SA-D

SECRET AND PERSONAL

PRIME MINISTER 12 December 1989

MONETARY CONDITIONS

The last meeting of officials on this subject was a fairly gloomy affair: nevertheless there is no reason for pressing for higher interest rates at present.

On the international scene, the Bank's view was that the vibrations from the Bundesbank suggested the possibility of a rise in German rates early in the New Year - though the stronger mark might cause some delay. The Bank of Japan also wanted higher rates but there is an election in February. In the US the prospect of a decline in rates has receded into the future.

The evidence on the response of the economy to the current tightening is in three categories:

- evidence of a slowdown in consumer spending is in the recorded data, the most recent being the retail sales figure for November;

- evidence of a slowdown in company spending is in the surveys and intentions data, but not in business spending yet;

- evidence of balance of payments adjustment is not apparent but only forecast to happen.

Two causes of concern are inflation and the monetary indicators. The inflationary outlook has deteriorated since the Autumn internal forecast. With the futher worsening of pay settlements and the depreciation of sterling since the beginning of October, the inflationary outlook for 1990 has got worse - the best guess being that it might be as high as 6-6½% by end 1990.

B

SECRET AND PERSONAL

The monetary indicators, MO and M4, do not give much ground for hope. The growth of MO, while having fallen from a peak of over 8% in late 1988, is still outside of its target range, and the forecast for MO in 1990 is simply a reflection of the expected slow down in the real growth of the economy.

The growth of M4 carries on at 17%, but the composition of this growth is difficult to explain. There is a striking divergence between the behaviour of retail and wholesale deposits - retail deposit growth having fallen substantially but the growth in personal sector wholesale deposits being very large and difficult to explain.

Policy Response

There are risks in both directions:

Raising interest rates might cause unnecessary damage to the economy; but equally not raising rates carries the risk that inflation would not be on a firmly downward path in a reasonable period of time.

Striking a balance between these risks is difficult - and there are different views among officials on this subject and tactics on intervention.

The conclusion of the meeting was that monetary conditions were barely satisfactory to have confidence that inflation would definitely fall, but that there is no immediate reason to recommend higher rates.

Comment

My personal view is that it is but a short time before the corporate sector responds to the fall in retail spending - and that early

C

in the New Year we should expect de-stocking and an adjustment by companies of their production schedules.

In these circumstances, higher interest rates could well lead to overkill. Unless sterling comes under strong pressure, the case for higher rates has yet to be made.

BG

BRIAN GRIFFITHS

Chart: MO growth

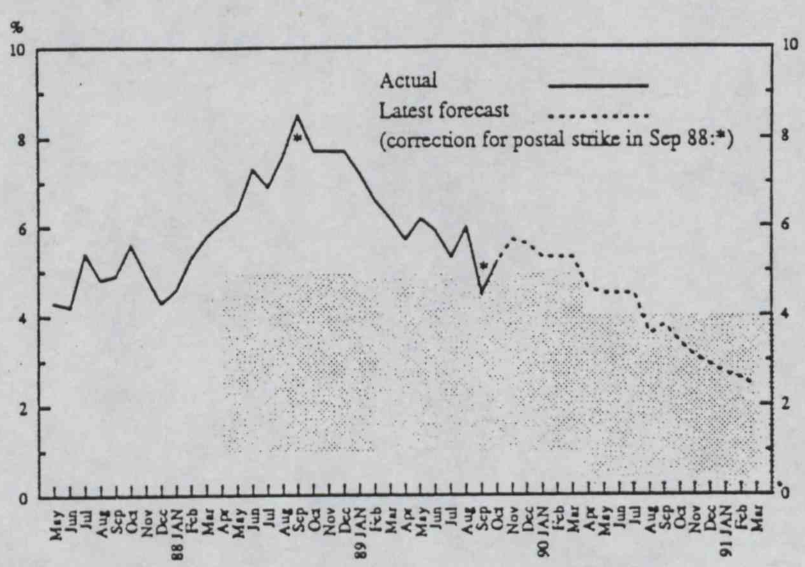
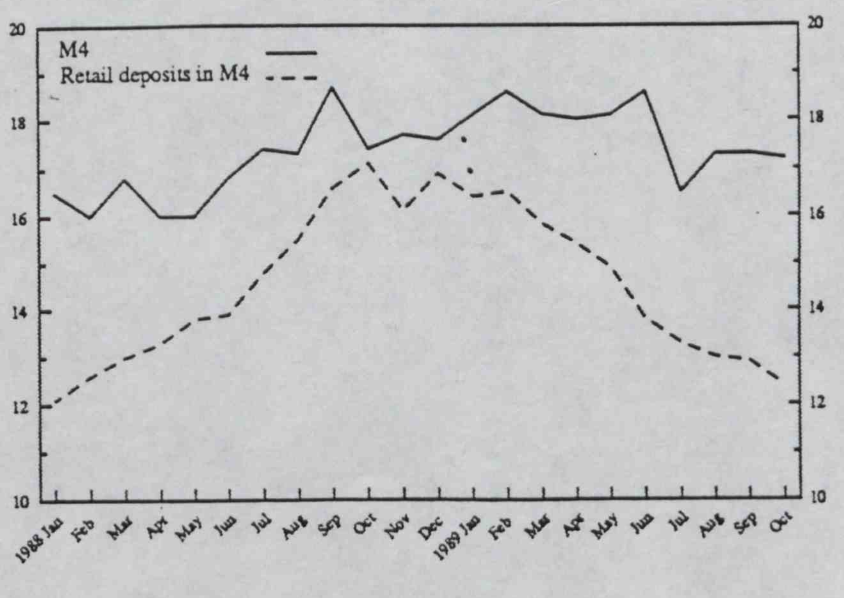


Chart: M4 growth



RA

TRANSCRIPT: For instructions on its use, see below Ev. 3

HOUSE OF COMMONS

MINUTES OF EVIDENCE

TAKEN BEFORE

TREASURY AND CIVIL SERVICE COMMITTEE COMMITTEE

MONDAY 4 DECEMBER 1989

THE RT HON JOHN MAJOR, MP, SIR PETER MIDDLETON, KCB and SIR TERENCE BURNS

Thanks. 7.11

Evidence heard in Public Questions 196 - 295

USE OF THE TRANSCRIPT

1. Members and prospective witnesses to whom the transcript is sent in strict confidence, under the authority of Mr Speaker and the Committee, are asked to note that the text is unpublished and that its use should be governed by the guidelines in the following paragraphs.

2. Members receive copies for the purpose of correcting questions addressed by them to witnesses, and are asked to send any corrections to the Committee Clerk as soon as possible.

3. Prospective witnesses receive copies in preparation for any evidence they may subsequently give.

4. This is an uncorrected and unpublished transcript of evidence taken in public and reported to the House.

5. No public use should be made of the text.

MONDAY 4 DECEMBER 1989

Members present:

Mr Terence L Higgins, in the Chair
Ms Diane Abbott
Mr Anthony Beaumont-Dark
Mr A J Beith
Mr Nicholas Budgen
Mr Neil Hamilton
Dr Lewis Moonie
Mr Giles Radice
Mr Brian Sedgemore
Mr John Townend
Mr John Watts

EXAMINATION OF WITNESSES

THE RT HON JOHN MAJOR, a Member of the House, Chancellor of the Exchequer, SIR PETER MIDDLETON, KCB, Permanent Secretary and SIR TERENCE BURNS, Chief Economic Adviser, HM Treasury, examined.

Chairman

196. Mr Chancellor of the Exchequer, may I begin by congratulating you on your appointment to your high office and to welcome you to the Committee this afternoon. We have, of course, the task of monitoring the work which the Treasury and indeed the Civil Service Department do and a major feature of our annual programme is, of course, the evidence which we take on the Autumn Statement. We are glad already to have received evidence from Sir Terence Burns and your officials and also, of course, last week from the Chief Secretary of the Treasury who was particularly concerned with the public expenditure aspects of the Autumn Statement.

This afternoon we would like to concentrate on the overall state of the economy. We hope then to produce a report before Christmas which no doubt will be debated early in the new year. So you are indeed very welcome. Perhaps I might make just one point at the beginning, the microphones do not of course amplify the sound in this room only for radio and television. The accoustics are somewhat better than upstairs but are still somewhat difficult and no doubt you and your colleagues will wish to bear that in mind. May I begin by asking whether there is any initial statement you would like to make and then perhaps begin in the traditional way by asking you to introduce your officials for the benefit of the shorthandwriters.

(Mr Major) Mr Higgins, thank you very much indeed and thank you for the welcome you gave me to my new job and to this Committee this afternoon. In so far as an opening statement is concerned, we have had a number of opportunities in the last month or so, rather more than ideally ~~one~~ I might have wished in the first few weeks of a new job, to make those statements on the floor of the House so I think I will not weary the Committee with an introductory statement. I suspect there are lots of questions to be asked and I think perhaps the sooner we get down to those the better. In so far as the accompanying officials with me are concerned, I think they are well known to Members of the Committee. On my immediate right is Sir Peter Middleton, the Permanent Secretary at the Treasury and on my left is Sir Terence Burns, who attended your Committee a few days ago and whom I am sure you will be pleased to see again. I have no further opening statement to make, I am quite content, if you are, Mr Higgins, to move straight to questioning.

197. You are indeed most welcome and I think the Committee are glad to proceed straight to questions. Perhaps I might begin in this way, in the debates which you have mentioned, you have pointed out yourself a

number of difficulties in the present economic situation and we wondered if you would like to start by giving us a brief explanation as to how you think those difficulties have arisen before we turn to analyse the sitaution of the present and for the future in greater depth.

