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Policy Unit

Econ PA

PRIME MINISTER

ECONOMIC STRATEGY

I mentioned that we are preparing a paper doing a reappraisal of strategy, primarily economic but also touching other things. I thought you might like to see a note from Douglas summarising our discussions over recent months. You may also like to have another look at a minute we did for you before the last Budget which foreshadows some of the things we are now thinking about again. I have marked the relevant parts in red.



JOHN HOSKYNS

WHERE WE ARE NOW

1. Since June 1979 the balance of macro-economic policy has been wrong. We cut taxation before we were certain that we could restrain public spending.
2. This led to a high PSBR at a time when inflation/recession were keeping private sector borrowing high. Gilt sales were not large enough to prevent the combined (public plus private) demand for money from raising £M_3 in 1980 at an annual rate of over 15%. This rise was masked by the "corset" so that remedial action was delayed.
3. Market prices led to high interest rates. They would have been even higher but for intervention by the Bank of England.
4. Macro-economic policy has been lopsided, with too much emphasis on monetary policy and too little on fiscal. Monetary policy itself has been lopsided, with inadequate control of the quantity of money leading to excessive interest rates. Pressure on the economy has been lopsided, with too little on public spending and too much on private; too little on wages and salaries and too much on profits; too little on the employed and too much on the unemployed; too little on public current spending and too much on public capital.
5. Despite our failures, inflation has come down. This is partly because of world recession and high interest rates, but mainly because of the high exchange rate.
6. No-one knows how far the high exchange rate results from high interest rates, how far from North Sea Oil and how far from the recession.
7. Most commentators underestimate the importance of structural changes in the UK. North Sea Oil represents a major new export. Because total export volume is not increasing, it follows as a matter of arithmetic that other net exports must be falling. This is hitting the net exports of, eg, textiles and simple metal/engineering products.
8. The development of manufacturing capacity in LDCs is mainly hitting companies producing these same products.

It is difficult for us to separate the effects of faulty macro-economic policy from those of the structural changes. It is therefore preferable to allow market prices to reshape the economy. They may be impersonal, but we are ignorant. Moreover, 'solutions' often seem to require reductions in real income. The TRG wants to deal with North Sea Oil revenues by the Government investing much of them overseas. But this would raise the PSBR or require a similar amount of revenue to be raised from other taxes. And most of those who want a lower exchange rate forget that this will raise prices and so reduce real incomes.

10. I therefore strongly argue that we should not do anything to interfere with North Sea Oil or the exchange rate, certainly until we have removed the distortions we have ourselves introduced.
11. The first priority, as I have argued since June 1979, is to restore the fiscal balance and so reduce interest rates. This will presumably reduce the exchange rate too. When Government-induced distortions are out of the way, that will be the time to get a better sense of what the effects of the structural changes are, and whether we should try to soften them. As Sam Brittan says, we must see that we under-shoot the monetary targets from now on - by 1-2% pa.
12. There is a caveat. We must restore the fiscal balance mainly by cuts in public spending. We may need to raise some taxes, but we must avoid asset sales and pressure to increase nationalised industry prices above commercial levels. That would only put even more pressure on the private corporate sector.

DOUGLAS HAGUE