap between our rates and those overseas become very large, and the pressures of arbitrage in financial markets very strong. As long as the US position was thought to be a very temporary aberration, movements out of sterling (and into the dollar in particular) only had a limited attraction. But once the US position began to be seen to be much more serious and likely to last, pressure on our rates grew inexorably. By September it had reached a point where continuing to hold our rates down became impossible because of the scope for arbitrage and round-tripping. The same process repeated itself shortly afterwards in October when the world stock markets crashed. In sum this experience showed very clearly how US policy and international conditions exercise a massive influence on the range within which domestic interest rates can fluctuate, an influence commensurate with that of domestic policy and circumstances.

I should note one other point in passing. Our low interest rates in the earlier months of 1981 went hand in hand with a falling exchange rate. Whatever its benefits may have been for exports, that lower rate pushed inflation up and we have therefore missed the single digit inflation we might otherwise have expected by now. The costs of this are difficult to assess. But leading as it has to much greater pessimism about the inflation outlook in the medium term, we can expect to experience a less dramatic reduction in pay than we might have had in this pay round; and the poorer inflation outlook has played an important part, too, in pushing up interest rates, particularly at the short end.

This bring me to the pre-Christmas Statement about which you enquired on pages 2 and 3 of your letter. Happily the problems

/the Cabinet

the Cabinet faced were not quite as difficult as you feared, at least as far as the PSBR was concerned. The outlook for the PSBR for 1981/2 was and remains broadly on target (allowing for distortions) despite higher spending than foreseen. Your questions about spending and tax increases next year are ones I cannot answer fully until the Budget. On the spending front we have agreed, as you know, to very substantial increases beyond last year's White Paper, many of which will be of direct benefit to industry, such as the extra cash for Defence. On the revenue side we have no real choice over raising extra money to finance social benefits unless we are willing to reduce the levels of benefit to a degree and in a manner which you will, I am sure, agree would be provocative! We did, however have to decide whether to put the additional financing burden on persons or industry. There was no real doubt about where it should go at the end of a period in which real personal incomes have increased greatly while output has shrunk and the real rate of return in industry (after inflation) has sunk to a perilous 2 per cent in comparison with 10 per cent or more in the 1960's. Had we split the real burden equally between the two, we should have been faced with a furious reaction from industry. It was by no means muted in the event even though the real burden of employers' contributions will in fact fall next year.

You suggest on page 3 the need for tax cuts to stimulate consumer demand. The case for tax cuts can be argued several ways and depends a great deal on what assumptions one makes about the associated changes in the PSBR and how the cuts are to be financed. However while I want nothing more than to be able to cut taxes, particularly on industry and incomes, I have the gravest doubts about a policy of massively stimulating consumer demand. For one thing our recent experience is most discouraging. Between 1977 and 1980 consumers' expenditure rose by nearly 12 per cent in real terms (about £7bn in 1975 prices), equivalent to some 7 per cent of GDP. Yet GDP itself only went up by about £2bn or 2 per cent. That sorry story is but one aspect of the wider problem that reflation has lost its potency. The extent to which expenditure increases go into inflation (or imports) rather than real output has been horrendous for a decade now. Thus between 1971 and 1980 money GDP went up by 294 per cent, while real output rose by only 6 per cent - in other words by a mere fiftieth as much.

One reason for this is our deteriorating competitiveness, which has been entirely due to pay movements taken as a whole in the period since the 1979 election. I am at one with you in your concern to get the general level of pay increases down. But I see no scope for a more formal policy for incomes. Even if one were negotiable I am sure that the quid pro quo would be unacceptable and that the policy would explode in our faces before long. In the event we have done and continue (touch wood) to do well by our deliberately informed approach and to edge gently towards a greater and deeper national consensus, particularly with the CBI.

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On the price front we all naturally shrink from any act which can be construed as putting up prices. But I know of no realistic, let alone prudent alternative to what we are at present doing. And there are serious misconceptions around which do not help matters.

Thus while the annual increases in excise duties are clearly seen as "the Government putting up prices" by the public, the truth is that as a rule we are only matching inflation between one year and the next - at best. The real price of e.g. petrol is no higher than it was ten or twenty years ago, while real cigarette and spirit prices are lower than in most of the post-war period. Broadly speaking the real tax yield from excises is under serious and constant threat; and the task of reversing such a trend after a year or two has become quite impossible.

On the Nationalised Industry front, the prices set are in truth determined by the need to earn a proper return on capital and, in the case of Gas, by basic principles of economic pricing. I can assure you that there is no question of our deliberately pushing up their prices beyond sound economic and commercial levels just to save money. The industries themselves often have to push up their prices because of their poor performance, particularly on pay and costs. But that is not something we can do much about directly or in the short term.