(Mr Major) Yes, I am happy to do that. I did seek to make it clear in the Autumn Statement, and in the subsequent debate, that I think we will have a less easy year in the next year in terms of growth than we have had in the past and of course that entails a number of other attendant difficulties as well. ~~In so far~~ As to how those have arisen I think there are a number of factors that one needs to take into account. It is I think clear in retrospect, though it was less clear at the time, that demand ~~has~~ probably ~~been growing~~ grew at a faster rate than was desirable right the way through 1987 and right the way through 1988. I think that is now ~~perhaps~~ quite clear. We have also seen ~~a very considerable growth in borrowing~~, a very considerable growth in borrowing by the ~~private~~ personal sector and a very considerable growth in investment by the company sector, both of those, of course, have very materially added to demand over the period of the last two years or so. It is ~~in essence~~ I think the growth of that demand pressure that has led to the inflationary impulse we can see at the moment and the need to deal with that quite firmly with the consequent effect on growth over the period of the next twelve months or so. ~~I think there were~~ One or two other matters ~~that it~~ might be worth~~while to~~ including in the ~~catalogue of the~~ background to the present situation. I think it is also clear that in company with all other commentators, both inside this House and beyond this House, at the time we misread the likely impact of the Stock Exchange crash at the end of 1987. It was our judgment at that time that ~~that~~ it would have very substantial deflationary effects. ~~As a result of that and~~ Because we did not wish to disturb the growth pattern ~~that was~~

and ~~clearly benign at the time, we did not wish to disturb~~ the growth in employment that was very welcome at the time and has been very welcome over the period of the last few years, and ~~that~~ at the time of the Stock Exchange crash, believing that there would be a very substantial slowdown (as indeed history would have suggested) we relaxed monetary policy. ~~at that time and~~ I think in retrospect it is clear that we relaxed monetary policy perhaps at precisely the moment that we should have made it a little more severe. I think that was a misjudgment that we made and that every other commentator shared as well at that time. I think there is perhaps one other ~~element~~ factor that I would touch upon and ~~I think~~ that was the changes we made to multiple mortgage relief in the 1988 Budget. For the best of reasons we allowed a timelapse between the announcement of the ending of multiple mortgage relief and the actual ~~absolute~~ ending of it. ~~We did so, and~~ I take my own share of responsibility for the misjudgment; it is not something I seek to heap upon my predecessor; that was a view that all Treasury ministers took at the time ~~as~~ we considered the Budget. We were concerned about the social impact of the ending of multiple mortgage relief without any period of warning. We were concerned that lots of young people would have been in the midst of purchasing their own houses (and we of course are keen on an owner/occuping society). So we did allow a period for those completions to conclude and others to take place. I think probably in retrospect that proceeded on a far more rapid pace than we had any reason to expect; so I think in retrospect that was a policy misjudgment. It was done for the best of social reasons but nonetheless was a policy misjudgment that added to the growth of the housing market on the back of which there was ~~a~~ considerable ~~degree of~~ borrowing for other purposes. So I think those are the underlying reasons. I think those are overwhelmingly the main reasons: the Stock Exchange crash, the policy misjudgment in terms of the multiple mortgage decision in the 1988 Budget and the fact that in retrospect we can see that demand was growing faster than we had then thought in 1987 and 1988. I think those are the factors that have led to ~~this~~ the bubble of demand that underpins the present inflation ~~that concerns us~~.

198. Perhaps I might restrict myself to one question before I turn to Ms Abbott who has some related questions to ask. The Committee has in the past drawn the rather simple minded analogy between the Chancellor of the Exchequer - both your predecessor and yourself - being on a tightrope with danger on one side being falling over into recession and on the other falling over the problems of inflation. As the forecasts now stand, within the margins of error of those forecasts, one could get both at the same time, what the late Ian McCloud used to call stagflation. May I ask do you think that is a danger and related to that has the forecast previously under-estimated the upturn in the economy which was to a considerable extent due to the expansion of credit? Do you think there is now a danger that they under-estimate the downturn with the result that we do go into a significant recession?

(Mr Major) Perhaps I can take the point ~~of~~ on recession first? There was some comment after the Autumn Statement that I might have plumped down, if I can use that expression, our forecasts for the next year so that it would seem during the course of the year we were performing better than I had imagined and I could proclaim an economic miracle. If I may say so firstly to the Committee I neither plumped up nor plumped down ~~those~~ the forecasts that I put in the Autumn Statement. They are the absolute central forecasts of what we believe will be the outcome over the period of the next twelve months. It must be said on the back of that that they are forecasts and all forecasts are fallible, we have proved that in the past and so have all other forecasters so I cannot tell you whether they will be precisely accurate. What I can say is that those forecasts do not ~~forecast~~ show a recession ~~in~~ on any accepted definition. We actually anticipate growth at 1½% or three quarters of a per cent ~~in non~~ excluding North Sea oil terms over the period of the next twelve months and although we may over-estimate ~~that~~ it it is equally true that we may under-estimate ~~that~~ it. I do not in fact anticipate a recession. I think we will have a period of slow growth over the next twelve months or so. I ~~think in~~ terms of dampening down demand and helping to squeeze inflation out of the system not only will we have a period of very slow growth, it seems to me necessary now that we should have a period of very slow growth ~~over the next twelve months or so~~. You touched in your second question on whether the under-estimate of demand that we made before might swing back to an over-estimate now and whether we might actually be in a recessionary situation for that reason. Again, I can only reiterate that although it is perfectly true that we under-estimated the demand of growth in the fashion I explained a few moments ago we have taken that into account and we have made the best central forecast of what we believe demand will be over the next 12 months. ~~That~~ It does assume that consumers' demand is absolutely flat. ~~So, T~~the danger ~~clearly~~ of the forecasts being inaccurate is always there. No-one ~~could~~ can say now or at any other time that we ~~can be~~ are certain that the forecasts are right; ~~and~~ we will have to watch the indicators over a period to see whether or not they are. One of the virtues of using monetary policy ~~in the way that we use monetary policy~~ is that we are able to have a more flexible weapon at our hands than would otherwise be the case. I do not anticipate a dramatic swing back to a recession~~ary situation.~~ We have actually produced forecasts that ~~we think will lead~~ point to a lower growth level next year; ~~but,~~ nonetheless, we do believe there will be a growth next year. That does, and must, come with ~~a~~ the health warning that all forecasts are ~~always, of course,~~ fallible.

Ms Abbott

199. You have just said that your forecasts are not foreseeing a recession within any accepted definition of the term, what is your definition of a recession?

(<u>Mr Major</u>) I think I would take as a definition of a recession the one that we have traditionally accepted and that is a reduction in gross domestic product over a measurable period of time, probably two or more quarters, although there is no formal and wholly agreed definition of recession. That is the sense in which I would use the term; a reduction in GDP over perhaps two or more quarters, at least a six month period.

200. What sort of reduction would you be looking at to call it a recession ~~reduction~~?

(<u>Mr Major</u>) Of course in other countries they have different definitions of recession. Some people in the United States from time to time would refer to a ~~smaller growth in one quarter being~~ a recession in one quarter if ~~it~~ growth was smaller than the growth in the previous quarter. That is not the sort of definition I ~~have~~ use. If we have a reduction in GDP over a measurable period of time then I think it is reasonable to begin thinking in terms of a recession but that is expressly not what we are forecasting at the moment.

201. You would accept, would you not, given you are, I think, forecasting a three-quarter of a per cent increase in non-oil GDP for the next financial year that a recession, in your own terms, is well within the margins of statistical error?

(<u>Mr Major</u>) I do not think there is any virtue in anyone seeking to talk us into a position that I am not forecasting. ~~and~~ If I thought that was ~~to be~~ the case I would have forecast that in the Autumn Statement. I reiterate what I said a moment ago, ~~now~~, that the Autumn Statement is

~~absolutely and~~ literally what I expect to happen over the next 12 months. You are right in saying that the forecast is fallible but I do believe that the forecast we have made is the most realistic one available and upon that basis I am not forecasting a recession over the next 12 months and I hope very much that we will find we do not have one.

202. On the question of your forecasts, obviously all the forecasts are based on assumptions and some of those assumptions are made explicit in the Autumn Statement, some are implicit. Your forecast about inflation rates is quite explicit, I think it is five and three-quarter per cent in the fourth quarter of 1990, but some forecasters are saying there is an implicit forecast about interest rates - that they are going to remain the same - and they say this by looking at some of your forecasts on your housing costs and so on. What are your assumptions about interest rates?

(Mr Major) Well, if I may say that comes in the definition of an extremely good try and you did it with great charm, but you will know and the Committee will know, for a number of the Committee present have lived through this exercise in previous years, that for perfectly good and understandable market reasons the Treasury never make public their assumptions on interest rates. I fear I must give you that deadpan answer again this afternoon. As far as our projection on inflation is concerned you are absolutely right, the projection on the average level of inflation for the fourth quarter of next year is five and three-quarter per cent and I hope very much we will be able to hit or beat that.

203. But in drawing up your forecasts you will admit that you do make an assumption about interest rates?

(Mr Major) It would be difficult for us to make a forecast on inflation without making assumptions about all sorts of things including interest rates, but for the reasons I set out a moment ago it is not in my interest, or anybody else's interest, for those to be anything other than private assumptions. I am sure that is disappointing but I know you will understand why that must be the case.

204. You cannot make a present to mortgage payers, a Christmas present to them, of an end to their mortgage misery?

(<u>Mr Major</u>) I am not sure that revealing the underlying assumptions in that forecast of interest rates would actually turn out to be a present for mortgage payers. I do not know that this would ~~will~~ be the case. ~~I do not know that will be the case~~ at all. I do not believe it would ~~will~~ be a wise thing to do and much as I would like to assist the Committee I think the Committee will understand I am not going to give that assumption.

205. Can I ask finally, there is a lot in the Autumn Statement about current account flows but there is very little explicit about capital account flows. It would certainly help the Committee if we had your forecasts and also what happened in the last financial years about capital outflows inwards and outwards. Will they be available?

(<u>Mr Major</u>) We take account in all our forecasts and calculations of what we think is happening on the capital account~~s~~ but as you will know from your interesting exchanges with Sir Terence Burns at the last Committee meeting (and I am aware he owes you a letter on this matter which will be with you very shortly ~~I understand~~) ~~but you will know from that~~ that we do not, in fact, make public our assumptions and our forecasts ~~on the question~~ of the capital account. ~~and~~ So, again, although it is extremely tempting of you to invite me to do so I must decline I am afraid.

Mr Beith

206. Would we be right in assuming it is no longer the exchange rate which is determining the level of interest rates?

(Mr Major) Well, we have taken account of the exchange rate alongside a whole series of other monetary indicators in setting interest rates. That was the position before and that remains the position today. It was never, if I may use the expression in a different context, a one club policy ~~as to~~ on how interest rates were determined.

