PO-CH/NL/0049
PART A

CONFIDENTIAL

PO -CH /NL/0049

PART A

1986 BUDGET TREASURY
CIVIL SERVICE COMMITTEE
ENQUIRY INTO THE BUDGET

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PO -CH /NL/0049
PART A

STARTS: 14-03-86
30-6-86

TREASURY CIVIL SERVICE
COMMITTEE ENQUIRY
INTO THE BUDGET.
PT. A
Date 14/03/86

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FINANCIAL SECRETARY TO THE TREASURY

RUP

FROM: VIVIEN LIFE
DATE: 14 March 1986

MR CRAWLEY IR

cc PS/Chancellor
PS/Chief Secretary
PS/Economic Secretary
PS/Minister of State
Sir Peter Middleton
Mr Kemp
Mr Monger
Mr Gilhooly
Miss Sinclair

TCSC

1. The Financial Secretary was grateful for your minute of 11 March. He has also seen Mr Kemp's minute of 12 March. He agrees with Mr Kemp's recommendation that he should discuss your note and its timing further with you before a decision to submit is taken.

2. He had specific points on the text itself. Firstly, while he understands that you only collect information centrally on a regional basis for the six regions which are experiencing the highest regional average resignation, he is concerned that by giving these figures to the TCSC we are painting a blacker picture than is necessary.

3. Secondly, in your paragraph 5, while you give an example of an area where resignations are higher than the average, if you are making the point that there are variations it would be helpful to give an example where the figure is lower than the average.

4. He awaits further advice in the light of your discussions with Mr Kemp.

VL

VIVIEN LIFE

FROM: E P KEMP
12 March 1986

PS/FINANCIAL SECRETARY

cc PS/Chancellor
PS/Minister of State
Sir Peter Middleton
Mr Monger
Mr Gilhooly

Mr Rogers
Mr Crawley

TCSC

Mr Crawley kindly sent me a copy of his note to the Financial Secretary of 11 March.

2. We are in very lively current discussion with both the IRSF and the AIT about a number of matters relating to Inland Revenue staff pay; we are also in lively discussion with the CPSA about matters concerning clericals pay. It would I think be helpful, therefore, if you the note to the TCSC could be delayed for a small while. First, I think it would be desirable for it to be completely up to date and for us to be able to say in it what we have under discussion (and in some cases we may have made firm offers) in relation to some of the problems seen; this would surely be better than the Treasury/Inland Revenue submitting what looks like a note about a problem without any indication of ideas about a solution. Second, we in Pay would like to look very carefully indeed at the material that is to be sent to the TCSC anyway; this presumably will be published sooner or later, and it is very much meat and drink of the negotiations we are currently having with the various unions. If material like this is to emerge, we would like to think carefully about how it emerges and in what form.

3. Could I ask that the Financial Secretary allows us to discuss both this note and its timing further, with the Inland Revenue, before a decision to submit is taken?

E P KEMP

FROM: J M CRAWLEY

INLAND REVENUE
FINANCE DIVISION
SOMERSET HOUSE

11 March 1986

FINANCIAL SECRETARY

TCSC

1. Mr Rogers reported in his note of 23 January on his appearance before the TCSC on Revenue workstate and related matters. In the course of the hearing, Mr Rogers undertook to provide notes on:

a. the size of staff cuts in local offices;

b. resignation rates in regions;

c. a comparison between on the one hand the overall costs incurred since 1983 as a result of resignations and, on the other, the savings from giving pay awards at a level below union claims.

2. While the answers to a. and b. are straightforward, the answer to c. has required a fair amount of work. It also requires sensitive handling since it impinges on wider civil service pay policy issues. It had been our intention to to submit draft replies for your approval on all three items together, but an appropriate response to c. is currently

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c. Chancellor of Exchequer
Chief Secretary
Minister of State
Economic Secretary
Sir Peter Middleton
Mr Kemp
Mr Monger
Miss Sinclair
Sir Lawrence Airey
Mr Isaac
Mr Battishill
Mr Rogers
Mr Pollard
Mr Cherry
Mr Crawley
Mr PBG Jones
Mr Roberts
Mr Marshall
Mr Gant
Ms Tyrrell

under consideration by Treasury Pay Division (in the light of factual material which we have supplied) and we are not yet ready to submit a draft. Meanwhile, the Clerk has been asking about progress.