Were we to restrain NI prices, as in 1972-5, there would be little to gain and much to lose. Other things being equal the increase in NI financing requirements would have to be met by higher taxes and charges elsewhere. At some stage their prices would have to be returned to proper levels, thus wiping out the advantage one had initially gained. In the meantime some of the industries, such as Gas, (and their customers) would suffer from excess demand, and many of them would suffer from distortions of one kind or another.

As you know, while not believing in a systematic extension of protection, I have a lot of sympathy for your view that we could sometimes be tougher and defend our interests more effectively. I am asking Adam Ridley to pursue his dialogue with you on this, and he will be in touch with you again shortly.

Finally, I should like to thank you for writing in such a considered way. I hope that this reply will meet the anxieties you raised. I am grateful that your letter has been kept confidential, as it enables me to respond to it

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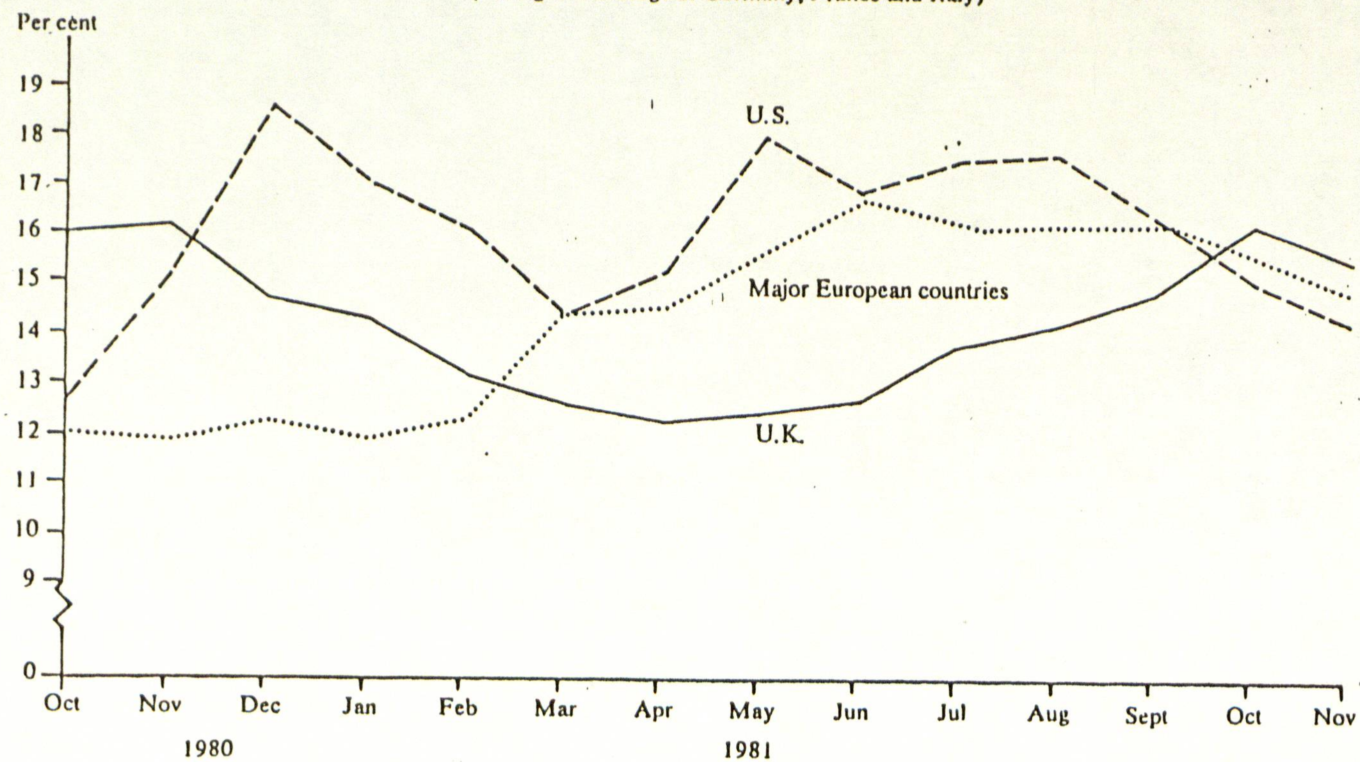
properly. Like you I am letting Edward du Cann and Cecil Parkinson see this letter.

GEOFFREY HOWE

Graph 2

U.S., U.K. AND MAJOR EUROPEAN* COUNTRIES 3-MONTH INTEREST RATES

(*Weighted average of Germany, France and Italy)



Latham

26th January 1982

Thank you very much for your letter of 20th January, with which you enclosed a copy of a letter dated 12th January which you had received from Geoffrey Howe.

I would like to have a chat to you about this (and other matters) and I will seek you out.

IAN GOW

Michael Latham Esq MP

FROM MICHAEL LATHAM M.P.

