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**DRAFTS OF BUDGET SPEECH:  
PART A - 23<sup>RD</sup> FEBRUARY 1981**

[REDACTED]

COPY NO 12 OF 12 COPIES

Mr Monck

cc Financial Secretary  
Sir Douglas Wass  
Mr Ryrie  
Mr Burns  
Mr Britton  
Mr Cassell  
Mr Unwin  
Mr Wiggins  
Mr Fforde B/Eng

BUDGET SPEECH

I have had a go at the monetary parts of the speech on the assumption that the order remains the same - ie with the PSBR after the monetary section. I have included the passage on MLR because its placing is of some importance to the development of the argument. The draft will need a lot of polishing - but I should be grateful to know if those to whom I have copied the draft think that the argument is reasonably presented; where the emphasis needs changing and where the sequence can be improved.

*PE*

P E MIDDLETON  
23 February 1981

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[REDACTED]

Notaphische  
abt. BSK.

~~BSK~~

[Redacted]

① Too January  
② ~~3 billion~~  
③ MTFB  
① 1b  
② 1b  
W  
Byson

The Medium Term Financial Strategy

1. These achievements form the background to my review of the medium term financial strategy. Its publication last year was a major innovation. It demonstrated the Government's intention to make a sustained attack on inflation ~~through a progressive slowing down of monetary growth supported by limiting the public sector's demand on the rest of the economy.~~

*I am convinced*

2. ~~Everything~~ that has happened since has convinced me that this is the right approach. Low activity and low employment are the result of low productivity, low profitability excessive pay, and years of failure to face facts. They cannot be cured by injections of monetary demand. If employment is to be safeguarded and the basis built for future expansion, the Government must cure inflation and the expectation of inflation must be permanently reduced.

Government cannot do the job alone. But it can provide the right framework. That means sticking to a disciplined medium-term path of the kind I set out last year.

3. The main objective, the reduction of inflation, is clearly on track. And the tight financial conditions over the past years have clearly been instrumental in bringing this about. However £M3, the measure of money used to express the strategy has been well outside the first year target range of 7-11%. There are a number of reasons for this, some are long lasting. Some are connected with the special circumstances of last year, and some reflect the particular characteristics of £M3 as a measure of money.

*Not much  
realism*

All indicators

~~\_\_\_\_\_~~

North Sea Oil

*Dud*

4. The main long term development concerns North Sea oil. Revenues from North Sea oil are certainly now beginning to make a significant contribution to Government finances. But they are markedly lower than had earlier been expected. [80] million tonnes of oil were brought ashore in 1980. But that is only four fifths of what was expected just [three] years ago. In the coming year, even with the new tax regime, receipts from the North Sea are expected to provide only about one [twentieth] of the Government's total revenues. Less than [a fifth] of the receipts from income tax. The scaling down of forecast North Sea revenues inevitably means more will have to be found elsewhere.

Monetary Growth and the Recession

5. Much of the rapid growth in £M3 last year resulted from the unexpected depth of the recession and from the nature of the recession.

*Phosphate  
Zinc*

6. The depth of the recession has meant that public expenditure and the Public Sector Borrowing Requirement have been higher than forecast. There has been higher public spending on some programmes. It has not proved possible to offset this in full by cuts elsewhere. And the rapid increase in public services' pay relative to the private sector over the last [two] years has also raised cash spending. Revenue from indirect taxes has fallen as people have switched their spending to take advantage of lower priced goods.

7. The nature of the recession has also added to £M3 growth.

[REDACTED]

Businesses responded to the prospect of financial stringency by cutting stocks. Private individuals on the other hand, benefitted from the combination of a strong pound and excessive increases in pay; they set an unusually large proportion of their income aside as saving. This caused a greater demand for bank borrowing and bank deposits.

[REDACTED]

£M3 as a Measure

8. £M3 has been affected by two changes, both of which were highly desirable in their own right. First was the abolition of exchange controls. Second was the abolition of the supplementary special deposit scheme - the corset - in the summer. £M3 will be a superior measure as a result - but over the past year it has been swelled by the combined effect of unravelling years of distortions. It is therefore no surprise that it has not given a true reading.

MLR

9. In assessing monetary conditions I have therefore had regard to other factors. The narrower measures of money which tell us about the requirement to finance transactions have not grown rapidly. The exchange rate is also higher than would be indicated on the behaviour of £M3 and the other measures of liquidity. This unexpectedly fierce external pressure over the past year has meant that a more benign view could be taken <sup>for the time being</sup> of the build up of liquid resources in the economy.

