The Deputy Gov. [illegible] May wish to see this exchange.

SECRET

14. 7.81

THE GOVERNORS - personally

Copies to Mr Fforde) Mr Loehnis) Mr Flemming) Mr George) Mr Goodhart) Mr Holland) Mr Walker) Mr Brierley) ONLY

JCRD. I will keep the attachment. I've always thought that the fiscal measures that you suggest, in the present political context, would in practice 'precipitate a pay explosion' – especially in the public sector – and could not be contemplated except in exchange for a (??) watertight bargain with the unions or else (better) a statutory 2-yr freeze. In the absence of a freeze, or near-freeze, I would fear HMG being in the very weak position of 'failed-monetarists' who had given way to disaster and disturbance what they had denied to reasoned argument. But I could be wrong.

AN ALTERNATIVE POLICY

May I be allowed to inflict on you some reflections on the possibilities of an alternative policy. The subject may not be topical, in the sense that there is likely to be a political opening for a change of policy. But it is clearly important, and worth thinking about from time to time. Since a note on this subject is bound to raise awkward issues, I thought I should restrict the circulation. It is based on a more technical note by Mr Brierley which I have not attached but which is available to those who need it.

JSF

Yes though I cannot see anything like my package coming all at once or quickly, & later other things will come change. However I was trying to clear minds not promote action at this moment. JCRD.

JCRD

14 July 1981

J C R Dow

JSF 15/7 13 JCRD 16/7 2 DG 17/6 1

AN ALTERNATIVE POLICY

1 It is sometimes said, even in the Bank, that there is no practical alternative to continuing with the present line of policy. The proposition is worth examining since the prospects on present policies appear so unsatisfactory.

2 The present forecasts (to the end of 1982) show output remaining at about its present (mid-year) level, through next year and the one after, and unemployment mounting gradually - to 3 million in a year's time and still growing. Forecasts can always be wrong; but I do not see why these should be: we have lived for two years with recession developing very much as predicted.

3 Eventually, if this prediction proves to be correct, I feel sure a different policy will be adopted. It is true that there seems no practical way (short perhaps of Godley's desperate cure) of completely revolutionising the situation and reducing unemployment quickly. But there are ways of making it significantly better. It is also unfortunately true that even modest improvement of this sort would call for modifications of policy which seem quite large.

The theoretical possibilities

4 To illustrate what might be possible, I asked Mr Brierley to run some simulations, as modifications of the present Bank forecast, to show the effect of various alternative assumptions about policy. The task I set was to hold unemployment at its present level (i.e.2.6 million instead of rising another half million). To do this, he was to be allowed to assume cuts in income tax, VAT and insurance contributions of the size required to do this. This would be likely to bring a fall in the exchange rate (which itself could be expected to have as important an effect on activity as some of the tax cuts). Since it is difficult to know how much the exchange rate would be affected, an arbitrary adjustment, building up to 10% in a year, was assumed.

The effect could of course be larger. The more detailed figures in the effects of the exchange rate change are shown as a component separate from the effects of the other changes, in order that readers can try out their own modifications. The policy change is assumed to start now (1981 Q3): a delay would alter the figures in detail, but not the broad picture.

5 The broad conclusion is that output could be made to increase this year and next by a rough 2% a year; that unemployment could be prevented from rising much over 2½ million; and that a moderate expansion of this sort could be combined with quite significantly better price performance than is now likely. This would admittedly require quite a large fiscal package, putting up the PSBR this year and next by £4 or £5 billion, which may hardly be politically thinkable. Nevertheless, the combination of significant expansion instead of indefinite stagnation, together with quite a bit better inflation performance, is so attractive that the possibilities seem worth looking at more closely.

6 I therefore summarise below the general picture - before turning to think of whether some compromise, going only half-way (and thus more realistically possible) would be worthwhile. The projection is summarised in the table attached.

7 The welcome effects on inflation come, of course, from the cuts in VAT and insurance contributions. Their effects on prices more than outweigh the harm done by the lower exchange rate. The tax changes assumed are

(a) VAT rates back to where the present Government started (8% standard rate, 12% on luxury items);

(b) NI surcharge removed;

(c) Income tax basic rate from 30% to 27%.

The VAT cut has the largest effect on activity; that in income tax the least.

8 It has to be admitted that the effect on interest rates - like that on the exchange rate - is really unpredictable (a small rise is allowed for, but the growth of £M3 is also assumed to be allowed to rise to 13 or 14% a year). Nevertheless it seems likely that both investment and the financial position of companies would be strengthened.