CONFIDENTIAL

Box

HOUSE OF COMMONS
LONDON SW1A 0AA

20th January 1982

Dear Ian,

You will recall that I showed you my private file of correspondence with Geoffrey Howe before Christmas, and I thought you would wish to see the detailed letter which he has since sent to me. While I do not find this letter wholly persuasive, it is fully and powerfully argued and I readily accept that many of the points are compelling.

I hope that we shall see a "touch of the accelerator" as Harold MacMillan put it, in the Spring Budget, and I have said so to the Chancellor.

Best wishes,

Michael

Ian Gow Esq. M.P.
Private Office of the Prime Minister,
No. 10 Downing Street,
London S.W.1.

encl.

Latham

FROM MICHAEL LATHAM MP

STRICTLY PRIVATE AND CONFIDENTIAL

18th September 1981

It is almost exactly twelve months since I wrote to you at considerable length. In that letter, I argued that it would be impossible for us to fulfil our objectives of restoring enterprise and cutting taxes so long as the economy was in recession. I suggested that it was not possible for the nationalised industries to meet their targets in the absence of growth in the economy, and that an acceleration of unemployment could only mean that the P.S.B.R. targets would be unobtainable as well. I further suggested that high interest rates were self-defeating, in that they led to an increase in the money supply through distress borrowing. I suggested that, since it is made virtually impossible to measure the money supply satisfactorily - as illustrated by the difficulties which arose over the "corset" - it was doubtful if it should be based on our economic policy. I went on to recommend that we should take counter-cyclical action to reduce the degree of over capacity in the economy by a tax cut of three billion pounds, divided between reductions in the standard rate of Income Tax and in the National Insurance surcharge. To restrain imported caused inflation, I suggested more protection, and to control domestic wage inflation, which I personally believe to be the real cause of price rises in a modern economy, I suggested a more formal policy for prices and incomes.

Following my letter, which was, of course, a radical departure from Government economic policy, you were kind enough to invite me to meet you, and I have also had several sessions with Adam Ridley. While there has been some slight movement towards my ideas in some directions - we now have a much more credible policy for incomes, particularly in the public sector, and it is obvious that Treasury ministers have some sympathy with my proposals in non-tarriff barriers - in June, the Government's decision was in totally the reverse direction. Your economic package of November/December last year, and your Budget this year, were both intentionally deflationary, in that they sought to reduce the P.S.B.R. through fiscal means and further reductions in public spending. I did not agree with that, and I still do not, but I felt it my wider duty to the Government at least to acquiesce in it, and to concentrate on other aspects of Government policy with which I had more natural sympathy.

However, the latest increase in interest rates, cancelling out the reduction contained in your Budget, leads me, with great reluctance, to write to you again. I naturally appreciate that the Civil Service dispute has clouded the issue, but it would appear that the money supply is still not properly in control, according to your own definitions. As for the P.S.B.R., while I have no knowledge of the figures since they have not been revealed, I would be highly sceptical if this was within your target figure, partly because of the increase in unemployment, but also because of the additional bail out operations which there have had to be in various nationalised industries, allied to the decline in tax revenue, both through unemployment itself, and the consequent reduction of purchasing power.

Let us therefore suppose that we find ourselves at the time of your November review which has to be published under the Industry Act 1975, with a PSBR much wider than you intended, the money supply still off target, and worsening because of additional distress borrowing under higher interest rates and the intended economic recovery receding further into the background. I would suggest to you that all those three things are possible, indeed, I would argue that they were certain. Would it then be your intention to say that there must be further cuts in public spending or further increases in taxation to bridge the P.S.B.R. gap? I would suggest to you that such a course of action would be totally self-defeating, as, indeed, I believed it was last year.

I feel, therefore, that I must repeat once again the suggestion that I made last year - the need for an immediate and substantial tax cut to increase consumer demand, coupled with an import deposit scheme, similar to that produced by the Labour Government in 1968 at the suggestion of Harold Lever, and a more formal policy for prices as well as incomes. I am hoping to see Leon Brittan on Monday to try to persuade him that it is simply not possible to persuade workers to put in low wage claims, when the Government itself is responsible for much of the inflation. Surely, we do not need to increase gas prices or telephone charges when both are making substantial profits, solely in order to outweigh the deficits of other nationalised industries? Surely, there is scope for a substantial porfitisation of gas itself: why do we not sell 40% of the equity of that industry rather than messing around with showrooms? And why are we taking the opportunity, through a rise in interest rates, to bring to a grinding halt again the incipient revival in those areas of business, such as private house-building - in which I am myself involved - and demoralising private industry? This puts us back many months and can only delay still further any improvement in industrial output.

Twelve months ago, I kept our correspondence totally confidential. While I do not intend to publish this, I feel that I have a clear duty at least to show it to Cecil Parkinson and to Edward du Cann. I greatly respect your own courage, determination and sincerity, but I believe that we are stuck in the sand at the present time and that, if we do not extricate ourselves forthwith, we will run out of time.

The Rt Hon Sir Geoffrey Howe QC MP
11 Downing Street
London SW1