3. In the circumstances, we think it would be courteous to send the Committee a note on a.and b., telling them that a note on c. will follow shortly. I attach a draft on a. and b. This has been seen by FP division (Mr Monger) who is content. Subject to your approval, we will send it to the Clerk forthwith.

J M CRAWLEY

SUPPLEMENTARY NOTES BY THE INLAND REVENUE
QUESTIONS RAISED AT THE COMMITTEE'S HEARING ON 20 JANUARY 1986

Staff reductions in tax offices

1. Mr Townend referred (Question 3) to the reduction of about 9,000 in staff numbers in the Taxes network (pararaph 2.2 of the Inland Revenue's memorandum). Mr Townend asked what proportion of these reductions was made prior to October 1981, showing the reduction between October 1978 and October 1981, and between the latter date and October 1985.

2. The total reduction in clerical staff numbers in tax offices between October 1978 and October 1985 was 9,336, of which 6,949 (74%) had taken effect by October 1981 (5,511 by April 1981).

Resignations: Regional figures

3. The Committee asked (Questions 20 and 21) for regional figures of resignations, broken down between Inspectors and others, with a breakdown in each region, depending how easily the figures were available.

Oddly Phrased

4. Records are kept for each office of the location of staff who resign for use, eg by those responsible in regional offices and, as appropriate, centrally, for recruitment. Figures for each office, and for each region, showing all resignations in all grades in local offices are not normally collated centrally. But information is available for Taxes and Collection network offices as a whole and for the 6 regions (Eastern Counties, South East and the 4 London regions) which are experiencing the highest regional average resignation rates. Table 1 below gives this information for the 4 years 1982/83 to 1985/86 (projected) for Tax Officers (Higher Grade) and Collectors (broadly equivalent to Executive Officer), for Tax Officers and Assistant Collectors (broadly equivalent to Clerical Officer) and for Clerical Assistants in local offices in the Taxes and Collection networks. Table 2 gives comparable information for fully trained Inspectors (ie, those who do the most complex accounts work) and non-fully trained Inspectors (ie, those who do less complex accounts work).

Why no example of lower than average here?

5. Within these regional averages there are wide local variations. For example, in 1984/85 clerical resignations in Guildford and Woking had risen to 16.7% and 11.6% respectively. In 1982/83 the corresponding rates were 3.7% and 8.8%. The highest resignation rates are at CA level but, whereas CA replacements are expected to be fully effective within a few months, it takes up to 6 years to train a fully trained Inspector, about 2 years for a non-fully trained Inspector, up to 2 years for a Tax Officer (Higher Grade), and a year for a Tax Officer.

yes. it might well bring out the Regional differences.

ie where very low

LIST OF QUESTIONS

CONFIDENTIAL

FROM: R PRATT
DATE: 21 MARCH 1986

MR SCHOLAR

cc Chancellor of the Exchequer
Chief Secretary
Financial Secretary
Economic Secretary
Minster of State
Sir Peter Middleton
Sir Terence Burns
Mr F E R Butler
Mr Anson
Mr Cassell
Mr Monck
Mr Evans
Mr Odling-Smee
Mr Monger
Mr Peretz
Mr Turnbull

TCSC ENQUIRY INTO THE BUDGET: MEMBERS' BRIEF

I have now heard, from the Adviser to the Committee, what questions they will be briefed to ask on Tuesday and Wednesday. Essentially, the same brief will serve both for the officials' session on Tuesday and the Chancellor's on Wednesday.

Monetary targets and money GDP

- Why does the emphasis switch from monetary aggregates to money GDP?
- Are the money GDP figures aims or targets and what is the difference?
- What would be the advantage of targetting money GDP? (when monetary aggregates were first introduced, the Government argued that they were more controllable than money GDP)
- How do oil prices affect money GDP targets or aims?
- How do interest rates affect money GDP targets or aims?
- Why has £M3 been resurrected; how, precisely, does the Government interpret the movement of £M3?
- What is the point of maintaining MO as the monetary target?
- Given the high level of £M3, the high level of liquidity; the low level of MO growth and high interest rates, what is the Treasury's view on the current state of monetary conditions?
- How can oil prices reduce inflation if monetary conditions are kept unchanged?

- Why is there no target range for the exchange rate?
- Why are we still accepting an overvalued £ against the Deutschemark?

