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THE GOVERNORS

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Mr W A Allen
Mr Iles

TOMORROW MORNING'S MEETING WITH THE CHANCELLOR OF THE EXCHEQUER

The attached paper by Terry Burns was handed to me in the Treasury this morning by Middleton, with the suggestion that it be circulated within the Bank and regarded as a background Treasury note for use ahead of tomorrow's meeting. It will have been so circulated in the Treasury. You will no doubt wish to glance at it before your own meeting at 5.00 pm this afternoon.

21 January 1981

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POLICY IMPLICATIONS OF THE WINTER FORECAST

Policy Stance in 1980/81

I find it useful to begin an assessment of the budget strategy by considering the stance of policy over the past year and its role in the development of the economy. There have been two noticeable aspects of economic performance this year; the first has been the very sharp fall in output, brought about by a contraction of domestic demand, mainly in the form of de-stocking; the second has been a sharp slowdown in inflation from an annual rate of about 20 per cent in March 1980 to a projected 12 per cent in the year to March 1981.

2. The profile of output and inflation in competitor countries has been similar; output in the major industrial countries is now lower than it was in the first quarter of 1980; the year on year rate of increase in OECD consumer prices peaked at around 14 per cent in the spring and has since fallen back slightly. There has been some public discussion of the extent to which we can blame our recession and inflation on events in the rest of the world. I would not wish to argue that the causality runs from the conditions in the world outside to the UK; but I would argue that a good part of our recession and inflation is derived from a common source as the cyclical movement of output and prices in the UK is so similar to that in Europe and North America. The latest recession can be partly associated with the sharp rise in oil prices and the subsequent inflation, involving as it does a sharp contraction in real money balances. However a comparison of recent performance with the 1970s suggests that in the current downturn we have probably done rather worse relative to the rest of the world as far as output is concerned but possibly better on inflation.

3. Assessing the role of domestic, fiscal and monetary policy against the background of the very sharp increase in the exchange rate is difficult; but I would want to argue that both were very tight during the winter of 1979/80 but that taken on their own the pressure from this direction has now eased substantially, and indeed in recent months can almost be described as expansionary. For this

purpose I am judging the stance of policy in relation to the 'real' money stock and the 'real' stock of the PSBR (changes in this magnitude are broadly equivalent to the 'real' PSBR as described by Taylor and Threadgold).

4. Figures for the stock of the PSBR are shown in the table together with the inflation rate. Their relative magnitude has followed a zig zag path with a significant 'real' increase in the stock in 1978/79, a major real reduction in 1979/80 and some real growth in 1980/81.

	PSBR	PSBR 'stock'		RPI[xx]
	£b.	level[x]	% change	% change
1977/78	5.6	69.9		9.1
1978/79	9.2	79.1	13.2	9.8
1979/80	9.9	89.0	12.5	19.8
1980/81	12.8	101.8	14.4	11.7

[x]Gross financial indebtedness of the Public Sector - end financial year. Obtained by cumulating the PSBR from an estimated base. There is of course a degree of arbitrariness in the choice of the base value, but analysis with alternative definitions (for example, those used in Taylor/Threadgold) suggests that the conclusions are unaffected.

[xx]March on March figures.

An examination of the quarterly figures suggests that the fiscal squeeze measured in this way was intense from the second quarter of 1979 to the first quarter of 1980 but that there has been no 'real' squeeze since then. We may wish to argue that in a recession some 'real' increase is appropriate as a result of the automatic stabilisers and that the 'real' PSBR has not fully reflected the effect of recession. But of course some tightness was implied by the need to squeeze real money balances if the year's money target was to be met. Taking this into account my judgement is that fiscal policy over the course of the past eight months has been more relaxed than is consistent with the government's strategy.

5. There is a similar story with the monetary figures. A rapid increase in inflation during last winter brought about a sharp decline in all measures of the real money stock; particularly for the narrow aggregate M1. Since May this decline has been reversed for the broader aggregates and almost stabilised for the narrower aggregates. Again it is difficult to argue that money policy has been "tight" since last summer.

