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Chancellor of the Exchequer

cc Chief Secretary
Financial Secretary
Mr Burns
Sir Douglas Wass
Sir Kenneth Couzens
Mr Ryrie
Mr Monck
Mr Britton
Mr Riley
Mr Turnbull
Mrs Lomax

MLR IN THE BUDGET

1. We still have to decide on the appropriate size of the MLR reduction in the Budget. The choice is not an easy one; it might help if I attempt to set out some of the considerations.

2. The forecasters have now made an assessment of the prospects, taking account of the latest position on the Budget and the PSBR, together with an up-to-date view of the course of overseas interest rates. Their judgement is that it should be possible to achieve the mid point of the new target range (£M3 growth of 8%) and see MLR come down by 2 points next year. The narrower aggregates would be expected to grow more rapidly than the wider ones. M1 could grow by around 14% consistent with a 2% lower MLR.

3. The forecasters do not however attempt to guess precisely when a particular change in interest rates would take place. If a 2 point cut was made on 10 March, it would accentuate the tendency for £M3 to grow more rapidly in the early months of the year. To some extent, this is to be expected anyway because of the profile of the PSBR and the need to come down from the pretty rapid current growth rate. On the present forecast, 2% would be as much as could be managed during the whole year, so there would not be much immediate prospect of further reductions.

4. The alternative would be to restrict the cut to 1% in the Budget in the expectation of doing another 1% sometime thereafter. It is impossible to be very confident about the path of monetary growth, but it would probably be smoother throughout the year. As we have also seen recently, the prospect of further interest rate falls might help to maintain favourable expectations in the gilts market.

5. You will want to take the Bank's view on the market reaction

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to the speech. My own feeling is that the measures you announce will be seen as a very tough package. There would be no surprise if interest rates are reduced by 2 points and I doubt whether there will be many who are unwilling to accept that it would be consistent with the new £M3 target - especially if the short term outlook seems to be improving as might be the case if we get a February figure of around 1%.

6. If this is a fair assessment, then the deciding factor might be the general reaction to the Budget and particularly the reaction of industry. Given the way their expectations have been aroused, a 1% reduction would be a very considerable disappointment. Even a 2% reduction runs some risk of being criticised as inadequate.

7. Each 1 point reduction in interest rates in the Budget would, however, reduce the interest payments of industrial and commercial companies (net of interest receipts) by about £280 million in 1981-82. We have checked these figures with the Bank and they confirmed that their own estimates are very similar. This is before allowing for the effects of a reduction in interest rates on the amounts that companies actually borrow. In practice, there would of course be some increase in company borrowing, but after this the change in their net interest payments would still be around £200 million.

8. The financial position of companies would also benefit from the general stimulus to activity and company profitability brought about by the reduction in interest rates. Taking account of this and some consequent increase in companies' expenditure, we would expect the net improvement in industrial and commercial companies' cash flow for each 1% reduction to be of the order of £250-33 million.

9. Reflecting on these numbers, inclines me to suggest that a 2 point cut in MLR is a necessary ingredient to give a proper balance to the Budget. The main immediate benefit to industry in the Budget comes from the £200 m plus first year effect of the stock relief - though the full year effect is £600 m and we shall be able to make something of that. Many will be less than overjoyed by this. Companies have been acting since November as though

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the implementation of the stock relief, apart from the credit restriction, was a formality. Moreover it will be set against companies' share of the increases in petrol, derv and VED - and some will undoubtedly complain of deflationary effects from the fiscal package. The prospect of £600 million or so relief from a 2% reduction in MLR and the accompanying change in base rates would put us in a much better position to meet this sort of potentially damaging criticism. 1% just does not seem enough.

10. The arguments at present deployed in the monetary section of the Budget Speech were designed to support a 2% reduction in MLR though they are also consistent with a smaller change. But there are other considerations which you will wish to take into account nearer to the Budget, particularly the state of the domestic and external markets. This note is simply intended to help you and others to begin coming towards a conclusion on this question.

PEM

P E MIDDLETON
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