207. Perhaps I was just struck by this phrase of the Prime Minister: "Look, you cannot have two priorities in life, our top priority is to bear down on inflation". She must have been meaning that you could not operate on this range of indicators, must she not?

(Mr Major) No, I do not think that is what she meant at all. It is an intriguing assessment of what the Prime Minister might have said at some unspecified time. But what the Prime Minister said was, in fact, perfectly clear: the Government's central concern is to bear down on inflation, that we think it is higher than ~~we think~~ it ought to be and we wish to bring it down, and in terms of doing that we will use monetary policy, to an extent we will use fiscal policy, and we will look at a whole range of indicators. But in so far as interest rates are concerned we will, as we traditionally have, take account of the exchange rate le~~ve~~ls and also have a careful look at the monetary indicators and other matters as well. It is ~~a~~ the range of th~~os~~e matters that we bear in mind when we set ~~the~~ interest rates.

208. Are you not making the dangerous assumption that interest rates do not influence inflation unfavourably? I am thinking particularly of the likely impact of wage increases and the pressure for wage increases arising from ever-increasing mortgage rates now that so many more people are buying their own homes.

(Mr Major) No, ~~I make no such assumption in the way in which I approach the setting of interest rates.~~ I do not make that assumption. ~~I am bound to say~~ On the subject of wage increases, I think one of the more worrying elements about wage increases is not so much the way in which they might feed into inflation but the way in which unjustified wage increases — not wage increases justified by productivity which are perfectly satisfactory whatever that level might be, but unjustified wage increases — ~~that in my assumption~~ are as likely to reflect in the levels of unemployment as they are to reflect in the levels of inflation.

209. What are you assuming about savings given the very low rate of personal savings when compared to most of our competitors? In the past you have tended to say when questioned in the House the higher rate of interest is itself a major attraction to savers but we still have this very low rate of personal saving, are you looking at other ways we can increase?

(Mr Major) We have had a fairly remarkable conjunction of events on the savings front over the last year or so and that is not unrelated to pressure we have seen in terms of demand. We have seen ~~the~~ a very rapid change in the personal sector in terms of savings, that has been very remarkable. It has largely ~~come~~ been brought about by an increase in borrowing rather than a reduction in ~~absolute~~ the gross stock of savings. If you are asking me the direct question would I personally wish to see a higher level of personal savings I probably would, yes.

210. I hope it is something you look at in advance of the Budget.

(Mr Major) That is your assessment of what I will do rather than my indication that I will.

211. That is for the record. In your opening answer you mentioned the point about multiple mortgage interest, you recall your predecessor as Chancellor in appearing before this Committee conceded precisely this point in April of this year in answer to the Committee's questions but he blamed the computers rather than any error of judgment and said he had been advised the computers would take that long to work.

(Mr Major) I have always been very fond of computers myself and that being so I choose to accept whatever the computers might have said but in retrospect (which was the way I put it) it was perhaps an error.

Mr Beaumont-Dark

212. Do you agree with a former Chancellor of the Exchequer that a £20 billion trade deficit does not matter as long as you can borrow the money to cover it?

(Mr Major) I suppose the way in which one looks at that is to ask yourself the question would I prefer to have a £20 billion trade deficit or would I prefer not to have a £20 billion trade deficit? On that I think the balance of probabilities is ~~I would answer~~ I would prefer not to have a balance of trade deficit of £20 billion. I think the fact it has been readily financiable is a point that has been well understood ~~in the past~~ but I would prefer not to have a £20 billion trade deficit. ~~I am delighted to see~~ The forecast improvement next year is not as much as ideally I would like to see ~~it.~~ but it ~~It~~ is a very material change ~~in the forecast~~ if it proves to be correct (and I enter the health warning again) with the deficit coming down from £20 billion in the present year to £15 billion next year, that is in terms of GDP ~~something over~~ around a 1% change.

213. That is a wonderfully Delphic answer, I must say. If you take table 213 on page 6 from 1985 right through to 1989 stocks rose from 600 million to 5.4 billion, the forecast for 1990 is a fall of 0.3 billion.

(Mr Major) Yes.

214. Does this not represent a substantial and an intense period of de-stocking and cancelled order? Why do you think there is this huge turn round in de-stocking?

(Mr Major) ~~If I may say so,~~ Of all the elements in the forecast the one that I think ~~in behavioural terms is the one that~~ gives me the most degree of concern is w~~hat actually is going to be~~ the position ~~in terms of~~ on stocks. ~~In fact if you look at that~~ What we are actually ~~proposing~~ forecasting is that there will be a £300 million reduction in stocking during the period of 1990, ~~that is in essence what that table means~~. ~~I think~~, Given all the information available to us, that that is probably - probably - the best ~~central~~ forecast that we will be able to make. Certainly we looked very carefully at that and I am very ready to acknowledge the ~~sensitivity~~ uncertainty of that particular forecast but I think it is the best forecast we are in a position to be able to make.

215. I am glad it does disturb you because is this not really the crux of it: unless it is just a transitory thing, in other words the balance of payments only increases because of a very short term thing, it must mean there might well have been a fundamental shift because with small and medium term businesses borrowing at 18% (and your predecessor used to say how fluid industry was with money) I can tell him and you with small and medium businesses if you cannot afford to borrow at 18% (and many firms cannot, I can assure you of that) does this not mean that investment must drop because I can tell you now many smaller busienses in the Midlands, they are deferring investment plans. Does this not mean a recession could be very likely? Does it not mean we should try and get it into a straight downturn as soon as possible and use other weapons?

(Mr Major) Let me turn back to those stock building figures for a moment. I share your view they are important ~~to forecasts but~~ and it is extremely important we look at them carefully. ~~The recent estimates themselves returned~~, £300 million for 1990 in stock building~~, that~~ represents the best judgment~~al case~~ that can be made by the Chief

Economic Adviser ~~Statistical Officer~~. He has looked very carefully at it, it is the best forecast ~~adjustment~~ he thinks he can make. ~~They are uncertain so~~ There must be uncertainty about the outlook for stocks. The important point ~~we are saying~~ is that we are not forecasting intense de-stocking which I think may lead to the recessionary concern, which I think is in the back of your mind, what we are forecasting is a slight fall in stocks after a very, very rapid build up in 1989. That is, I think, the central point of the forecast there. It is also true, and I think it is worthwhile making the point now, that the turn around in stock building between 1989 and 1990 very largely accounts for the depressed outlook for domestic demand. That is the principal single major ~~factor~~ for the depressed outlook in domestic demand. If we look back at periods when the economy ~~one first~~ moved from ~~a~~ higher growth to lower growth ~~in the past~~ that ~~that~~ is normal in any cyclical slow down in demand and output growth. So I think the recessionary fears that, I suspect, lay at the back of your mind are not perhaps as great as you wish.

216. Not wish.

(Mr Major) As you fear. Though it must be said in addition to that that if that huge change of 5½ billion growth in stock building to a 300 million reduction were the only change and there were no other consequential changes, which there could be, that of itself would ~~can~~ cause a slight fall in GDP. I think Sir Peter Middleton might want to add to that.

(Sir Peter Middleton) I just wanted to say that as you know, and the committee knows as well, with national accounts we have great difficulty in making them absolutely coherent because of the errors in the statistics.

217. We know!

(Sir Peter Middleton) These show up, particularly as regards the past, in stock building and that is one of the elements one would look to to make the figures add up, as it were, and the forecast for the future reflects what we have for the past as much as it does a judgment for the future.

218. Can I ask one more question, it is germane to this very point which obviously worries you as it does all of us. I am sure when it is used it does help because all of us in the end we have to export or die and manufacture or die. What kind of forecasting are we doing for companies' financial deficit if it does look as though the companies' financial deficit, in other words retained profits, is likely to be severely reduced? Would you not agree reducing direct taxation is inflationary because it puts more money into people's pockets directly and if there are any tax concessions available would it not be better to think along the lines of helping industry by lowering corporation tax or the national insurance charges than any other single thing to help keep this country moving along the right lines, which it has been now for two or three years?

(Mr Major) If I may say so I am grateful to Mr Beaumont-Dark for the first budgetary representation I have yet had ~~over the period of the last month or so~~ and I will take it into careful account as we look at options for the Budget over the period of the next few months, but I think that falls very much into the area of a budgetary judgment. I will note what Mr Beaumont-Dark says, if I may.

Chairman: We will remain in hope.

Mr Watts

219. At its inception the medium term financial strategy was intended to provide a declared policy framework for economic management and at the start had headaches over spending, borrowing money supply and so on. Your predecessor, as he explained to us, allowed the slow shifts of

emphasis in the spending on products and, therefore, abandoned targeting broad money so that at the end he was left targeting only MO and with a rather more general objective than keeping the exchange rates stable. Do you consider it helpful to have declared targets for such things as monetary growth, public spending borrowing or debt repayment and the exchange rates so that policy responses are to some extent predictable or do you think it is preferable to retain the discretion of responses flexible to changing conditions?

(Mr Major) Well, if I may, I think the truth is perhaps slightly different from the two options that you place before me. I certainly think that it is ~~a~~ wise proposition to have fairly firm financial policies and to set those out in a medium term financial strategy. I think that is the right ~~. I think that is the~~ way for us to continue. It is perfectly true that there will need from time to time to be changes ~~in~~ of emphasis ~~of~~ in policy. ~~and~~ It seems to me ~~in terms of~~ from my experience at the Treasury, both as Chief Secretary for two years until June and subsequently, that the economy is a very moving and fluid thing. It is not always wholly consistent. It is sometimes like surfboarding on a fairly heavy sea, you have to take account at any time of the way in which circumstances are changing. So I think you do need a firm policy framework but I would not wish that firm policy framework to close out options that may be necessary. I have formed the impression over the last few weeks that a number of people want to see whether I am going to close down one option or another in terms of policy. I have observed they want to see me close down policy options, I am ~~less~~ not inclined to do so. I believe we need a firm policy framework ---

Mr Beith

220. What is it?

(Mr Major) --- I hope we will continue to provide a firm policy framework but how we operate within that framework ~~may~~ will entirely depend on the particular sequence of events.

