1. MR KEMP

2. PRINCIPAL PRIVATE SECRETARY

cc Chief Secretary
Financial Secretary
Minister of State (L)
Minister of State (C)
Sir D Wass
Sir A Rawlinson
Sir K Couzens
Mr Burns
Mr Ryrie
Mr Cassell
Mr H P Evans
Mr Williams
Mr Ridley
Mr Cropper
Mr Harris

THE ECONOMIC ALTERNATIVE: SIR IAN GILMOUR'S "FRINGE" SPEECH AT BLACKPOOL ON 14 OCTOBER

Your minute of 16 October to Mr Kemp noted that the Chancellor would like to give a private response to Sir Ian Gilmour's request for a full model-based assessment of the economic consequences of the Gilmour proposals.

2. I attach a draft "private letter". This sets out the reasons why we would advise against acceding to Sir Ian's request. This is not just a question of resources, but also could set an unfortunate precedent.

3. There is probably no need to send Sir Ian "qualitative" comments on his package but, in case the Chancellor feels that this should be done, I attach a short commentary. I have also added an appropriate paragraph in square brackets at the end of the draft letter.

R.A

R I G ALLEN
EB
23 October 1981

DRAFT PRIVATE LETTER TO SIR IAN GILMOUR

I have studied the text of your 14 October Blackpool speech with great interest. Much of the speech covers the case for a modest reflationary package on which my general views will be familiar to you. But I would like to respond, on a personal and private basis, to some points you make on page 23 of the speech as press released. The relevant paragraph reads as follows:

> "I would welcome the Treasury's own assessment of all the economic consequences of this package. But I shall only pay any attention if they set them side by side with what their own model is telling them about the consequences of sticking to the course on which we are at present set. The Treasury should not be allowed to get away with using its forecasting machinery to disparage every idea which is advanced by anyone else, when it is not prepared to publish what the same machinery tells it about the results of its own policies."

There are several points I would like to make here. First, you will I am sure appreciate that it is an expensive, and time-consuming, exercise to construct full quantitative, model-based comparisons of alternative economic packages. As anybody who has had experience of this will know, it is not simply a matter of pressing a button on a computer. Resources within the Treasury are tightly stretched and we have always resisted making such simulation results available publicly because of the fear that this would provide an "open door" for individuals and groups of all kinds to request access to our facilities. That is not to say that we are in any sense secretive about the model, or its properties. As you probably know, full public access to the model is available either through the Economist Intelligence Unit or, in the case of Members of Parliament, through the House of Commons Library.

Secondly, I think it is easy to overstate what can be learned from direct comparisons of model forecasts based on existing and alternative policies. Relationships described by the Treasury model are essentially based on an analysis of the past behaviour of economic agents - consumers, traders, wage bargainers, and so on. But it is precisely some of these key relationships - the role of market forces, and expectations, in determining prices and wages; the determinants of productivity growth; and so on - that the Government is trying, through its current policies, to change. Hence a comparison of our economic strategy with a return to some more "orthodox" set of policies is not, I think, as simple as it sounds.

Thirdly, the final point you make in the paragraph is simply not true. Forecasts based on the effects of current policies are published twice a year, at budget time and in the autumn.

[Although, for the reasons mentioned above, we have not been able to undertake a full quantitative assessment of the economic consequences of your package, I attach a short commentary on the main points you make.]

[GH]

COMMENT ON ECONOMIC ASPECTS OF GILMOUR'S 14 OCTOBER FRINGE BLACKPOOL SPEECH

Speech divides into four sections

1. <u>Where we are today</u>.

- Gilmour recognises poor inheritance (industry weak, poisoned industrial relations, post dated cheques) and elements of success (realism emerging, demanning, recent lower pay settlements).

<u>Comment</u>

- No mention that economy was at peak of cycle. Recession only to be expected. Nor that full implications of further doubling in oil prices by OPEC yet to come.

- Ignores rising trend in underlying inflation in early 1979 despite factors suppressing it.

2. <u>Why we have not succeeded</u>

<u>Content</u>

- Policies have caused an intensification of recession (whereas oil self sufficiency should have alleviated it), and added to inflation. Expenditure cuts self defeating ("largely cancel out") in PSBR terms, but do lower level of activity. Pursuit of PSBR has raised public sector prices. Attempt to control money supply futile. Interest rates too high. Sterling overvalued.

- Adherence to MTFS will further intensify recession and exacerbate inflation.

- Government has never convincingly explained how lower inflation would aid recovery.

