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23rd May 1979.

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(My dear Chancellor)

I enclose a note prepared in the Bank which looks at the possible implications for monetary control of the outline Budget proposals as we understand they are emerging. It is essentially a first look at such proposals from the point of view of financial markets and does not of course represent the Bank's final view.

As suggested in paragraph 29 it would at a later stage be desirable for the Bank to give a fully considered assessment of the implications of the Budget proposals for markets and for monetary policy.

I should be pleased to have an opportunity to discuss this with you.

(Yours sincerely)

(Sgd.) Gordon Richardson

The Rt.Hon.Sir Geoffrey Howe, QC, MP,
(Chancellor of the Exchequer,
H.M.Treasury,
Parliament Street,
SW1P 3AG.)

Budget SECRET

POSSIBLE IMPLICATIONS FOR MONETARY CONTROL OF THE BUDGET PROPOSALS

1. The conduct of monetary policy stands to be affected in various ways by the Budget and the effects the Budget may have more generally on the economy. These effects need to be taken account of as one ingredient in the determination of budget strategy.

2. This note seeks to identify considerations that may arise from this context. At this stage it seems more useful to raise questions that may call for consideration than to indicate firm advice.

3. While the maintenance of monetary control will have an effect on confidence, the reverse chain of reaction is also important. Thus the difficulty or ease of ensuring monetary control will be affected by the general reaction of financial markets to the Budget and the effects on the economy expected from it.

4. The present note therefore touches both on questions such as the impact of the PSBR on financial markets, and on more general aspects. The reaction of financial markets cannot be predicted exactly but it is useful to set out a first provisional attempt at a broad assessment.

I Preliminary comments

5. As we understand it, the broad lines of the Budget proposals are for a fairly sharp reduction in income tax, matched by a fairly sharp increase in indirect taxation; for cuts in Government spending and for sales of public-owned assets. Given that the "pre-Budget" forecasts of the PSBR in 1979/80 are considerably higher than the outturn for 1978/79, considerable difficulty must clearly arise in achieving a result where the forecast for next year's PSBR is £8 bn., which we take it would be a first preference for the outcome.

6. Assessment of the ease or difficulty of financing a PSBR of this size has to take account of how the Budget is likely to be received in financial markets. The reaction is likely to be somewhat complex, and judgement on this question is best deferred till the final section V of this paper.

7. It is however relevant to comment on the present situation. There have lately been signs of greater apprehension about future inflation. The recent trend of the monetary aggregates is not comfortable, with £M3 fluctuating around the top of the 8-12% target range. The near advent of the Budget makes it impossible to seek to procure adjustment in interest rates at present; and were it not for this inhibition, the Bank might have wished to raise the question whether MLR should not be raised at an early date.

8. Some words are called for on the subject of asset sales. Sales of publicly owned assets are in some ways similar to sales of Government stock. There will be commentators who say that asset sales reduce the PSBR only in appearance, and that the problem of financing a PSBR of £8 bn. which has been reduced by asset sales of £1 bn. is identical to that of financing a PSBR of £9 bn. with no asset sales.

9. The Bank's view is that there will be "additionality" from asset sales, ie. that the sale of £1 bn. of publicly owned assets will not reduce the potential sales of gilt-edged by the same amount. Such sales should therefore be of considerable help in closing the "budgetary gap" - though they are likely also, by reducing equity prices and raising yields, to increase to some extent companies' difficulties in obtaining equity finance. A fuller judgement would depend on the exact composition and timing of the asset sales proposed and needs to be looked at in the light of the developing financial situation of the corporate sector, on which the financial forecasts now being produced should throw light.

10. The further factors to be considered are of three main sorts

- The effects on inflation and inflationary expectations.
- The net effect of budgetary and monetary policy on the real expansion of the economy.
- The effect on market opinion of the "composition" of the Budget.

These are exemplified below.

II Effect on inflation and inflationary expectations

11. The ease of financing the PSBR, and the level of interest rates required for this purpose, will depend in part on what is expected about inflation.

12. The retail price index is now 10% above a year ago. "Pre-Budget" forecasts of retail prices suggest that the index for the year on year increase might rise by the end of this year, to 11 or 12%.

13. Such forecasts are uncertain. The risks seem to be on the up side.

14. The exchange rate has been beneficial from the point of view of inflation. But the recent high rate has reduced the competitiveness of exports; and in the end market forces are likely to produce a downward adjustment. A further worsening of the oil situation (see below) might strengthen sterling, as it has in the past. On the other side, the figures for overseas trade since January (when published, possibly about Budget day) might be poor and have an unfavourable impact on sterling. The effect of relaxations of exchange control on the exchange rate is difficult to predict, but is more likely to be downwards than upwards.

15. Perhaps more ominous are current developments in the world oil market. The latest information suggests there could now be a considerable new explosion of oil prices this year, in addition to what has happened so far. This could have a serious impact on domestic prices in this and other countries, and, later, on world activity.

16. Given this somewhat delicate situation, it is important to weigh up how it stands to be worsened by indirect tax increases

- The fact that monetary control is being maintained, and perhaps that a lower monetary target was in place, will provide an important safeguard against runaway inflationary expectations. It might in the end prove enough to reverse a temporary burst of faster inflation. But markets are unlikely to be clear about this. The first result, if there is reason to fear upward pressure on prices, has in the past been a rise in interest rates.