Fiscal policy

- If revenue determines expenditure, why has not the reduction in oil revenues resulted in a cut in expenditure?
- Would it not have been responsible to have responded to the loss of oil revenues by reducing the level of borrowing?
- On the other hand, given the strength of the economy, was there not a case for increasing the PSBR?

Oil and the forecast

- What effect does the fall in the oil price have on the forecast?
- The Committee's advisers agree with the Treasury's forecast on output and inflation, but consider them optimistic on exports, investment, and non-oil tax revenues. Would the Treasury's forecasters care to amplify?
- Why should the oil companies be expected to absorb the increase in petrol duty?

Employment and unemployment

- Why do the Government reduce the basic rate of income tax, rather than reduce national insurance contributions or expand special employment measures?
- Is there any expectation that a reduction in taxation will reduce wage demands?
- How does the Treasury model rate the effect of an income tax cut against other possible methods of spending £1 billion, in terms of the effect on employment?
- Will not the income tax cut encourage married women to enter the labour force as part-timers, rather than the low paid?
- Why has the Chancellor given up any attempt to alleviate the poverty trap?
- Can the Government do nothing to stop real earnings rising so fast?
- Does the Government not think that with rapidly increasing profitability, management are now more likely to concede higher wages?
- What impact do the Government think the profit sharing scheme would have on wages and when can such a scheme be brought in?
- Would the Government not accept that the employment measures package in the Budget was clearly ineffective and more likely to induce low wages rather than more jobs?

Richard Pratt

RICHARD PRATT

Chancellor

cc Sir P Middleton
Sir T Burns

TCSC

It went pretty well: we were rather lack-lustre, but so were the Committee. I think the transcript will read quite well, but excruciatingly boringly.

I don't think we said anything which will give you any trouble tomorrow.

The most effective of their questioning was on monetary policy - why had we promoted money GDP, was it really a medium-term strategy if there were no medium-term targets? Mr Budgen tried to get us to agree the Bank were very unhappy with all this, and expect a disastrous outbreak of inflation because of all this liquidity and the 'high' £M3 target. We didn't. Quotes from Dec 85 BEQB: "potentially worrying level of liquidity" - we countered with quotes from FSBR. This led - bizarre outcome - to a request for a note on the implicit breakdown of the GDP deflator between oil and non-oil. I am entirely unclear about why Mr Higgins wants this.

Mr Townend went on ADR's (will it now be more difficult for UK companies to have access to international capital markets?), revenue effects of pension fund surpluses (how calculated?), will PEP take-up be low, disappointment with the rules on trusts on CTT (we said it was to protect the death charge). Mr Corlett good on all this.

Messrs Fisher and Mitchell tried to have fun with 25 weeks / 25 years - what studies had we done on the effect on the UK economy of the reduction in oil volume in the 1990s - must have done some to justify the Chancellor's optimism? We waffled a lot on this - lots of analysis and papers (confidential, of course), no reason to think oil price would by then be high - esp. in real terms compared with now. Mr Fisher wondered if the higher PSFD meant the economy was being expanded (~~and~~ answer PSBR down, no single measure of fiscal stance, PSFD only £2b higher while oil revenues £5½ b lower), then allowed us to give him a lecture on depletion policy ("surely you know we haven't got one because we don't think it right to have one?")

Mr Higgins asked me what we'd do if the oil price rose mid year. I said it was a hypothetical question; I didn't know what circumstances he envisaged; and I didn't know what the Chancellor's response would be. To my relief he didn't press me very hard.

Mr Mitchell asked what fall in the exchange rate was required to cope with the fall in oil prices since November. We dodged. Why didn't we publish exchange rate and interest rate ranges, to give exporters assurance (we explained this wd. be self-defeating)? Why not depreciate in order to preserve / improve competitiveness? (Standard answer). What did the Tsy model show for unemployment on 3% growth (depends on pay etc), what on jobs for 1p cut in basic rate v. more job creation measures (lecture from Mr Odling-Smee on the perversity in this regard and non-dynamism of the model).

Mr Browne then argued we weren't doing enough for the individual investor compared with the tax advantages enjoyed by the institutions - shd do more on the BES - Inland Revenue frustrating the Chancellor? Good mandarin replies by Mr Corlett, Mr Monger & me.