Mr Watts

221. Would you agree the overriding policy concern should be to maintain monetary policy sufficiently tight to keep inflation under control and that if that can be achieved then there should be little need for concern about external pressures on Sterling?

(Mr Major) We certainly need to keep monetary policy tight and to bear down on inflation. We have already touched upon that in questions Mr Beith asked a few moments ago. I agree we need to keep monetary policy tight and we need to keep fiscal policy tight as well. We have had over the last few months a strong monetary and fiscal position, I think it is desirable we should. We need to sustain that. I will take into account all the things set out earlier in terms of monetary policy to ensure we keep monetary policy tight and there should be no doubt ~~in terms of what we have said and done~~ that we believe in a tight fiscal policy and will sustain that too.

222. Do you agree pressures on currency tend to be either a reflection of its experience of inflation or of inflationary expectation and therefore the control of inflation is really a cornerstone for successful financial policy?

(Mr Major) I think it is the key to it. I do think from time to time there are other factors that put pressure on the exchange rate quite apart from inflationary expectations, ~~a whole range of things can do that~~ both in the short term and medium term. But I agree with your underlying proposition that the confidence people have in the Government's anti-inflationary policy is essential to the exchange rate.

223. Why is it there is now no target for broad money and only M0 is targeted?

(Mr Major) It has been very erratic, broad money, and it is very difficult to draw policy conclusions that would be coherent from the movement of broad money over recent years. If there were a way one could draw coherent conclusions from the movement of broad money then I would look at that as well. If you look at what has happened to it over recent years, it is extremely difficult to argue that it has been the case. M0 has been a far more coherent guide and I think we must for the moment stick with that.

224. Is it so much a guide or rather more a record of what has happened?

(Mr Major) It certainly indicates retrospectively what has happened, that is certainly true, but I think if you talk in terms of a guide it is perfectly clear M4 is not a guide, broad money is not a guide. I have looked very carefully to see whether it could be made one. I do not think it can be made one at the moment and nobody has suggested to me how it can. In terms of narrow money that is the best guide we have in an uncertain field and that is the one to which policy is geared at the moment.

225. If a little attention had been paid to the growth of broad money in 1987 and 1988 you do not think that would have helped to have predicted the inflationary pressures which have now overwhelmed us?

(Mr Major) We do not ignore broad money. We certainly keep a close watch on what broad money is doing. What is less easy is to draw clear cut and coherent conclusions ~~from the~~ for policy ~~of~~ from broad money. If you actually see what has happened to it and relate it to what has happened to inflation at a measurable lagged period of inflation later on it is difficult to find broad ~~levels of proper coherence~~ rules that would enable one to make policy decisions.

(Sir Peter Middleton) M4 growth was not very different in the years 1979/1980, 1985/1986/1987/1988 but inflation was very different.

Mr Townend

226. Can I raise a matter of principle which is important to England and particularly to the North and that is the allocation of Government resources to the various component parts of the United Kingdom. Can you confirm this year in your Autumn Statement the public expenditure for Scotland, Wales and Northern Ireland was based on the Barnet formula and is it correct when this formula was established in 1978 it was based on population?

(Mr Major) It was essentially based on population and that is certainly the method of allocating most but not all of public expenditure subsequently. So, on a pro rata per head basis, there would be a higher level of expenditure per head in Scotland, Wales and Northern Ireland; highest in Northern Ireland, second highest in Scotland and third highest in Wales. That is certainly the way in which things have worked out in recent years. If I may argue on behalf of the Scots, Northern Irish and Welsh they would also say they have a different pattern of problems to confront and they would also, in the case of Scotland particularly, argue that sparsity is a factor but that is a matter the Chief Secretary may have dealt with.

227. This is a matter of principle. Is it correct according to the Government's own actuary, the forecast is for the population of Scotland to continue to decline in the coming years and this is going to compound this unfairness? How can I, as a Northern MP, explain this as being fair to my

own constituents who have just as many problems as those in Scotland?

(Mr Major) As to whether the population continues to fall in Scotland relative to England we must wait and see. We have to look at the formula population system on a continuing basis ~~and~~ but I have no proposals to change that. I understand the sensitivity you feel about this and I know historically you have ~~had~~ raised this in the past but there are a whole series of different factors which determine the allocation of public expenditure and those factors are considered on a year by year basis. In my judgment the method of distributing public expenditure using the formula~~, the principle,~~ has worked out pretty well in recent years. There are some elements of expenditure which fall outside the formula: industrial expenditure is one illustration of this. So it would be a mistake to assume all public expendiure in Scotland, Northern Ireland and Wales operates ~~in~~ on the formula system, they most expressly do not.

228. A lot has happened since 1978, would you not give us an open undertaking to look at the Barnet Formula before next year's Autumn Statement?

(Mr Major) I have no immediate plans to look at that formula before next year's Autumn Statement. I would be very unwise to give you an undertaking I would be changing that policy.

229. Very disappointing. Can I turn to fiscal policy, in the Autumn Statement you are forecasting the PSDR will fall from 12½ billion in 1989/1990 to 10 billion next year. Would you consider if that happens fiscal policy will have relaxed?

(Mr Major) At the moment the 10 billion is an illustrative assumption and I will provide a ~~more formal~~ forecast at the time of the Budget. I think it would not be surprising if the deficit were to fall back in a period of lower growth - clearly in a period of lower growth there are going to be some tax revenues which will fall - and ~~I think it will b~~e if tax revenues were consequently to fall the ~~and~~ PSDR might ~~to~~ fall from its historical high level. Having said that I still think that would leave fiscal policy extremely tight although all the definitions are not on precisely the same basis. I think one would be very hard put to find another nation with as tight a fiscal policy as we have ~~in so far as debt repayment is concerned and fiscal surplus is concerned~~. Japan, perhaps, has a surplus of about the same ~~level~~ proportion of GDP ~~as the surplus that~~ as we have but I cannot immediately think of any other nation that would be remotely in that ballpark. Our policy is very strong, even ~~if that~~ illustrative assumption you have before you turns out

SHL to be outturned ~~a real assumption~~ when we come to the Budget - forecast I should say rather than assumption - even if that forecast turns out to be reality I think we would still have a very tight fiscal policy now.

230. Those other countries you have mentioned, they have not anything like the private sector deficit we have got. Could it not be argued that we need a tighter fiscal policy to offset that large deficit and if we had a tighter fiscal policy we would be able to reduce interest rates sooner rather than later?

(Mr Major) I hope we are going to see a change in the private sector position. Certainly with the proceeding impact of the monetary policy I hope we will see a change in the private sector position. We will have to see how that turns out. I certainly hope that will prove to be the case.

231. You have changed the method of dealing with local authorities' self-financing expenditure for this year which I think we welcome, but if the expenditure by local authorities that is self-financed, within their own control, grows faster than you have forecast will that not compromise your economic policy or your fiscal stance?

(Mr Major) I think there are two different elements. If we have more local authority self-financed expenditure that effectively will reflect in a higher community charge, so in terms of demand within the economy it will be replacing demand in the hands of the individual with expenditure in the hands of local authorities and that, in its macro effect, could be broadly neutral. What would not be at all neutral would be that the levels of public expenditure themselves would rise as compared with private expenditure and that would put very considerable pressure on general Government expenditure. Self-financed expenditure under our own new proposals ~~are~~ is outside the planning total~~s~~ but ~~they are~~ within general Government expenditure and ~~they are, therefore, being within general Government expenditure~~, part of the ratios that we determine ~~to keep~~ as our public spending targets ~~on track~~. So, if there was to be a very dramatic increase in self-financed expenditure reflecting ~~in~~ higher local government expenditure it would certainly put pressure on Government expenditure totals, but that is the principal damage it would do.

232. That would undermine your policy to keep expenditure down as a proportion of GDP?

(Mr Major) Unless we took corrective action it would, yes, but if local authority expenditure is higher than expected this year we ~~would~~ will have to take that into account at the time of the next survey~~, what we see in public expenditure outturn this year~~. In the current year, as the Chief Secretary will have mentioned to you, public expenditure will be higher than we had anticipated largely because local authorities have ~~overspent, have~~ spent more than we anticipated and believed they should have spent, by around two and three-quarter billion and that effectively ransacks the whole of the resources that were available in the previous year's accounts. That is a matter of concern and if local authority expenditure is higher than expected in the forthcoming year we will have to take that into account when we next come to consider the survey.

233. You say in your report there has been a further large drop in public sector debt and this has been one of the great achievements of the Government, what do you feel is a desirable level of Government debt or would you eventually like to see it all repaid?

(Mr Major) I am never sure in terms of debt that there is a desirable level. If I can speak on a domestic level, in my own home I would prefer to have ~~there is~~ no debt! If the underlying question is is it our policy to liquidate all national debt as policy -----

234. Progressively.

(Mr Major) That is not necessarily the aim of the policy. The aim of the policy is to stop the national debt rising. We are aiming over the medium term for a balanced budget which would mean the national debt would not rise in cash terms but would fall proportionately to GDP. That is certainly our policy but we have not extended our policy further to the actual liquidation of the national debt ~~as a policy~~. When we have a fiscal surplus we can take the opportunity to diminish the stock of debt and that is what we have done over recent years. If I can take the figures from memory, I think we have liquidated something in the region of £30 billion of debt, or will have done by the end of this financial year. Over the period of the last three years, That has been a very considerable liquidation of debt and that diminution of the stock of national debt has a ~~this~~ direct impact on national expenditure totals because it reduces propor~~ti~~onately the amount of interest paid on national debt. That reduction of interest has enabled us to make a significant increase in public expenditure programmes with priority like the health service and so on.

235. You have not got a medium term target as to the percentage of GDP you would like to see national debt fall down to?

(Mr Major) Not in that sense we have not, no. We want to maintain a balanced budget over the medium term. I have not set a particular target for the reduction of stock of debt, no.

Chairman

236. These are fairly technical questions but, nonetheless, questions which could have an immediate impact on our institutions. We understand the point about debt repayment and savings and interest charges but I wonder if I might examine with you the effect of public sector borrowing requirement or public sector debt repayment as far as economy management is concerned. You are at the moment continuing the policy your predecessor followed: if there is public sector borrowing requirement of funding it fully, or if public sector debt repayment was offered fully unfunding it. Could you tell us what you think the impact of a given size of PSBR is when you are adopting the policy of fully unfunding it? There are those who suggest it does not matter whether it is 15 billion or five.

