6 Febn.

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SOME OUTSIDE VIEWS

Mr. Ridley, Mr. Middleton and I have discussed the Budget issues with Brian Griffiths, Gordon Pepper, Harold Rose and Alan Budd. We sent them an outline of the issues to be covered. This outline is attached to this minute together with their replies. We have also met them to discuss their views.

2. In reading them it is useful to bear in mind the range of outside opinion as outlined by Sam Brittan at a dinner this week. He outlined six positions; they range from the most severe critics that monetary policy is lax to those who believe it to be severe:

(i) Those who simply look at the rate of growth of the broad agrregate; £M3 has been growing at 20 per cent per annum and therefore inflation will be 20 per cent in 18 months' time.

(ii) There is time to put the strategy back on course and reinforce expectations but this implies taking back the overshoot of this year.

(iii) There has been a step change in the demand for money. Inflation will not be serious provided we get the growth of money supply back down now.

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(iv) There has been a step change in the demand for money which may continue. This could lead to a further overshoot next year without damaging the inflation prospect.

(v) Policy has been properly restricted as M1 and MO have been growing slowly. The danger is not to recognise this and give up trying to control the base because eyes will be on the wrong indicators. Therefore fix the base.

(vi) Policy has been far too restrictive. The shift has been too drastic and has led to an overshooting of the exchange rate. Even a fairly tough stance requires greater accommodation.

3. Brian Griffiths is close to view (i). He argues that we need to re-establish credibility of the MTFS by revising the figures, have a commitment to more efficient techniques of monetary control and cut public sector employment. This year's overshoot should be clawed back over the next three years; the target for £M3 for 1981-82 should be 5 per cent to 9 per cent and the PSBR about £8¾b. (3½ per cent of GDP). He argues that if we do not change the system there will be a money supply "explosion" when the economy next revives. This means moving to MBC (mandatory for one year to eighteen months and non-mandatory after the transition) and selling gilts by regular weekly auctions. He suggests some fiscal transfer from persons to the corporate sector by reducing national insurance contributions and increasing indirect taxation as it would have an employment effect. In discussion he said that no one measure of the money supply was ideal, and you had to know how to interpret the figures. The government has gone for M3 but this is now known to be off course. There are political dangers in now replacing M3 with an alternative, like MO or M1. He believes M3 gives a reading above the true money supply, M1 is below and MO is about right. Griffiths did not feel that it was possible to reduce MLR quickly. Asked if there was anything that could have been done in the course of 1980 to have prevented money supply overshooting so much he argued that first and

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foremost more effort should have been made to hold down public expenditure. Secondly he argued that interest rates came down for political rather than good economic reasons, and thirdly the bank had used repurchase agreements for gilts which were too permissive. He said that interest rates should have gone up rather than down.

4. Gordon Pepper seems to be near to view (ii) on the monetary question. He suggests extending the current range of 7-11 per cent for £M3, based on February 1980, until April 1982. The aim should be to reduce monetary growth below the top of the range as soon as possible. He is inclined to disregard any rise in the PSBR due to the necessary transitional increase in unemployment. He suggests some tax increases and that help to the corporate sector should be from lower interest rates, a modest depreciation of sterling and possibly a NIS reduction for manufacturing industry. He also makes a plea for a change in the system of monetary control. In discussion he explained that he thought the problem was an excess supply of money rather than a problem from demand side; people tend to concentrate on the demand for credit and ignore the savings function. The money stock was rising due to the fact that people were saving more and keeping it liquid because of the good return from money. The ? danger is that eventually this money will be spent as excess money supply cannot be allowed to remain for more than six months. He advocated bringing MLR down immediately, before the Budget, to promote a gilt selling period to mop up the excess supply. He blamed the problems of 1980 upon a variety of factors. He said that the removal of the corset had introduced unnecessary distortions. There was no discipline on the banking system and nothing was introduced to replace the corset. He agreed that we should take more notice of the narrow aggregates although the broad measure had been the centre of discussion over the last year. He also argued that the PSBR was of secondary importance and that it was more important to control public expenditure. He was uncertain how to measure the natural level of unemployment and therefore it was very difficult to make the appropriate constant employment adjustment. He emphasised the need to avoid attempting to fine-tune or tinker with the monetary and borrowing figures.

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5. Alan Budd was nearer to the point of view (iii) although he did envisage some claw back of this year's monetary overshoot. He expects part of the monetary overshoot to be reversed automatically but that some of it was due to the PSBR overshoot this year. In discussion he suggested that we should allow undershooting if it occurred automatically and we should present a lower money supply range for 1981-82 than was laid out in the MTFS although we could present a range of 6 to 10 per cent and then make it clear that we were heading for the middle to lower end of the range rather than for the top. He stressed that if we were planning to get back to the MTFS it should be done now and not wait until 1982-83. In his note he argues for a PSBR of £10b. as equivalent to the MTFS figure after allowing for the extra 2 per cent fall in output due to recession. This compares with a pre-budget forecast of £12b. on unchanged policies in 1981-82 after £13½b. this year. He proposes that the burden of increases in taxes should fall on the personal sector and argues for a NIS cut.

6. Harold Rose is nearer to position (iv); he now believes that the original 7-11 per cent target was unrealistically tight but suggests a monetary target of 6-10 per cent next year partly for psychological reasons and partly to limit the temptation to tolerate an excess of money supply should there be signs of a reversal of the desire to hold money. For the PSBR he arrives at a target figure of £10b. making allowance for the recession. To achieve this some tax increases are necessary and he argues it should come entirely from direct personal taxation. In discussion with us he argued that much of the rise in money supply was because of the need for the real value of PSL1 and PSL2 to recover their normal level. He argued they were very low in 1978; it was possible that they were still low by historical standards and there could be some further catching up to do. He advocated being more relaxed on monetary policy this year, but tough on fiscal policy. This could lead to a fall in interest rates which might help. Although personal sector bank lending had been rising in the past, Professor Rose thought it had now levelled off and was even falling. He said that the personal sector would be the future battlefield, with the building societies fighting the Treasury for index linked bonds,

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and generally a more positive attitude to personal loans. For the company sector, dividends were likely to drop this year, and rights issues would be difficult. The margins on corporate sector lending are now very low, whereas they were much higher for personal sector lending. He said that he would like to see some help to the company sector which was in large deficit, as basically the liquidity of the personal and company sectors had got out of line. But he saw a danger, in putting indirect taxes up too far which would lead to adverse wage effects.

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(TERRY BURNS)

6th February, 1981.