% change	RPI	Mo	non-interest-bearing M1	under-lying £M3	PSL1	PSL2
June 1979-June 1980	21.0	8.7	4.4	16.5	13.4	11.0
June 1980-Dec. 1980 (annualised)	7.9[x]	8.3	8.8	17.4	18.9	16.4

[x]The RPI figure is not seasonally adjusted. The annualised 6 month rate to December will tend to understate the equivalent underlying annual rate of inflation.

6. My interpretation therefore is that the fall in demand and output during 1980 can be related to the tight monetary and fiscal conditions of last winter caused by the sharp acceleration of inflation. In part this was due to the oil price movement and the increase in indirect taxes and nationalised industry prices and possibly partly due to earlier expansionary policies. However the deflationary pressure from this source is now much lower.

7. The analytical difficulty is that an estimate of the appropriate stance of fiscal and monetary policy has been confused by the behaviour of the "real" exchange rate and relative cost competitiveness. The effect of this has been to reduce sharply the real income of the company sector and increase the real incomes of the personal sector. Over the past year the real disposable income of the personal sector has risen while the real disposable income of the company sector has fallen very sharply (possibly by 30 per cent).

£m.	1978 level	1979 level	(% change)	1980 level	(% change)
Personal Disposable Income	112303	133153	(18.6)	155995	(17.2)
Non-Oil Company* Disposable Income	13742	13502	(-1.7)	10770	(-20.2)
£m. 1975**					
Personal Disposable Income	78042	81840	(4.9)	82276	(0.5)
Non-Oil Company Disposable Income	9550	8299	(-13.1)	5680	(-31.6)

*Defined as company sector balance of undistributed income less stock appreciation, net of North Sea Oil income defined as private UK gross profits less private UK interest payments less private UK tax payments less dividends.

**The total final expenditure deflator is used.

The result seems to have been a major reduction of company expenditure in the form of de-stocking whilst consumer expenditure has not risen fully in line with income to offset this. We seem to have a result that by the standards of post-war orthodoxy is perverse as it was often argued that redistributing income from companies to persons would result in a fall in the aggregate savings ratio and therefore an increase in overall demand. There may also have been some adverse effect on export volumes because of the loss of competitiveness that has exacerbated the problem of declining companies' income but the bulk of this effect is not expected until 1981. Coinciding with the effect on demand this process also seems to have added to monetary growth; the fall in company incomes seems to have resulted in a substantial increase in the demand for bank lending while the higher personal sector incomes and savings have been largely held in the form of money.

8. The combination of the high exchange rate and sharp fall in domestic demand has reduced the inflation rate sharply. Just as inflation rose quickly in 1979/80 in a way that cannot be explained solely by previous monetary growth so the deceleration this year is greater than expected given previous monetary growth. Despite the rapid growth of £M3 the housing market has remained depressed, the exchange rate has remained strong and there are no evident signs of excess demand. One possibility is that the recent monetary growth is merely validating the rapid rise of inflation in 1979 brought about by the VAT decision and the movement of energy prices. Although it was not government policy to validate these price increases, to the extent this is responsible it may not imply accelerating future inflation. The second reason is that the effect of the high exchange rate and high interest rates may provide an independent anti-inflationary pressure which enabled us to accept some faster growth of sterling M3 without inflationary implications for as long as the high interest rates and high exchange rate continues.

9. Summarising the present year I would want to argue that the balance of fiscal and monetary policy has changed quite remarkably thanks mainly to a sharp reduction in inflation which was probably associated with the previous contraction of demand and the high exchange rate. There has been a sharp reduction of domestic demand in output; domestic demand may now recover to some extent although weakness in exports and manufacturing investment is expected. The balance of these forces will determine the outcome for output over the year ahead. Monetary growth and fiscal policy have recently been more expansionary than is consistent with long term single figure inflation but this may be tolerable to some extent in the immediate future because of the recent rise in the exchange rate by comparison with relative costs and relative money supply.