(Mr Major) You say it is a technical matter and I think you have understated that, if I may say so. There are perhaps five people in the country who understand that and, fortunately, two of them are flanking me. Let me have the first crack at it.

237. I wonder who the fifth is!

(Mr Major) There are further flankers on either side, I accept that. ~~point without qualification.~~ I think the fiscal surplus in the present circumstance is a good thing for the reasons I have set out in the last few moments. It adds to the stock of public sector savings and total savings. ~~which~~ means Government is not a net borrower; we are not competing with other borrowers, and ~~to drive~~ driving up national interest rates. It means that we can diminish the national debt and the interest burden and that ~~can be taken as read~~, I think, ~~it~~ is thoroughly desirable. Next ~~I said~~ you have to ask if you have ~~future~~ public sector surpluses, what do you do with them, ~~the public sector surplus~~? You can buy some~~thing in terms of~~ financial assets like ~~Treasury~~ bills. You cannot leave ~~it~~ the surplus to disappear in a black hole ~~like~~ as though it does not exist. So you essentially have two options: you can buy something with it ~~in terms of~~ like Treasury bills, a stock of financial assets, or you can buy in national debt, liquidate it and diminish the stock of debt and interest in the fashion that I have proposed. Now, what I think underlies your question is the question of whether one should overfund, that is for example not buy in debt for a while. I suspect that is what underlies your question, ~~not buy in debt for a while, and~~ Of course you can do that but not, I think, for very long. One of the reasons we welcome a public sector debt repayment is that it gives us an opportunity to damp down demand ~~in terms of what we do with that~~. It has been our funding policy for some time to actually neutralise that to avoid driving up short-term interest rates in the money market. One of our concerns is to draw a distinction between fiscal policy, ~~and~~ the arrival of the surplus, and our funding policy ~~in~~ (in) the money markets. If we were to reduce the stock of money using our public surplus in terms of overfunding that might have the effect of driving up short-term interest rates and that, of course, is something we expressly would not wish to do. For that purpose we do tend to use our surplus to liquidate the historical stock of debt.

238. But that being so, why would one not limit the buying in of gilts to the extent necessary to maintain the banks' operational deposits? What has happened is that whereas before we rather commended the view of your predecessor that if there was a PSBR one ought to fund it fully to

prevent expansion of the money supply, you seem now by a policy of fully unfunding to give up any prospect of bearing downwards on the money supply?

(Mr Major) Let me come back to that point. That is a school of thought which I understand and which is advanced from time to time, though perhaps not as eloquently as you have just put it. ~~I think there are alternative views about that as well~~. Let me firstly come back to the point I made a moment ago about the impact ~~of~~ on long and short term interest rates. The concern I would have is if we do not neutralise the loss of liquidity that is implicit in a public sector debt repayment, we do stand the risk of forcing up short term interest rates through money market shortages. That is the ~~concern~~ risk we believe exists and which would be unwelcome. The second point which relates to that too is the need to neutralise the impact by buying-in gilts. If we do not do that, which I think is the proposition under-pinning your question, I think two consequences follow. Firstly, long term interest rates may rise and that could have the damaging effect ~~of damaging~~ on long term investment, and secondly interest rates generally might also follow. Those are the two fears we see if we were to follow that proposition. It is those fears that lead us to the conclusion funding policy should be neutral and not to distort monetary policy. It leaves monetary policy entirely free to do its own work through the impact of interest rates. That is the way I would respond to the point, but it may be H.L either of the world's greatest experts would intervene and wish to add to that!

(Sir Peter Middleton) I think it is really very important to split this subject down, and I think there are three parts to it. The first one is fiscal policy, secondly monetary policy, and third is money market management. It is the confusion of those three together that tends to get us into this tangle. As far as fiscal policy is concerned, the overwhelming factor, macro-economically speaking, is the size of the deficit or surplus, so if we have a surplus that is the thing which is going to be reducing private sector wealth and that is the main effect. Now of course if then you repay some debt, it will have a slight mitigating effect but one that nowhere near offsets the original effect of the fiscal policy. That is the first thing to get hold of. The second question you have to ask yourself is whether there is any monetary policy reason to fund, not fund, or do anything at all. I think by common consent the aspect of monetary policy this would affect is the broader monetary aggregates, M4. We have already had some questions on that and, as you know, our view is M4 is such an uncertain monetary aggregate it simply is not worth trying to control it by selling a lot of public sector debt. What is more, even when we did have M4 as a target, we never succeeded in controlling it by those means. The third thing is money market management: if you have a surplus you are withdrawing money from the system, you are doing that in an even bigger way if in addition to that you fund. We have taken the view that the best position to be in is a neutral one as far as the public sector is concerned, so you do not add to liquidity or subtract from it. If you did drain cash from the system on the scale which would be implied by doing nothing, or still worse funding if you had a surplus, what would happen is that your short term interest rates would be driven into the stratosphere. That you clearly could not allow to happen because by definition our short term interest rates are where we want them to control the narrow aggregates to which policy is directed. So you have to put money back into the system in those circumstances. You either have to make deposits, buy assets from the bank or adjust your position with local authorities, and so you find yourself in the position of borrowing long and lending short, putting up long term interest rates at the expense of short ones, neither of which are very clever pieces of economic policy.

Chairman: Thank you. I think we must move on.

Mr Hamilton

239. Chancellor, I was surprised in your opening statement to hear you ascribe the up-turn in inflation to the fall-out from the Stock Exchange crash - I was not surprised to hear that but surprised to hear the importance you attached to what was actually a relatively minor tax change and yet you ignore entirely the consequences of your predecessor's policy of unofficially shadowing the deutschmark in the early part of 1988 which caused very substantial reductions in interest rates. Whilst that particular policy move may not have been the initial impulse to our present inflationary difficulties, do you not think it has protracted and intensified those difficulties?

(Mr Major) What I actually said about the Stock Exchange crash was that it was a ~~component~~ factor. I think it was an important ~~component~~ factor not because of the crash itself, but because of the impact that the crash had on the monetary policy we subsequently followed ~~in terms of monetary policy~~ with the reduction of interest rates, whe~~re~~ in retrospect it might have been wiser if we had put them up. Looking back over the past two years that was a ~~more~~ material factor ~~proposition than any other~~. I added to that the growth of demand that was clearly there, though it was not ~~fore~~seen at the time, and also the policy misjudgment we made at the time of the Budget. I did not explicitly exclude the shadowing of the deutschmark when setting out the real causes of the difficulty.

240. So you agree that the shadowing of the deutschmark at that time was another policy error which we could have done without?

(Mr Major) I do not think I want to get into that. I am here to discuss predominantly the future and the present, and I think that is the most productive thing to do. Thee are a variety of views in retrospect as to whether the policy~~, if indeed it was,~~ of following the deutschmark was a wise thing to do, but ~~certainly~~ that is not what we are doing self-evidently now. I do not think I wish to delve back historically into what is now an arcane and historical argument.

241. I am surprised to hear you say that. It is perfectly true, unlike your predecessor, you have a future, whereas he has only a past in political terms. I do think it is an important element which we cannot put in the dustbin of history because we might find ourselves in similar circumstances again and we ought to learn from history rather than be condemned to repeat it.

(Mr Major) We all learn from history, and even chancellors are not immune from learning, and I will endeavour to do so.

242. I am sure Mr Budgen will take this point further in due course. He is a far more penetrating cross-examiner than I, having made money out of it!

(Mr Major) If I may say so, he is not going to make any money out of me!

Chairman: Whether he is the ~~b~~Bourbon of the Treasury Committee remains to be seen!

Mr Hamilton

243. I wonder if I could ask you another question about inflation: you have said interest rates can be brought down when inflation is brought down, can you tell us whether your measure of inflation for that purpose is the crude RPI or whether it is the underlying rate, ignoring changes in

interest rates?

(Mr Major) The forecast is ~~on~~ of the crude level of the RPI. I think "crude" ~~that~~ is a ~~precisely~~ accurate description. That is certainly what is anticipated in the forecast.

244. In the Autumn Statement itself, in chart 2.15 which shows the growth rates of monetary aggregates, you will see that broad money is shown as broadly flat, albeit in the region of growth of around 17.5 per cent per annum, whereas the narrow measure of money, M0, has declined very substantially over the last year or so and is now just outside its target range at about 5 per cent a year. Do you think that this indicates that monetary policy is still rather too lax and that a further tightening might not be called for?

(Mr Major) There is always a time lag before ~~existing~~ policy is reflected in the monetary aggregates, and that is ~~always~~ one of the things one has to take into account. It is certainly the case that narrow money is still outside its target range which at presents rests at 1 to 5 per cent and for next year is 0 to 4 per cent, so to that extent you can argue it is too lax. But there is always a time gap and the M0 trend has been in the right direction. It has flattened a little more than I would have liked over the last few weeks but it is still I think in the right direction and I hope that it will ~~prove to be so~~ continue to do so. We do have a very tight policy, I think, still. It is our determination to keep it as tight as ~~it is~~ necessary ~~to be in order~~ to hit our targets and to bear down on inflation. ~~and~~ That is certainly what we intend to do. I think you can see, if you look at the chart, the very considerable reduction there has been in the growth of narrow money over the past year or so. ~~I think that~~ That is clearly the result of the monetary policy that we have followed and that we shall have to continue to follow. But we have set a target for narrow money and I wish to see us get down to, ~~and that is~~ it.

245. I am glad to hear you say that. I did, of course, hear previous exchanges in respect of broad money, therefore I was interested, looking at this chart and bearing in mind what you said earlier on, to see that in the latter part of 1987 and well into 1988 MO expanded at a very rapid pace. If, therefore, it is an accurate predictor of what is going to happen in terms of price level, at that time one should have been pursuing a relatively restrictive policy, whereas perhaps our policy at that time was not as restrictive. As it has been declining very rapidly - not quite as rapidly as it rose, but nevertheless quite rapidly - over the last 18 months, does that indicate that you expect inflation to respond pretty smartly over the next 18 months or so, and therefore you will not be required to protract the slow-down in the growth of the economy which you have been talking about?