10. Moreover, as inflation has fallen relative to interest rates, the burden on the industrial sector has increased sharply. [Many companies, in holding down prices have found that they are not profitable enough to offset the interest charges against tax.]

11. Reducing interest rates as the policy succeeds in reducing inflation is an integral part of Government policy. Modest

Other  
Section

[REDACTED]

reductions were made in the second half of last year. And the market is correctly signalling a further reduction in interest rates as the outlook for prices improves. The Bank of England is, with my approval, today reducing its Minimum Lending Rate by [2] percentage points.

The MTFFS Path

12. It is important to distinguish between circumstances last year and those to be expected over the succeeding years of the medium term financial strategy. The increase in liquidity which has taken place cannot be regarded with complacency. It will need to be watched very carefully in relation to developments in inflation. If public sector borrowing and the rate of price increase continue to decline as we expect, some of this year's excess liquidity can be clawed back in the form of lower monetary growth without high real interest rates. It is certainly our intention to do this. However, for the present, the thrust of the strategy is best represented by basing policy on the path charted out last year. The aim therefore remains to reduce monetary growth (£M3) to 4-8% by 1983-84. This is set out more fully in the Financial Statement and Budget Report.

13. I am fortified in the conviction that this should be possible by two considerations. First, though for the time being the path of public spending over the years to 1983-84 is higher than in last year's plans, over the medium term the planning totals for the volume of spending falls substantially. With declining inflation and lower pay settlements the growth of public expenditure in cash terms will be much less in the coming year than in the past year.

[REDACTED]

And we shall be re-examining spending programmes further this summer and also tightening the procedures for planning and control of expenditure and getting public sector costs down.

14. Second, the Treasury in common with most forecasters agree that, although unemployment may continue to rise for some time, the worst of the output loss may now be over.

The beginnings of a recovery during the course of 1981 are in sight. The broad prospect is reflected in the Industry Act forecast published today in the Financial Statement and Budget Report. This will of course make it easier to keep the PSBR within acceptable limits next year.

#### The Target for 1981-82

15. In expressing the medium term strategy again in terms of  $\text{£M3}$  I have taken account of the fact that past distortions have now largely worked themselves out. Moreover a wide aggregate with its close links to fiscal policy does seem to give more forward looking information over the medium term. None of the other wider measures seems to offer any significant advantage over  $\text{£M3}$  - certainly to the extent which would be necessary to justify making significant changes to this familiar concept.

16. But it is common knowledge that  $\text{£M3}$  is both difficult to control and may give misleading signals over relatively short periods. It is not ideally suited for annual targets, because it responds uncertainly to interest rates, and the full effect is spread over many months. The narrower aggregates

[REDACTED]

contain a much smaller interest bearing element, and so are much easier to control by changing interest rates. But in some ways they respond too easily to provide adequate information about the broad thrust of policy. And I am not satisfied that we yet have a better candidate than £M3. However, this is not a question which can be finally settled now. I shall return to it when we have the results of monitoring two new measures which are about to be published - the monetary base and a series of retail deposits in the banking system.

17. The new target range, based on the actual figure for banking February, will be an annual rate of 6-10 per cent for the growth of £M3 over the 147 months to April 1982.

It follows from what I said earlier that if there is any under-shoot of the monetary targets for the coming year, I would not seek to correct it. This implies a further moderate degree of monetary tightness taking into account all the surrounding conditions and the slower growth to be expected in nominal incomes next year.

18. However, this will not be a realistic possibility in the early months of the year. Indeed, I expect the current relatively high growth of £M3 to continue for a while until it slows down later in the year. The narrow aggregates may also tend to grow faster than last year for a time.

#### New Methods of Borrowing

19. The growth of £M3 will be held in check by a number of changes designed to sell public sector debt in a widespread

[REDACTED]

way without recourse to the banks.

20. First, more imaginative use of National Savings can help us to achieve our monetary objectives with lower interest rates. This continues the policy I announced last autumn. Our 1981-82 target is to raise £3 billion. It is an ambitious one calling for further measures which are set out in detail in a Treasury press notice.

21. The most important are that I shall make two changes to the second issue of index-linked certificates. The age of eligibility for them will be reduced in one step from 60 to 50 from the beginning of April. And a minimum bonus of 4% will be provided for existing holders as well as new buyers. 3

22. In October last year, My Rt Hon Friend, the Secretary of State for Energy announced plans for a bond which would allow British investors to have a stake in North Sea oil revenues. The Government intend to issue such a bond later this year. It will be aimed at small savers and should be widely held. It will be a non-marketable certificate, administered by DNS. Its capital value will be fixed but the return on the bond will be linked to some measure of BNOC's revenues<sup>7</sup>.