Policy in 1981/82

10. The policy requirement in 1981/82 is to determine a fiscal and monetary stance that is consistent with the thrust of the MTFS and the continued reduction of inflation well into single figures. With a projected 11 per cent inflation rate for 1981/82 this involves some further real squeeze of the stock of money and the real PSBR,

but this may be limited to 2-3 per cent this year permitting some stabilisation and recovery of the level of domestic demand. A balanced development of the economy would also require some correction of the adverse level of cost competitiveness.

11. In the light of the forecast and the recent behaviour of the economy it is difficult to assess the balance of risks. If we attempt to meet the MTFS figures for 1981/82 output may continue to contract sharply during 1981 and unemployment continue to rise at recent rates; under these circumstances inflation will probably continue to fall very rapidly and this would imply a deflationary policy faster than has, so far, been intended. If this was to happen it is difficult to see how this could be attributed directly to the stance of fiscal and monetary policy as this would not be particularly severe, relative to the underlying inflation rate. If the pressure is coming from the exchange rate being temporarily abnormally high for reasons other than monetary and fiscal policy and it is leading to a continued output slump and rapidly declining inflation it would require a judgement whether it is appropriate to compensate for this by a more expansionary fiscal and monetary policy; or to attempt to offset it either by attempting to bring about a reduction of the nominal exchange rate or by a fiscal switch between persons and companies.

12. Alternatively, even if we were to meet the MTFS guidelines for 1981/82 the recent behaviour of the money supply and fiscal policy may lead to a faster recovery of demand than is expected. A falling exchange rate and accelerating world prices might then point to a resurgence of inflation in 1982. At the moment output is depressed but there are usually important lags between monetary and fiscal expansion; the recovery of domestic demand and the adverse effect of the exchange rate on overseas demand may be less than expected by many. On balance my judgement is that the risks involved in inflation picking up sometime in 1982 are rather greater than of output continuing to fall throughout 1981. Nevertheless as long as the exchange rate remains abnormally high, and the narrow monetary aggregates grow slowly, we are justified in postponing any need to

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claw back the monetary overshoot of 1980/81. But the scope for flexibility is limited and I would be prepared to see it more as a reason for delaying an attempt to 'claw-back' the monetary overshoot than a reason for further excesses.

The Monetary Target

13. The case for and against an 8 per cent monetary target for next year was set out in the "pre-budget planning" note and for the purposes of the Winter Forecast we chose to continue to work with an 8 per cent target. This seems to be correct. There may be severe difficulties in convincing the outside world given the failures of the past year to control £M3 but this year we begin with an inflation forecast of 11 per cent which should involve only a modest 'real' monetary squeeze to achieve the target. We must also take a view on what to do about this year's excess growth. My judgement is that we should attempt to estimate the extent to which the monetary overshoot can be assumed to have merely validated the sharp price increases in 1979 and not attempt to claw this back over the lifetime of the MTFS. This is now water under the bridge and provides a lesson on the dangers of trying to prevent money supply from adjusting to 'exogeneous' pressures on prices from indirect taxes and possibly also from the long term adjustment of Nationalised Industry prices. Much of the rest of the excess, which is now showing up as velocity being below trend should be clawed back over the next three years. If there was any sign of undershooting emerging during the course of next year then there would be a case for allowing this to happen to a considerable extent particularly if the narrow aggregates show signs of faster growth. Similarly if the exchange rate seemed to be falling back to a more normal relationship with money supply there would be a case for tightening policy to attempt to compensate more quickly for this year's overshoot in order to prevent it being built into higher prices. Such a policy involves major difficulties of presentation as it implies a move towards conditional or multiple targets. With Mr. Ryrie and Mr. Middleton we are currently examining the possibilities and administrative difficulties of a move in this direction and hope to report early next month.