Comment

- Erroneous to suggest that offsetting effects of expenditure cuts neutralise them in PSBR terms at a lower level of activity. This amounts to a crude reversal of the self financing reflation argument. Such reasoning ignores (as does Gilmour's speech in several instances) the effects on inflation and interest rates. These are more enduring than initial offsetting effects.

- Whilst it is true that the PSBR benefits from higher public sector prices, there are sound economic reasons for the latter - unwinding of earlier period of NI price restraint, need for realistic energy prices, recent growth in rent subsidies.

- Whilst oil protects us from a terms of trade loss, we cannot, as a very open economy with a large trading sector, escape the worsened world trade position.

- In explaining the current depth of the recession Gilmour makes no mention of the poor inherited position, or of the inflationary pay rounds in 1978-79 and 1979-80. The implication is that all problems are attributable to MTFS.

- Policies are not inflexible. In response to unexpected nature of recession PSBR profile raised as a proportion of GDP between the 1980 and 1981 MTFS. It has been made clear that interest rate policy has regard to several factors.

- Lower inflation can be expected to aid recovery through:- improving competitiveness; lowering the savings ratio; lower interest rates and improved confidence would encourage company expenditure (investment, stocks and employment); and there would be greater scope for a positive fiscal adjustment. Proposals allow room for sustainable growth as inflation comes down.

3. Alternative policies

Content

- Reverses his contention that as recession has not reduced inflation, reflation would not stimulate inflation, especially as spare capacity exists and reflationary methods would reduce costs.

- Gilmour's reflation comprises:-

  (a) abolition of NIS (£3½b)

  (b) employment measures (£1b) - made up of a subsidy to employers taking on those unemployed for more than 6 months (¼ million jobs created); and the right to be employed on a publically supported project for those unemployed for over 6 months at a wage 20 per cent above benefit entitlement (a further ¼ million jobs).

  (c) increased public capital investment of at least £½b.

  The gross cost of £5 billion (described as a 'moderate beginning') is alleged to be much less in actual terms allowing for a higher level of activity.

- Interest rates should be reduced. Claims they have been sucked up by US rates and introduction of exchange rate target floor. Admits a higher money supply needed to validate lower rates.

- Join EMS to obtain stability preferably at lower exchange rate.

<u>Comment</u>

- Cavalier in attitutde towards interest rates and inflation. Views dominated by short term impact effects. Admits that money supply accomodation needed, yet sees no inflation implication. Similarly assumes this would not undermine interest rates. Sees no effect on inflation from a lower exchange rate.

- Reflation has not worked during the 1970's, our industry unable to respond to demand, failure lies on supply side (productivity and competitiveness)

- Gilmour's views contrary to general recognition by developed countries of need to restrain budget deficits.

- Gilmour has joined the NIS bandwagon emphasising the tax on jobs and exports aspects, but it is conditional on a moderate pay round. This appears inconsistant with Gilmour's relaxed inflation attitude.

- Gilmour advocates the Layard employment measures proposals.

  (a) At £2,000 per job Gilmour's cost estimates (presumably a net one but not stated as such) is acceptable on restricted premises, ie that they are sufficient to encourage the take up of the jobs to be created, and that other costs (ie materials etc) are not excessive. However the statement that such projects "would of course mean public expenditure in areas like housing investment" suggests substantial additional costs.

  (b) As with all such schemes, there is the suspicion that substitution and displacement effects would build up.

  (c) Is it realistic to assume different 'wages' determined by benefit entitlements for those on a project? If based on family man rates it would be more costly.

  (d) Labour markets would become more distorted; pressure towards market clearing rates weakened, public-private relativities affected.

  (e) ¼ million public project jobs could well be hard to find and arouse opposition.

- Additional capital spending would not provide many jobs.

- Joining EMS is not a panacea. Volatility in financial markets reflects divergent national policies and monetary/fiscal imbalances. These are the root problem. EMS cannot will them away.

4. Future

Content

- A tough public sector pay policy, improved collective bargaining machinery and balance of trade union power needed.

- Inadequate longer term bank lending to industry. Government should share risk.

- Direct selective Government support for high technology and tomorrow's successes.

- Work towards new fixed exchange rate regime.

Comment

- First point suggests some concern over inflationary pressure - a matter played down elsewhere.

- Average term of industrial lending by German banks now little different from ours. Idea that Government should bear risk is really bid for lower interest rates.

- Sympathetic to Gilmour's general aims. But policy already seeks to avoid subsidising loss-makers; encourages new activities. Already supports future technology through MISP, PPDS, information technology assistance, etc. R&D expenditure increased. A formal industrial strategy makes it no easier to avoid problems like BL or BSC.

- EMS comment applies to aim of fixed exchange rates.