MR CROPPER

c PS/Minister of State L
Mr Ridley
Mr Cardona

A FISCAL POLICY FOR THE 1980s

The Financial Secretary has seen your minute of 13 March, and your attached comments on John Forsyth's paper.

... He has written the attached note which you might like to add to your submission to the Chancellor.

SAJL

S A J LOCKE
14 March 1980

Forsyth's argument is basically as follows:

i. It is most undesirable that the improvement in the oil balance of payments on current account should be matched by a deterioration in the non-oil current account;

ii. this implies the need for an outflow on capital account;

iii. this is impossible so long as UK interest rates remain high;

iv. for interest rates to come down sufficiently to produce the desired outflow, the PSBR should be eliminated.

This does indeed have considerable similarities with certain strands in our own thinking - in particular the decision to abolish exchange controls.

However, I have one or two reservations.

In the first place, i is valid only to the extent that the improvement in the oil balance is a temporary phenomenon. (There can be no objection, for example, to a permanent shift from manufacturing exports to oil exports.) And of course this is partly true. But the oil will be with us - I suspect - far longer than most people think, and the exporting industries of the future may well be different from those Forsyth (and others) seek to protect today.

Second, and more important, Forsyth greatly exaggerates the relationship between the size of the PSBR and the level of UK interest rates. In an open world market, UK interest rates can never differ significantly (for any length of time) from world interest rates, other than to take account of the expected appreciation/depreciation in the exchange rate. Two consequences follow from this: (i) there is no scope for the dramatic fall in UK interest rates Forsyth wants to see unless either

world interest rates, which means in particular US rates, fall sharply, or unless there is an expectation of a substantial appreciation in the £ sterling (which Forsyth would not wish to see); and (ii) it will (in my judgement) not require a fall in the PSBR any greater than we are now planning to achieve. I think this will give us all the good (in terms of lower interest rates) that can be achieved by this particular route.

I would, however, agree that the general proposition enunciated by Forsyth underlines the case for foreign exchange inflow controls if these can be made in any way effective. (The argument here will essentially be that a temporary device is needed to counteract the temporary phenomenon of North Sea Oil earnings.)

Moreover, I cannot help feeling that we have not been given sufficient credit for the abolition of exchange controls. In the new situation the present net capital inflow could be quickly transferred into the net capital outflow that Forsyth seeks without any change in fiscal policy at all.

However, in conclusion, I am very glad that the latest draft of the MTFS shows a lower PSBR line than the earlier drafts.

NL

14 March 1980

Postscript. I also agree with the thrust of Mr Burns' minute of 7 March. You may be interested to note in this context that Sam Brittain's *Lombard* article of 7 November 1977, appended to that minute, was "inspired" by me.

NL

14 March 1980