Mr Higgins told me afterwards he'll give you a chance to give our documentation a puff. (I think you shd). MCS 25/3

FROM: D L C PERETZ
DATE: 26 March 1986

CHANCELLOR

cc Sir P Middleton
Sir T Burns
Mr Scholar
Mr Odling-Smee
Mr Monger
Mr Hall
Mr Walsh

TCSC APPEARANCE THIS AFTERNOON

You asked me this morning to check what the latest indications are of the volume of leasing business so far this calendar year.

2. I understand from the Equipment Leasing Association that they have no figures so far about 1986, nor do the Bank. The Association's latest forecast for the year as a whole is about £3½ billion of equipment purchased, for lease by members of the ELA. This compares with a 1985 figure of £5.7 billion, and a 1984 figure of £4.1 billion; and with forecasts made following the 1984 Budget measures of a level of business falling to perhaps £2 billion or so a year at most. I understand that the general feeling in the industry at the moment is that the £3½ billion figure will turn out to be a little on the low side (perhaps £½ bn or so) - and I suppose that reflects something about the volume of business being done in the first quarter.

3. Other evidence is that imports of capital equipment are ~~remaining~~ running at a lower level than a year ago. And the high volume of press advertising for leasing a year ago has not been repeated this year. In short, business is not slack: but last year's Q1 hump in leasing business seems unlikely to be repeated on a similar scale.

<u>**Mr Budgen and the BEQB**</u>

4. Perhaps I could also mention that the particular quote that Mr Budgen used yesterday, to try to demonstrate a

difference of view between the Bank of England and the Treasury, is the one sidelined on the attached extract from the December BEQB. I said that he should pay attention to the word "potentally" in the sentence; and that if he read elsewhere in the same quarterly bulletin I was sure he would find sentiments very similar to those expressed paragraph 3.24 of the Red Book (from which I read an extract).

5. In fact he need have read no further than the following sentence in the BEQB, and you could point that out to him if he returned to the same quotation. The same edition of the BEQB also included the text of the Governor's Mansion House Speech, and I attach the relevant page, with his remarks about £M3 sidelined.

DLP

D L C PERETZ

remained consistent with the ultimate objective of declining inflation and sustainable growth. The rise in £M3 growth over the summer had coincided with a period of heavy debt maturities and the authorities had not sought to achieve the target range by further overfunding. These changes were formally recognised in the Mansion House speeches, in which the £M3 target was suspended for the current financial year, while the continuing relevance of broad money was reasserted. It was announced that debt sales would be designed to fund the PSBR outside the banking system over the year as a whole. It was also recognised that these developments involved placing a greater weight on short-term interest rates in the conduct of monetary policy.

Second, the declining velocity of broad money implies a potentially worrying buildup of the liquidity of the private sector. There are reasons for believing that this liquidity is willingly held at current prices and interest rates. Were that willingness to start to weaken, it is likely that it would be signalled by a faster growth in asset prices or a weakening of the exchange rate. In fact, there are few signs at the moment of untoward developments in asset prices. Although house prices have on average been rising faster than retail prices for some time, there has been no sign of any relative acceleration. The stock market, on the other hand, has been buoyant: the FT500 share index rose by about 20% in the year to November, while turnover was boosted by takeover activity which reached a record level, with £2¼ billion spent on acquisitions of non-financial companies in the third quarter. Profits have, however, also risen strongly, so that the price/earnings ratio at about 12½ is not much more than half that seen in 1972 and slightly lower than two years ago. In real terms, moreover, the index itself remained 30% below its 1972 peak and its rise was not out of line with comparable markets abroad even before its sharp fall in early December.

Finally, the persistence of upward pressure on wage costs, discussed above, accompanying as it does high levels of unemployment, produces acute dilemmas for policy. There have been calls from industry for urgent action by the authorities that would lead to a reduction in the value of sterling, especially against the currencies of key competitors, like the deutschemark. In fact, the sterling index and the deutschemark rate are now lower than their levels of eighteen months ago. The entire loss of UK competitiveness over this period can thus be accounted for by faster increases in our prices and costs than in our competitors' expressed in the respective currencies. Although a lower exchange rate might provide short-term relief from competitive pressure, it is unlikely to offer a lasting solution, for experience in this country has repeatedly shown that such competitive advantage as has been obtained from time to time when sterling has fallen against other key currencies has largely been eroded, after a period of a few years, through the impact on inflation. The relief offered to companies' financial positions has been pre-empted by domestic wage and cost increases, instead of being used for investment or in other ways which might validate higher real wages, and has thus proved temporary. This experience over many years has made inflation expectations and nominal interest rates sensitive to exchange rate weakness. An exchange rate that can be relied on to be broadly stable over

The key question we have now to address is whether the strong acceleration of £M3 growth since the spring signals a dangerous looseness of policy or whether it represents a behavioural change without necessarily adverse implications for the future course of inflation.