But on their own changes in small savings instruments will not be sufficient.

23. ✓ I have therefore decided that the range of choice of marketable instrument should be widened. First, by the introduction of indexed gilts for pension funds and second by introducing new short term debt instruments later in the year.

24. Eligibility of the indexed gilt has been restricted in

[REDACTED]

order to avert the risk that this new step might stimulate unwanted inflows of funds from abroad, since such instruments are not widely available elsewhere. It is an addition to existing instruments and not a replacement for them. The eligible institutions will have a choice between indexed and conventional stock. The Bank of England is announcing this afternoon details of a stock worth £[ ] [ ].

### Monetary Control and Interest Rates

25. None of these improvements in borrowing methods will remove the need for more fundamental improvements in monetary control. Following the consultations on last year's Green Paper, I outlined in November some planned improvements which were both desirable in their own right and consistent with the gradual evolution to monetary base control. These will come into effect during the coming financial year.

26. The Reserve Asset Ratio has complicated monetary control. The first step in phasing it out was made in January; another last week. It will go completely by the spring. There is no risk to the soundness of the banking system.

27. The Bank of England has already modified its money market operations. In its dealing with the Discount Houses it now relies mainly on buying and selling bills. Direct lending to the market has been greatly reduced. The interest rate on this lending is also generally somewhat more than comparable market rates.

28. From [ ] [ ] MLR will be <sup>(suppressed)</sup> abolished. The authorities

*Barthol*

will then confine themselves to influencing very short term rates within a band [which will be progressively widened].

Decisions on short rates will pay account to the whole range of monetary indicators referred to earlier and other factors which affect the significance of these number. especially the progress of inflation.

*admit*

29. Discussions with the banks about these changes and about the cash ratio have progressed rapidly. [This will make it possible to operate more effectively on the banks' demand for cash.]

Smoothing the PSBR

*A →* *16/10* *+ < 1 1/2%*

30. One factor that has complicated monetary management over the last year has been the variance in the expected monthly level of the PSBR - particularly the central government component. This makes monitoring and interpretation of monetary developments more difficult than it otherwise need be. The problem lies mainly in fluctuations in the level of tax receipts during the year. In the long run it would be desirable to reduce both the size of month by month variations and the bunching of some major tax receipts in the second half of the financial year. There are various possibilities for change. Rapid progress will not be easy but I have identified some areas for improvement on which I propose to make an early start.

- ① *Widening RAR*
- ② *Time for change*
- ③

*abol temp prov*  
*newly to face*  
*not too long*  
*mon*

*each thing*  
*explains*

*3/27*

[REDACTED]

31. Customs will shortly open discussions with a number of the largest payers of VAT with a view to retiming their tax payments so as to smooth the monthly flow of receipts. At present, largely through an accident of history, there are distinct peaks of VAT receipts every third month. The aim of discussions with the firms concerned will be to agree a smoothing of the flow. This should have no significant permanent effect on company cash flow. [It would have the incidental benefit of reducing the 1981-82 PSBR by up to £250 million.]

32. Receipts of North Sea oil tax also contribute to the bunching of revenue. My proposals for changes in that taxation will take account of the need for a smoother flow.

33. I hope it will be possible to make practical progress in these areas so as to ease the task of monetary management during the financial year. I am also examining the arrangements for the collection of corporation tax. At present some £[1.5] billion, or [50] per cent, of mainstream corporation tax receipts comes in during the last quarter of the financial year and a smoother flow would be desirable. I have not taken a firm view on what might be feasible, and I should not want to put company cash flow under unreasonable pressure in present circumstances. But I believe the possibilities should be considered further and the Green Paper on corporation tax will set out some options for discussion.

[REDACTED]

Monetary Policy: Conclusion

34. A sustained reduction in monetary growth remains essential. The targets for 1981-82, the medium term path 1983-84 and the measures to improve control which I have just announced will all contribute to its success.

MR MONCK ✓

cc Mr Middleton ✓

BUDGET SPEECH: MONETARY CONTROL

The draft by the Bank which you circulated on Friday says of the Reserve Assets Ratio,

"This no longer has a monetary control purpose ..."

which implies it once did have - the draft seems to imply that it had such a purpose until the new method of operating in the money markets came into being. The ratio has not played a major role in monetary control for many years; perhaps it never did.

*Pauline Hogg*

pp A J C BRITTON  
23 February 1981

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