(Mr Major) I think there are two points about that. On the latter point firstly, inflation is a pretty stubborn proposition. As you mentioned a moment ago, our forecast for inflation is that it will get down to $5^3/_4$% by the fourth quarter of next year. That is where we think it will be. So it will be fairly stubborn, and in terms of getting inflation down to the sort of level that we would like ~~to see it~~ and getting it on a downward trend (, which I think is equally important in terms of confidence) we have to maintain a pretty firm monetary policy for some time, in my judgement. On the growth of MO ~~to A~~, if you look at ~~the~~ chart 2.15 it actually shows ~~a~~ rapid growth in the spring of 1988, and I think there are two points particularly to make about that. Firstly, interest rates were raised in advance of that. They were in fact raised in advance of the Stock Exchange crash, if I recall correctly, in August of 1987 (I think it was August). They went up unexpectedly in the market's eyes from 9% to 10%, as my predecessor had seen the danger signals in terms of the growth of M0. But with the slackening of monetary policy after the Stock Exchange crash, for the reasons we set out before and which I think are well understood, you then see the growth in M0 in the middle of 1988. So I think that that is a material point. As for the future, we certainly do need to get inflation down from the level at which we find it at the moment. That is why, although I expect the measures we have got in hand to work, we will need to keep~~s~~ at it perhaps for some considerable time.

246. You see, what concerns me is that the broad money M4 trend, in so far as it can be discerned, is that it has flattened out at a level which is higher than at any other time in the last decade. Although M0 may be declining very rapidly, I personally cannot see how logically it can be a sensible predictor of what is going to happen, whereas broad money I think can be. Nevertheless, you still discount the importance of broad money?

(Mr Major) I discount it only because of its historical record. As I think Sir Peter pointed out earlier, broad money was at the same sort of level ~~the inflation level was~~ at ~~the approximate~~ times that levels of ~~broad money~~ inflation were very materially different. So ~~that~~ it is extremely difficult to draw ~~accurate~~ policy conclusions from broad money. If one had a firm framework in which one could be absolutely certain what was going to happen when one saw the change in levels of broad money, that would be extremely agreeable, but history tells us there is no ~~co-~~relationship of that sort. Therefore, although you must clearly look at it, take it into account and see what it is doing and wonder what that might mean, I do not think you can actually pin firm policy decisions on it at the moment; it has just been too erratic historically.

Mr Budgen

247. Chancellor, I would like to give you an opportunity to reconsider one of your answers. You said somewhat earlier that in your opinion increases in wages, unjustified by productivity, were as likely to cause unemployment as they were likely to cause inflation. Could you explain to us how wage increases cause inflation? If they cause inflation, why do not we have a wages policy immediately?

(Mr Major) The latter part of the question is perfectly straightforward. If we were to seek to have a wages policy one would see, as in the past, that it was ~~an~~ unsustainable proposition; it would be bypassed in a hundred ways, as it was in the past. It was unfair, it was arbitrary, it was unworkable. Apart from that, I think it is undesirable.

248. But did it cause inflation?

(Mr Major) So for those reasons, I do not favour that. The extent to which wage increases may cause a rise in inflation is ~~in~~ the extent to which unjustified wage increases tend to be passed on in prices to the consumer. ~~I think that~~ In an increasingly competitive market (the point that I was seeking to make in answer to the earlier question), I suspect to a substantial extent that if there are unjustified wage increases, over a reasonable period - over a reasonable period - that is more likely to reflect in a loss of jobs as firms struggle to keep competitiveness than in an input to inflation. That is what I would expect to see, because in the competitive environment that exists at the moment companies need to keep a very tight control of their costs.

249. Chancellor, I am not arguing with you about the question of whether it causes unemployment or not. I am asking you to consider carefully what you mean by "causing". I put to you that there is only one way in which inflation is caused, and that is by an increase in the money

supply, something over which the Government has exclusive control, and that all the other things that you are talking about as causing inflation are merely consequences of it.

(Mr Major) I am perfectly well aware of what you are saying, and I am perfectly well aware of the theory that underpins it.

250. Have you abandoned it?

(Mr Major) It is not, if I may say so, a theory universally accepted (if I may quote from the outset of a famous novel). The point I was seeking to make, and which I thought I had made clearly before, was that the knock-on effect of wage increases before they manifested themselves in unemployment - which I think in a short while they might do - would be to increase the prices of goods in the market and consequently have an inflationary impact. After a while I think the increasingly competitive position in which companies have to operate these days could mean that that would be bound to reflect in unemployment, but in the short term it might not immediately do so.

251. Have you abandoned the theory?

(Sir Peter Middleton) No. If I might say so -----

252. Let the Chancellor answer for himself. It does seem to me to be a political point of some importance.

(Mr Major) I think that if Mr Budgen will answer a question for me, we might then be in a clearer position to deal with his particular question. On his point, which definition of money - M0, M4, some other M - does Mr Budgen think actually causes inflation? That is one of the first things that one needs to determine before one enters into an arcane discussion about whether monetarism pure and simple is the right way in which to manage the economy and to bear down on inflation.

253. It is not for me to be so impertinent as to answer your questions! I am here as a humble questioner! Surely the argument about the indicators is as to whether they are reliable as to the extent to which money is increasing in its supply. But the word that is important here is the word "cause". I am putting to you that inflation can only be caused by an increase in the money supply, however that may be either judged or later regulated. That theory used to be the theory that this administration followed, as you I believe conceded. Does the Government still follow that theory?

(Mr Major) I think you answered your own question yourself, Mr Budgen, when you said that used to be the theory, in your judgment, the Government may have followed some time ago. It certainly has not been the theory~~, if indeed it is a theory,~~ that the Government have followed during any period ~~in which~~ I have been in the Treasury. I do not think you can boil down all the causes of inflation to such a simple and straightforward judgment. It is necessary to take a very careful control of the monetary aggregates and we have discussed earlier the extent to which we do that and ~~the extent to which we~~ keep monetary conditions tight and the extent we take into account a whole series of monetary indictors, including the exchange rate in doing so. I am myself dubious as to whether the argument rests simply on the straightforward monetary principle you enunciated and which under-pins your question.

254. So you presumably then also say that falls in the external value of the currency cause inflation?

(Mr Major) I think if you have a fall in the external value of the currency for a material period of time it is bound to loosen monetary conditions and therefore have an effect on the inflation rate, yes.

255. How does it loosen monetary conditions?

(Mr Major) I think Mr Budgen will be well aware in terms of the exchange rate policy we have followed for some time we have taken the view - and I share that view and I did when I was at the Treasury before and I do now - it is worthwhile to have a firm exchange rate to bear down on inflation with all the other elements of monetary and fiscal policy as well. That over a period of time has proved a successful policy for us, and it is the policy I shall continue to follow in the future. As to the judgment as to what is or is not a firm exchange rate, that is a matter which one has to consider as and when necessary, but ~~and~~ it is undesirable to spell that out in a form on which you will subsequently question me, and I have no intention of responding to questions of that sort. What is absolutely clear is that we shall ~~have to~~ do whatever is necessary in order to keep inflation on a downward path, and I do not intend to allow a falling exchange rate or anything else to undermine that policy.

Chairman: I think we must move on.

Mr Budgen

256. Thirdly a change in the exchange rate affects some prices but not all prices. How can you say that a fall in the exchange rate causes inflation?

(Mr Major) I think, Mr Budgen, you may accept from me a fall in the exchange rate most certainly affects import prices.

257. Yes, some prices.

(Mr Major) And you will certainly, I hope, also acknowledge that import prices have a material effect - undoubtedly have a material effect - on ~~the~~ output prices in due course. To that extent a loosening of monetary conditions and a fall in the exchange rate must over a period of time affect the levels of inflation. I think that is a principle well understood.

Dr Moonie

258. Chancellor, just to come back to the real world from the arcane realms of monetarism for a moment, I was interested in your statement earlier in these questions of your support for the Prime Minister's idea that the paramount policy is to bear down on inflation. In February of this year however you said, "The first economic duty of government is to safeguard the value of the currency." How do you reconcile those two statements?

(Mr Major) I would have thought bearing down on inflation was certainly necessary to safeguard the value of the currency. Nothing destroys a currency more than inflation.

259. So you were stating the same thing in two different ways?

(Mr Major) Yes.

260. In measuring the pound against the deutschmark, it was 3.29 and it is now 2.79, is that what you would call safeguarding the value of the currency?

(Mr Major) In terms of the mark there has been a very considerable shift in the exchange value, but there are two elements to that. One is the movement of sterling on the effective rate index and the other is the movement of the mark on the effective rate index. It is certainly the case that the exchange rate value of sterling rises and falls from time to time, that is undeniably the case. What we have to ensure over a period of time is that we maintain a firm exchange rate and that is what we will seek to do. That does not mean it will be a rigid exchange rate against each and every currency under the system we at present operate; that cannot be so.

261. We are not just talking about the mark, 50 per cent of our trade is with countries whose value is pegged against the mark.

(Mr Major) If you look at the exchange rate of sterling you will find it is to within a whisker of being ~~precisely~~ the same - and I am taking the effective rate index so it is against a basket of currencies rather than the mark, which is the ~~one rather bizarre~~ the example you give - ~~effective rate~~ as it was at the beginning of 1987.

262. Some of us might disagree with that.

(Mr Major) That is a matter of fact.

263. Why are you not cutting interest rates, since your battle is to control inflation? You are afraid of recession but your present high interest rates are certain to push us over into one. There are signs demand is falling now, should you not reduce interest rates rather than battle against inflation?

(Mr Major) I find it quite reassuring that I am being urged on one side (not necessarily on this Committee) to increase interest rates and on the other to reduce them. That suggests to me we might have the right interest rates at the present time. We will certainly look regularly at what interest rates are and we will certainly make our judgment on the basis I set out earlier to ensure we bear down on inflation, and what that means in the future for interest rates, what happens to monetary aggregates, the exchange rate and other factors as well.

264. How much have we spent on intervention over the past three months?

(Mr Major) The figures i.e. the changes in Reserves were released this morning for the past month - at least I hope they were, somebody had better kick me if they have not been released yet - 931 million dollars for the last month. We spent 2.8 billion, 2.~~877~~ to be exact, in the month before, and in the month before it

2895

was a relatively modest sum but I do not carry the third month in my head.