- A rise in prices brought about by indirect tax increases is likely to be seen as something different from price increases brought about in other ways. A quick rise in the RPI of say 4% for this reason might not <u>in itself</u> cause an upward revision of market expectations.

- But the more important question is what that would be thought likely to do to wage increases in the next pay round starting this summer. With a retail price index standing say 15% above a year ago at the start of the round, markets may find it difficult to believe that wage increases will not be greater than the 14% or so which seems likely for this round.

17. Such developments could prove to be only short term. But they might, meanwhile, increase the difficulty of maintaining monetary control. Interest rates might have to rise - both because of the effect of expectations on interest rates, and because higher money incomes would tend to increase the demand for money.

III The impact of the expansion of the economy

18. The conventional forecasts (including those of the Bank) predict, before taking account of the Budget measures, a very moderate expansion of the GNP (1-2% a year). The prospects for the US economy appear recently to have deteriorated; and if oil prices now rise sharply (para.15 above), prospects generally and in this country may deteriorate further.

19. On conventional methods of forecasting the Budget proposals are shown as likely to have a further depressing impact on the economy for two main reasons -

(a) To meet the PSBR target, expenditure will have to be reduced in real terms, and/or the net real burden of taxation increased. This reduces expenditure by the public sector and/or the private sector.

(b) The shift to indirect taxation, by raising prices, reduces the real value of assets held by persons. Their reaction in the past to price rises seems to have been to save more, ie. private spending is reduced by this route also.

Conventional post-Budget forecasts therefore show a prospect of effectively no growth in the year ahead, and a presumption that unemployment will start to rise during 1980.

20. It may well be that the conventional forecasting models fail to reflect the total reactions of the economy, and that the deflationary impulses will be offset by expansionary influences of another sort. This is however uncertain and any such expansion could in any event be put seriously at risk if interest rates had to rise in the short term as a result of higher inflationary expectations.

21. It appears possible therefore that fears could arise of growing unemployment combined with rising inflation. It is difficult to judge how financial markets would react. It is possible that the expectation would be that the demand for equity finance would fall away, which in itself might be helpful for gilt edged prospects. With lower profits apparently in prospect, industrial demand for bank finance might however seem likely to remain high - a factor likely to keep up monetary expansion. It seems proper also to point to the possibility of more general apprehensions about stability since the Government might be under pressure from many sides.

If a recession of some degree in fact developed, this would make tax revenue lower than otherwise, and tend to increase the PSBR in 1980/81. It is possible therefore that the budgetary problem for next year may not be easier than this year.

IV The composition of the Budget

22. It may also be useful to flag some simpler points about the likely immediate market reception of the Budget. This is likely to be affected not only by the size of the PSBR, but by its composition.

23. In important respects the proposed composition should be a favourable factor. The proposals to reduce Government spending, and the reductions of income tax, will undoubtedly be welcomed by markets. This might mean that the market will accept a PSBR which embraces these elements more easily than a lower PSBR which did not contain them.

24. The general reception will depend in part on the belief accorded to the proposals to cut public spending. There have in the past been announced intentions to cut public spending which have not in the event been carried out; and the difficulty of cutting spending is generally recognised. The more precise and detailed an announcement on this score, the greater its credibility.

25. Proposals to dispose of publicly owned assets are not in themselves likely to raise objections in financial markets. There is likely to be discussion (on lines already indicated in paras.8 and 9) as to how far they ease the problem of financing the PSBR. But the resort to this method is unlikely to raise serious questions - more especially as part of a Budget of the proposed character and in view of the special difficulties of this year - provided it remains of dimensions which appear reasonable.

V Concluding remarks on the Budget and monetary policy

26. In conclusion it is necessary to formulate more closely, in the light of the foregoing considerations, the implications of the Budget for monetary policy.

27. The preceding discussion goes some way to modify the general presumption that a lower PSBR tends to ease the problem of monetary control. There is a question whether, in the circumstances of this year, to fix too low a figure might not be counter-productive in this respect. A particular difficulty here, which may, on certain assumptions, become even more severe next year, arises from the extent to which the PSBR is automatically boosted by declining activity. A lower PSBR could not be had without cost - which would either damage the compositional appeal of the proposals, or increase the need for indirect tax increases with disadvantageous effects already sufficiently indicated. The room for manoeuvre is however clearly narrow. In view of last year's PSBR of £9 bn., it would seem necessary to aim for a lower figure than that. But the choice as between £8 or £8 1/2 bn. seems more open.

28. Previous comments have also suggested that, in fixing the new monetary target, regard may need to be paid to whether markets will judge the target to be consistent with the announced PSBR and the current level of interest rates. Given possible inflationary fears arising from the proposed increases in indirect taxation, there may be a question whether or not we should lower the target to 7-11%. A decision in favour of a lower target would increase the chances of upward pressure on interest rates.

29. At a later stage it would be desirable for the Bank to be asked for a more fully considered assessment of the implications for markets and for monetary policy of the Budget proposals, including the proposals relating to asset sales. A firm recommendation regarding the new monetary target would be better delayed till that stage.