The Fiscal Stance

14. The forecast for inflation to the first quarter of 1982 is 11 per cent although a more rapid deceleration of costs or lower increases of nationalised industries prices might reduce this to around 9 per cent. Historically, over the cycle, this measure of the stock of the PSBR has grown by 1-2 per cent less than £M3. This is an average figure and does not hold for particular years but it does provide a medium term benchmark against which to judge fiscal policy. If the monetary target is 8 per cent and we wish to continue to exert downward pressure on prices this might imply a benchmark for the growth of the stock of the PSBR of 6-7 per cent - a nominal PSBR for the financial year 1981/82 of about £6-7b. The MTFS figure of £7½b. was justified in this framework because it was expected that output would be below trend in 1981/82. The present forecast where output is expected to be a further 2 per cent below the MTFS assumption is for a PSBR of £10½b. in 1981/82. The extent of the extra recession compared to what was expected in the MTFS and the external pressure being exercised by the exchange rate might be used to justify some overrun of the MTFS figure but this should probably be limited to about £1½b. This would involve measures directed to reducing the PSBR by about £1½b. compared to the position represented by current policy. According to the forecast this should enable us to meet the £M3 target of 8 per cent with a bit to spare, on the assumption of interest rates slightly lower than those ruling today.

The Company Sector

15. A major feature of the present disequilibrium and the difficulty of producing a coherent forecast is the very weak position of the company sector. This has been brought about by relatively high wage costs, a high exchange rate and high interest rates. If the company sector is to increase its expenditure in line with the growth of potential output it needs access to purchasing power. There are several channels through which this potential severe disequilibrium (which has its counterpart in an implied excessive level of real wages) might be corrected:

(i) A fall in the nominal exchange rate; this might improve profitability and reduce real pay although it would add to the pressures on the price level. It is not feasible to achieve a reduction in the exchange rate to order but I have argued that some decline may occur once the tax gathering season has passed and to some extent this is to be welcomed. Because of the inflation objective any such depreciation should ideally be limited to about 10-15 per cent.

(ii) Lower pay levels relative to other countries; although as world costs are rising at a single figure rate an actual reduction in UK pay levels would probably be required to offset a major part of the loss of cost competitiveness over the last two years. There is severe pressure on UK pay levels at the moment and it is possible to expect that some correction of the problem may come from this direction and therefore partially achieve a market solution to the problem of cost competitiveness.

(iii) Higher company borrowing; although if this is through the banks it must be offset by higher debt sales (particularly to the personal sector) if the monetary consequences are to be avoided. Direct borrowing (for example through equities or debentures) from the private sector is a non-monetary alternative channel. There may be a case for some subsidy to encourage this process.

(iv) A switch of taxation from persons to companies; however because of the non-selective nature of a general tax switch the sums of money involved are extremely large.

(v) A rise in the PSBR brought about by companies failing to pay taxes, billing early or undertaking government work more rapidly than normally.

It is likely that none of these routes on their own are feasible or desirable to bring about the full adjustment of the problem of the exchange rate disequilibrium. In my view it is desirable that the adjustment process should be shared across the first four routes.

CONCLUSIONS

16. My conclusions are as follows:

(i) We must continue to direct monetary policy towards the thrust of the MTFS. The target for the next financial year should be 8 per cent as set out in the MTFS. Any excess monetary growth this year that can be attributed to the large increase in prices in 1979/80 can probably be allowed to go without being corrected. Apart from that it is important that the excess monetary growth this year should be clawed back at some stage over the lifetime of the MTFS. The speed at which this is necessary may be governed by the extent to which the exchange rate falls back to a more normal relationship with monetary factors. The longer the exchange rate remains above normal the less urgent is the need to claw back the excess monetary growth. As we move through this year we need to also pay attention to the behaviour of the exchange rate, and the narrow monetary aggregates if there are continued difficulties in controlling £M3.

(ii) On the basis of the current forecast of output I would be inclined towards a PSBR figure of about £9b. for the next financial year. If output turns out to be higher than expected the PSBR will automatically be lower than implied.

(iii) Some decline in the nominal exchange rate would be welcome although no active steps should be taken to bring it about. Because of the inflation objective ideally any such depreciation should be limited to about 10-15 per cent.

(iv) Some switch of taxation from persons to companies is desirable although this can only go part of the way to correcting the problems of the company sector.

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(v) We must continue to pay attention to any possible schemes that would enable the company sector to borrow without the monetary consequences involved in bank lending.

TB

(TERRY BURNS)

14th January, 1981.