265. Would you agree a central element of your policy is to maintain the value of the pound at the present time?

(Mr Major) I think the intervention figures speak for themselves. We have been prepared to intervene to sustain a firm exchange rate and intervention is necessary in day-to-day market conditions.

266. Would you sum up what is your exchange rate policy?

(Mr Major) I set out the exchange rate policy perfectly clearly a few moments ago, and I will reiterate it again. Unless one uses the same incantation one runs into all sorts of difficulties with commentators who comment on these important matters, and in fact you run into all sorts of problems if you actually neglect to make the same incantation you made the week before, so I will be boringly tedious and say yet again ---

267. Why break the habit of a lifetime?

(Mr Major) ---- that was our policy and remains our policy.

268. Does a firm exchange rate policy therefore mean you have a commitment of no further fall in the value of sterling? Yes or no?

(Mr Major) I think nobody would be more surprised than you if I were to answer that question, except perhaps me! I admire your skill in attempting to get an answer to that unanswerable question!

Mr Sedgemore

269. I take it, Chancellor, that it is axiomatic from what you have said to Dr Moonie that a 15 per cent devaluation of the pound against the deutschmark, from 3.27 to 2.80, occurred not because of Government policy but in spite of Government policy?

(Mr Major) Of course the deutschmark has appreciated against all currencies almost without exception over the period of the last few months.

I do not think it would have been accepted by anyone in this Committee - indeed I might have been running into some difficulty had I admitted to shadowing the deutschmark over the period of the last few months. I concede freely, Mr Sedgemore, there has been a drop in the effective rate index over the last few weeks but I do not think necessarily taking the deutschmark as the benchmark is the most accurate reflection of what has been happening to the value of sterling.

270. So has the 10% devaluation against the dollar occurred because of or in spite of government policy?

(Mr Major) I think the decline in the effective rate index - ~~which~~ and it has declined, as I said a moment ago - is undesirable, but it has occurred, and from time to time currencies go up, exchange values go up and exchange values go down. That has happened before and no doubt will continue to happen again, both up and down. It depends which period of time you take. If you were to take, instead of the timescale that you are taking in your question - you are perfectly entitled to take that timescale, but if you were to take a longer timescale - and if you were to take from the beginning of 1987, as I remarked a moment or so ago to Dr Moonie you would find our effective rate index was precisely the same.

271. Chancellor, we only took that timescale because it related to a statement that you actually made in Hansard on 9th February 1989, Volume 146 column 1154. But leave that aside for the moment. During the first 10 months of this year we have had a visible trade deficit of £20 billion - the worst in our history. Reading your speech in Hansard of 28th November 1989, columns 595-597, you seem to be saying that that was a wonderful expression of the strength of our manufacturing industry. Is not that using words a bit like Humpty-Dumpty used them in Alice in Wonderland?

Would not it be fairer to say that the figures demonstrate a fundamental weakness in UK manufacturing industry?

(Mr Major) No, I do not think it does demonstrate a fundamental weakness in manufacturing industry. Indeed, if you actually look at the performance of manufacturing exports, I think that would argue against the fundamental weakness in manufacturing industry. The point I was seeking to make in the extract to which you have referred was the sheer scale of manufacturing capital investment in its future productivity capacity. I think that that is ~~a~~ desirable ~~thing to do~~. What is undesirable in the short term is that so much of that capital investment in new machinery has meant that the new machinery has had to be bought in from abroad and has widened the balance of payments in the short term. So you have had two effects. You have what I consider a very desirable thing, which is that the manufacturing industry is investing in fresh capital machinery to improve its productive capacity. All of us would agree that that is a good thing, because we wish to see the strongest possible manufacturing industry and the greatest productive potential of manufacturing industry. In the short term what is less immediately attractive is the effect ~~that~~ that has on the balance of trade, for clearly it widens it to the extent that that machinery is purchased abroad, and a good deal of it has been.

272. I think Mr Radice and I have agreed that he will blow you out of the water on that one, so perhaps I could move on. Both the previous Chancellor and the Chief Economic Adviser to the Government, who is sitting beside you, have told us that this mega-balance of payments deficit of £20 billion forecast for this year is self-correcting. I will pause for you to turn to the page, if that is all right. I must confess that generally I have not understood what either of them has been saying. Could I ask you what you think they have been saying? Could I give you a

quotation from Professor Brian Reading, who is sitting across there? I do not agree with Professor Reading on very much, but I think I do agree with him on this, and I suggest it is irrefutable. He says: "... the mechanism which automatically corrects a balance of payments deficit is the exchange rate. When the private sector can no longer borrow to go on overspending, the exchange rate falls. The payments balance is thus only self-correcting if the exchange rate is allowed to float freely. Trying to stabilise the pound is incompatible with treating the balance of payments deficit as self-correcting." I suggest to you that that is not only true by definition, it is almost tautological.

(Mr Major) In so far as Professor Reading is concerned, he perhaps should have the right of reply, since you say you do not always agree with him. No doubt he will take it up, but perhaps not in this particular forum. In so far as the remarks which you attribute to, I think, my predecessor and also to the Chief Economic Adviser are concerned - who is more than capable of answering for himself if he wishes to this afternoon - over a period, yes, the current account must be self-correcting; it has to be self-correcting over a period. The more relevant question - and I will return specifically to your question - is whether the deficit matters.

273. That is not my question.

(Mr Major) The best answer is, as to whether the deficit matters -----

274. That is not my question.

(Mr Major) I will come on to answer your particular question.

275. Could you answer my question?

(Mr Major) I will answer it, if I may, in my own way.

276. You can waste 10 minutes on that, but we are time-limited here. Will you answer the question I asked?

(Mr Major) I will if you will let me, but I will answer it in my own way and not in the way that you choose that I should answer it! The more relevant question is whether the deficit matters. The best way to answer that is whether you prefer to have it or not, and obviously not. What the deficit actually reflects is essentially a private sector deficit. A fall in private savings combined with a rise in private investment - that is actually what creates the deficit. Such a private sector financial deficit is very rare indeed. There was one in the 1940s. I do not know whether there has been another since the 1940s. The Chief Economic Adviser will perhaps tell us. That must mean - it can only mean - that the private sector is running down its net stock of financial assets. That is the only conclusion one can draw from that. If that is the case, that has to stop and it has to correct itself. Although it is not for me to define what was in my predecessor's mind when he answered the original question about whether the current account deficit is self-correcting, I can only assume it was that. To that extent the current account deficit must be self-correcting over a period of time.

277. But how can it correct itself unless you are using deflation, depreciation or some kind of import controls? What is the mechanism through which it self-corrects?

(Mr Major) Because the private sector financial deficit cannot continue. The stock of private sector financial wealth which is being run down cannot continue and must of necessity reverse itself. To the extent that it does reverse itself, it is bound to correct the current account deficit. That is the point, I am sure, that Nigel Lawson would have had in mind, and I think that is the way in which his answer should be interpreted.

278. Can I be clear? Are you saying that there is a fourth mechanism for dealing with a balance of payments deficit, which lies outside of devaluation and depreciation, which lies outside of deflation and which lies outside of some form of import control?

(Mr Major) No.

279. There is a fourth self-correcting mechanism?

(Mr Major) I think there is a form of self-correcting mechanism, and this is that eventually the private sector is going to move back into surplus. If that is so, as long as private sector financial wealth is maintained, the current account deficit will tend to cure itself as firms and individuals increase their savings or reduce their investment. I strongly suspect that the fall in private savings is probably in any case partly temporary - partly temporary. How temporary I cannot say, as it reflects the adjustment you have seen to the financial liberalisation we have seen in ~~the period of~~ the last decade and the inflation we have had in the 1980s. So I think that to that extent, yes, it is a self-correcting mechanism.

(Sir Terence Burns) Could I add one point, Chairman. Mr Sedgemore seeks to imply in the question today, as he did with me the other day, that somehow or other all that happens in the world is created by governments, that things only happen if governments do things.

280. No, I did not!

(Sir Terence Burns) The reality is, in which case I say to him how did the deficit arise in the first place, because it certainly did not arise through any of the factors that he is now suggesting as the only way in which it could be corrected. The deficit arose in the first place because of the behaviour of the private sector. That behaviour was not entirely, or it was not at all, in response to the movements of the exchange rate, it was due to the balance of its saving and its spending. It seems to be eminently plausible that deficits can correct themselves in much the same way as they arose in the first place. I would simply point out that there are also many examples in history of deficits emerging and disappearing in periods of fixed exchange rates. The idea that you only see this kind of behaviour under floating exchange rates has no basis in history.

281. Then you deflate?

(Sir Terence Burns) It does not require deflation. It can be simply the product of the way in which individuals and companies react to circumstances, based upon the way that they have behaved in the past.

282. Could I ask you one last question, Chancellor, and it is about financing this deficit. I am sure you will be aware of the research of Nigel Pain from the National Institute who has pointed out that between 1988 and 1989 the current account has worsened by about £7 billion and the net capital outflow on long-term capital account has grown by about £18 billion. Gavyn Davies, who I believe is also in the room - I hate to quote these eminent establishment figures! - says: "Far from financing the current account deficit, long-term portfolio investment and direct acquisitions of foreign companies have also plunged deeply into the red. Therefore the outflow which has to be financed out of the reserves, or by attracting 'hot money' into the country, has more than doubled to over £50bn this year. These staggering sums show little sign of improving." If I understand that, what that means is that you have got two choices. One is that you can raise interest rates above 15%, and the other is that you can actually let the exchange rate depreciate. So given that it is probably politically impossible for you to raise interest rates to 16%, does that mean that as a matter of fact we should expect the exchange rate

to depreciate?