Practical possibilities

9 The foregoing paragraphs are intended to establish the proposition that, if political restraints could be left aside, there could be an alternative policy, which would appear to have some fairly attractive features. It is obviously quite another question to see this as a practical possibility. Policy changes of this sort have happened on past occasions; but in the present context, it would undoubtedly seem a volte face. The reduction of indirect taxation would indeed be a plain reversal of recent policy. And hopes of reducing the PSBR year by year would have to be abandoned - though, in relative terms, the PSBR could still fall as % of GDP from last year's (high) level.

10 It may then be worth looking at a partial move in this direction. Politically the easiest component to contemplate would be reduction or abolition of the NI surcharge. Abolition of the surcharge however, on its own, would have a marginal effect only on activity - eg an upturn of manufacturing output of 1% next year and in 1983 instead of a flat trend, and less effect on GDP in total. If this also triggered some fall in the exchange rate, the stimulus could be doubled; but at the same time the moderately helpful effect on prices might be cancelled out.

11 The real benefits would only come if VAT were reduced a lot as well as the NI surcharge. The VAT increases two years ago, and the further indirect tax increases since then, have done a lot to increase inflation; and it is not surprising that only if this is reversed could much be done to reduce it.

12 The policy changes considered are not of course the only changes that are possible. Mr Prior's £ billion package to reduce youth unemployment would help output - as would greater public investment. But neither on their own would be a great stimulus.

13 The conclusion is inescapable that (on the basis of the forecasts we now have) action on a larger scale would be required to produce an upturn; and that, because of its effects on inflation, this would scarcely be tolerable without a sizeable cut in indirect taxation.

Final Comments

14 I have however three glosses to add, springing from normal scepticism about the literal accuracy of the forecasts, which somewhat qualify this pessimistic conclusion.

15 First, the predictions of continued stagnation may be too pessimistic. Activity might turn up on its own. Even so, the upturn is unlikely to be strong. Hence I would not rule out as too trivial to be worth thinking about a move to abolish the NI surcharge. It might prove a possible step soon; it might conceivably prove enough; and we could wait and see how things developed.

16 Second, the forecasts may be too mechanical. I suspect that if action were taken that really looked like an attempt to engineer an upturn, the psychological effects might be powerful, positive, and help the upturn quite a bit.

17 Third, the forecasts of wages are (of course) unreliable. The forecasts which are shown are fairly optimistic. But I cannot help thinking that, with unemployment continuing so very high throughout the period, and with firms in such large difficulties in meeting foreign competition, the moderation of wages may surprise us again. This could be very greatly helped by an obvious cut in indirect taxes and thus in retail prices. But, sadly, if it ever happens at all, it is likely to be late, and not come when it would be most useful - which is by this autumn.

18 In conclusion I may perhaps be allowed a final remark. The results of a policy on the lines here sketched out are not great shakes. Unemployment would still be very high. But it would surely offer some hope for the future. If no hope is given, there must be a danger that remedies of an altogether more desperate sort will, sometime, be tried. The tide is likely to run in favour of extensive import controls combined with expansionary policies, and very likely combined with extensive state direction of industry. This probably would not in fact prove at all satisfactory either: but that would be fully evident only after it had been tried. The economic outlook, whatever we do, looks very unpromising. The real question is whether there is any via media between the present course of policy, whose bankruptcy is likely to appear ever more apparent, and a more desperate course. I continue to hope that we can find a middle way. The package offered here illustrates the possibilities.

13th July 1981.

ANNEX TABLE 1 SUMMARY

		June Bank Forecast	Full Package
GDP output			
% change on previous year	1981	-2.4	-1.6
	1982	-0.7	2.2
	1983	0.0	1.5
Manufacturing output			
% change on previous year	1981	-8.3	-7.8
	1982	-0.1	4.6
	1983	-0.1	3.6
Unemployment			
millions, UK excl school leavers	1981 Q3	2.6	2.6
	1982 Q3	3.0	2.6
	1983 Q3	3.2	2.6
Companies financial balance			
ICCs £ billion	1981	+0.2	1.7
	1982	-1.8	-0.3
	1983	-3.5	-2.6
PSBR			
£ billion (brackets % of GDP)	1980/81	13.5(6.9)	13.5
	1981/82	9.7(4.6)	14.2(6.5)
	1982/83	8.7(3.7)	14.1(5.8)
Consumer prices			
% change on same quarter previous year	1981 Q4	12.2	8.3
	1982 Q4	9.4	8.5
	1983 Q4	8.0	7.3