(Mr Major) If I can take the last point first, I think it would be very unwise to make the assumption if necessary interest rates would not rise. I think it would be very unwise to commence with that assumption. Insofar as the point you have attributed to Gavyn Davies is concerned, he is a very distinguished commentator and I read him with very considerable pleasure and I was not aware he was here - I am pleased he is. On the subject of the capital flows, it is very hard to be precisely sure about the composition of capital flows, very hard indeed. If you take the figures for example for 1988, there was a current account deficit of 14.5 billion, with identified capital inflows of only £2.5 billion, and that means there is a discrepancy of over 12 billion which we reflect as a balancing item. That reflects errors in either the capital or current accounts, but we do not know which, or perhaps in both. Either there have been larger net capital inflows or the current account deficit has been overstated; one is correct. Because ~~banking~~ current flows tend generally to be well measured, I presume it is large~~r~~ly inward capital flows which are most likely to have been missed. The question then arises as to the use of the terminology you have used and which is regularly used - is that hot money? I ask the question, what precisely is hot money these days? The distinction between short and long term capital flows is neither easy to determine nor necessarily meaningful, because in the deregulated economy we have these days it is easy to acquire or dispose of most assets quickly. ~~and~~ That is certainly the case and it is almost irrespective of what the nature of the investment might be. Investment in equities and bonds may be just as easy to liquidate as bank deposits, and even direct investment can be pretty highly volatile these days, as you yourself have remarked in debates on the floor of the House, particularly in the growth of acquisitions and mergers and cross-border mergers most noticeably within the European Community. So not all bank deposits are short term and I think it is dangerous to refer to them as hot money.

Chairman: As to who is or who is not in the public gallery, the same rules apply here as apply on the floor of the House.

Mr Radice

283. Chancellor, you have explained the deficit, our very, very large deficit, mostly, as far as I can see, in terms of the British Government's invention, but if you look at the figures for 1987-89 you find 29 per cent of the deficit is accounted for by consumer goods and only 3 per cent by capital goods. So surely the answer which those figures suggest is that in fact there is a very large surge in imports which comes from consumption.

(Mr Major) There is a surge of both.

284. You did not mention that before, so it is worth pointing that out.

(Mr Major) If you had permitted me, I was about to mention it.

285. Good.

(Mr Major) There is certainly an element of both. I referred earlier to the extent to which the private sector can go into deficit. It is most unusual for there to be at the same time a fall in the private sector savings ratio and an increase in the private sector investment ratio. Maybe the Chief Economic Adviser can tell you when that last happened but it is certainly a very rare event indeed, and I think the conjunction of those two events clearly had a very dramatic impact on demand, and that dramatic impact on demand has of course reflected itself to a significant extent in the balance of trade and balance of payments figures overall.

That is undoubtedly the case. What is also true is there has been a significant amount of investment. The growth of investment in manufacturing industry, ~~a 14~~ over 40 per cent growth of investment over the past three years, is almost unprecedented. I cannot recall when there was such a growth over such a relatively brief time and, alas, a good deal of that growth is reflected in the import figures.

286. Granting the fact over the last three years there has been growth in manufacturing investment, and welcoming that, is it not also the case there are some disturbing features in our imports? The fact that in the early 1980s we had a surplus of manufactured goods whereas today we are running an over 17 billion deficit in manufactured goods? Does that not concern you?

(Mr Major) If I can talk about imports overall, because that is what reflects in the figures, it is perfectly true that import penetration has risen continuously over the period of the last 20 years. There is a chart somewhere. You can see there, whether you take the volume or value although volume is probably better, import~~ant~~ penetration has risen continuously almost in a straight line since 1970 over a period of the last 20 years from around 10 per cent of total domestic demand to 25 per cent of total domestic demand. That is as shown on chart 2.6. Rapid growth in demand also can cause a very rapid growth in import penetration, and that is what I think we have seen in the period of the last two years. Import penetration now is 25% of total domestic demand, as opposed to 10% in 1970. It is interesting to note, incidentally, that import penetration in Germany is even higher at 27% rather than the 25% we have and just under 25%, I think, in the United States. So it is a rising trend in a number of countries and ~~I think~~ that probably reflects ~~an~~ the increasing specialisation in production that we see these days.

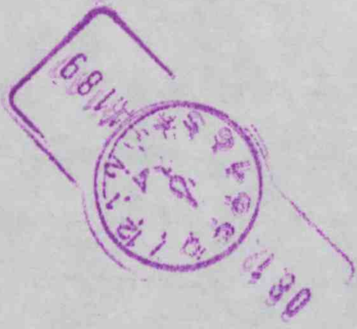
287. That may be so, but of course West Germany has an advantage of being able to pay for those imports by exporting in sufficient quantity and at sufficient value. Unfortunately, that is not the case in this country. You have explained, in contrast to the previous Chancellor, that you believe that the deficit does matter, and you agree with Sir Terence Burns that no one is ever comfortable with deficits on this scale. Why do you think it matters?

(Mr Major) I think that self-evidently the deficit matters. ~~I think that in a curious way~~ ----- Let me put it this way. A number of countries have run a deficit for a very considerable period of years. There is nothing unexpected or especially damaging about ~~over~~ running a deficit for a period of years. What has actually happened in the last year or so has been the very rapid move from surplus to deficit. I suppose in a curious way one of the most damaging aspects of that is not the reality of how you have to finance it, or what it actually means in terms of the productive capacity in a particular country present or future, it is the impact it has on other people's perceptions of what may act~~ua~~lly be happening in the economy. I think that is something that ought not to be understated. What we saw, I think, over the last couple of years with that very rapid swing was firstly the very rapid growth in consumer demand, and a very rapid growth in consumer demand and private sector investment at a time when the productive capacity of domestic industry was fully utilised. What we are going to see in the future is a contraction of consumer demand, a falling back of investment. I think both personal savings ratios and the corporate sector investment ratio will improve, and also I think the supply side changes will improve the productive capacity of domestic industry. That should help us both in terms of more exports - and our export trend is still up - and obviously more import pene~~trat~~ion substitution. I think we are going to see an improving position, and that is reflected in our forecast.

288. That brings me to my second-to-last question. When you made your Autumn Statement I said to you on the floor of the House that the only way deficits can be reduced is either by recession or by depreciation, or both. You answered that I was entirely wrong, but if you look at the figures you will find that the value of the pound has depreciated 12% against the deutschmark since the beginning of the year, so there clearly has been depreciation. In answer to Ms Abbott, you made quite clear that there is going to be a considerable slow-down in demand and in fact it is within the range of error that there could be a recession. Your definition of that was two quarters of falling output. So in fact you were wrong to say to me that I was entirely wrong about that, were you not?

(Mr Major) I am grateful for your assessment that I was wrong. I am not sure that I entirely sign up to the proposition. I think that there are two other things that need considering. The first is the impact of supply changes and improvements. I think nobody doubts that there have been ~~those~~ improvements and, indeed, that they will be reflected in the increasing capacity of domestic industry. Secondly, there is the question of competitiveness, for I suspect the best overall indicator of competitiveness is the share of world trade. That has changed very little really since 1981 following decades in which our share of world trade in this country actually declined; since 1981 it has ceased to decline and remained flat and it actually increased slightly last year and we project it to remain flat again in 1990. So those are extra factors that you omitted which are worth considering.

289. Of course share of world trade is imports as well as exports, and as you have rightly pointed out import penetration has increased



considerably, so it is not surprising our world share of trade has not gone down.

(Mr Major) If you actually look at our projections of imports and exports next year, you will see we expect that although import penetration will increase as a proportion we forecast the balance will get better over the period of the next year.

290. I hope you are right.

(Sir Terence Burns) There have been many occasions in the past when the share of world trade has declined and import penetration has risen. That is not as unusual as Mr Radice suggests.

291. I think you have made clear this afternoon that you want to see a firm pound, would you like to see the pound firmer than it is at the present moment?

(Mr Major) I do not think, Mr Radice, that you would answer that question if I put it to you! I do not think you expect me to answer that question if you put it to me!

292. I will try you on another question: what is the impact of depreciation at the level we have had on inflation? I understand there is a Bank of England rule of thumb that a 10 per cent change in the exchange rate has an impact of 2 to 3 per cent on inflation over 2 years. Is that an accurate assessment?

(Mr Major) That is a question which might more prudently be asked of the forecasters than of me. Let me say I do not think you can look at it in that purely mechanistic fashion. At any time in the economy there are a whole series of different factors at work which will determine both the inflationary impact and have their own ~~relative~~ impact on the exchange rate. So I do not think that is a proposition which I think you can look at in quite the mechanistic fashion you put it to me.

293. That is interesting because in the new Treasury model project it is said a 5 per cent change in sterling leads to a change of 4 per cent in the RPI over 4 years, which is another way of saying the same thing, so it may be mechanistic but your own Treasury is saying precisely that.

(Sir Terence Burns) I can assure you there is nothing more mechanistic than the particular numbers you are quoting from, because that is more or less the way you could headline it.

294. I think you made quite clear to Mr Budgen, you explained to him very carefully, that depreciation does have an impact on inflation. You would accept that, would you not?

(Mr Major) I am not sure I convinced him!

Mr Radice: You have convinced the Committee as a whole. You have convinced me anyway!

Chairman

295. Chancellor of the Exchequer, we are very grateful to you for coming this afternoon. I wonder if I might try one last question: when the present Government came to power in 1979 it was said to be a monetarist government, that is to say a government whose economic policy was based on controlling the supply of money, although Professor Milton Friedman in evidence to our predecessor denied the policy which was being followed was indeed a monetarist policy. Would you agree that the essence of your present policy is one of controlling the price of money, that is to say interest rates, rather than the supply of money?

(Mr Major) I am not at all sure I would ~~except~~ accept quite the division that you have in mind. We are certainly concerned with monetary policy ~~or~~ and controlling the price of money, I think that and all the other policies we have in place have their own impact on the monetary aggregates, and as I mentioned earlier we do look very carefully indeed at monetary aggregates. Monetarism has many fathers and many imitators and to the extent we look carefully at monetary aggregates we are certainly concerned with monetary policy, ~~that is undoubtedly so~~. But I think there are other things we can look at as well, and I have attempted to set out some of those for the Committee during the period of our discussion this afternoon.

Chairman: Chancellor, we are very grateful to you. I think we can all agree on one thing: that the degree of scrutiny of economic policy and certainly the extent of accountability of Ministers has been greatly enhanced by the development of the Select Committee system, and I think that that is something with which, after the last hour and three-quarters, you would agree. We are extremely grateful to you. We shall try to do our best to produce a report which is helpful in our task of monitoring the Treasury. We are very glad indeed that you and Sir Peter and Sir Terence have been able to be with us this afternoon. Thank you, all three of you, very much indeed.