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APPENDIX TABLE 2

SIMULATION RESULTS

		Final June forecast	Basic rate of income tax = 27%	Standard rate of VAT = 8%	NIS abolished	Exchange rate depreciation	Full package
1 Money supply (£M3)							
% change on same quarter previous year	1982 Q1	9.0	9.7	10.5	7.9	12.4	13.2
	1983 Q1	7.8	8.3	8.8	8.9	11.1	14.0
2 PSBR £billion							
(brackets % of GDP £)	1981/2	9.7(4.6)	10.9(5.1)	11.7(5.5)	11.2(5.3)	9.6(4.5)	14.2(6.5)
	1982/3	8.7(3.7)	10.4(4.5)	13.0(5.5)	11.0(4.7)	7.0(3.0)	14.1(5.8)
3 Average earnings							
% change on same quarter previous year	1981 Q3	9.6	9.5	9.8	9.7	9.6	9.6 ?
	1982 Q3	9.0	7.8	6.0	8.1	9.3	6.6
	1983 Q3	9.0	7.4	7.3	7.8	9.8	7.1
4 Consumer prices							
% change on same quarter previous year	1981 Q4	12.2	12.1	8.8	11.2	12.6	8.3
	1982 Q4	9.4	8.9	7.9	8.2	10.9	8.5
	1983 Q4	8.0	7.2	7.0	7.1	9.6	7.3
5 Effective exchange rate	1981 Q4	94.1	94.0	94.6	94.3	88.4	88.4
	1982 Q4	94.9	94.6	94.7	95.4	85.4	85.4
	1983 Q4	94.4	94.0	93.4	94.5	85.2	85.0
6 Labour cost competitiveness							
IMF measure, increase = worse	1980 Q4	149.3	149.3	149.3	149.3	149.3	149.3
	1981 Q4	141.8	141.2	142.1	138.1	133.3	128.8
	1982 Q4	144.5	141.7	139.3	139.5	131.1	121.9
	1983 Q4	145.0	139.6	136.5	137.8	133.7	120.2
7 Current balance							
£ billion	1981	3.1	3.0	2.6	2.9	3.1	2.3
	1982	0.7	0.2	- 1.2	- 0.1	1.9	- 1.8
	1983	1.0	0.5	- 1.0	- 0.2	4.4	- 0.4

		Final June forecast	Basic rate of income tax = 27%	Standard rate of VAT = 8%	NIS abolished	Exchange rate depreciation	Full package
8 Manufacturing output							
% change on year previously	1981	- 8.3	- 8.3	- 8.2	- 8.1	- 8.2	- 7.8
	1982	- 0.1	0.3	0.7	0.8	2.1	4.6
	1983	- 0.1	0.6	1.5	0.9	0.8	3.6
9 GDP output measure							
% change on year previously	1981	- 2.4	- 2.3	- 2.0	- 2.2	- 2.3	- 1.6
	1982	- 0.7	- 0.4	0.2	- 0.0	0.1	2.2
	1983	0.0	0.2	0.5	0.5	0.3	1.5
10 MLR							
Average quarterly rate	1981 Q4	12.0	12.0	11.8	11.7	12.6	12.5
	1982 Q4	10.4	10.4	10.6	10.3	11.0	11.2
	1983 Q4	10.1	10.1	10.4	10.3	10.2	10.5
11 ICCs NAFA							
£ billion	1980	- 2.6	- 2.6	- 2.6	- 2.6	- 2.6	- 2.6
	1981	+ 0.2	+ 0.3	+ 1.2	0.9	0.2	1.7
	1982	- 1.8	- 1.0	+ 1.2	- 0.7	- 2.4	- 0.3
	1983	- 3.5	- 2.1	- 0.0	- 2.5	- 4.1	- 2.6
12 Unemployment							
millions, UK excluding school leavers	1981 Q3	2.6	2.6	2.6	2.6	2.6	2.6
	1981 Q4	2.7	2.7	2.7	2.7	2.7	2.6
	1982 Q1	2.8	2.8	2.8	2.8	2.8	2.6
	1982 Q1	2.9	2.9	2.8	2.8	2.9	2.6
	1982 Q3	3.0	3.0	2.9	2.9	3.0	2.6
	1982 Q4	3.1	3.0	2.9	3.0	3.0	2.6
	1983 Q1	3.1	3.1	3.0	3.0	3.0	2.6
	1983 Q2	3.2	3.1	3.0	3.0	3.1	2.6
	1983 Q3	3.2	3.1	3.0	3.1	3.1	2.6
	1983 Q4	3.2	3.1	3.0	3.1	3.1	2.6