There are grounds for believing that £M3 growth should not be taken at its face value in the present circumstances:

- The broader monetary aggregates, which include building society as well as bank liabilities, have not shown any similar recent acceleration. £M3 specifically has been affected by the banks' success in attracting retail deposits since the spring, with building societies having more recourse to the wholesale money markets; and £M3 has been affected also by a switch in building society liquidity out of gilts into bank deposits. These and other factors have tended to increase £M3 relative to other measures of broad money.
- Narrow money, M0 but also M2—a wider measure of retail deposits—is growing relatively slowly.
- The exchange rate is still relatively firm.
- Inflation is currently falling and real interest rates remain high.
- Expectations about the future pace of business activity do not portend undue pressure.

For these reasons we cannot at present rely upon the broad monetary indicators as much as we would wish. We have therefore felt justified in overriding the present £M3 target, and placing correspondingly more emphasis on other indicators, particularly the exchange rate.

There may be some who are tempted to go further and conclude that the present difficulties of interpreting the behaviour of broad money are such that we should, for the time being at least, ignore it altogether. In my view that would be extremely dangerous.

For one thing, there are some worries in the situation which can be seen, as it were, with the naked eye. Pay settlements and earnings, and, most disturbingly, unit labour costs, are drifting up. If these trends are not contained in the wage round which is now starting, the pressures they represent could threaten the continuation of growth in output and in employment.

These concerns underline the fact that we cannot be indifferent to whatever happens to broad money. Nor can we ignore its credit counterparts, particularly bank lending, whether to the public or private sectors. The build-up of liquidity in the economy remains an important feature of the overall monetary situation. And the faster that build-up, the more cautious we need to be about its interpretation.

In policy terms this means that the faster the growth of broad money generally, taking £M3 alongside the other broad aggregates, the greater the reassurance we need to find in the other available indicators before accepting that monetary conditions remain appropriately firm and that policy is continuing to have its intended counter-inflationary effect.

Change in the City

I turn now to change in the City, where we find a spirit of enterprise and innovation as vigorous as any previously seen. Alongside these new initiatives from the markets there have been new initiatives from the supervisors. For instance, the Securities and Investments Board and the Marketing of Investments Board Organising Committee have already been set up. And I was glad to hear what the Chancellor said about the philosophical approach to regulation, which we can look to see reflected in the forthcoming financial services and banking legislation. Meanwhile, at the Bank of England we are increasing and enhancing the resources devoted to banking supervision.

The supervisors must clearly persist in their efforts but we must not forget that there are limits to what a supervi: can be expected to do. Let me make three points here.

First, no system of supervision, however good, can substitute for management unless the supervision is so intrusive as to risk throttling the business. Good external supervision is necessary, but not sufficient, to assure the prudent and responsible conduct of business in an open and competitive financial service environment. The direction and management of individual businesses themselves are the key factors here.

Second, good supervision and regulation can ensure that financial service companies can transact their business in well-regulated markets, with protection against intermediary and counterparty risk and with disclosure and other provisions to combat manipulation. But this does not of course insulate shareholders in such companies from loss either as a result of fierce competition or from market risk, both of which may eve become greater. We need to keep very clearly in mind tha the more entrepreneurial environment in the City brings greater risk of loss as well as greater prospect of gain. When the gains come they will be generally welcome; but when the losses come, and they will, they should be construed not as a failure of the new City but rather as evidence of market forces at work in a competitive environment.

Third, like the Chancellor, I want to touch on the subject of fraud. Strengthened regulation and supervision should make fraud less likely, by reducing the possibility of dishonest managers entering the system; but they cannot be counted upon to stop every fraudster. There must also be a determination to investigate and prosecute where fraud is suspected and evidence found, so that those responsible are brought to book. The establishment of th Roskill Committee was a welcome initiative by government, and I hope that the vigour and resources pmg

CHANCELLOR OF THE EXCHEQUER

HONI SOIT QUI MAL Y PENSE

TCSC

C/

Peter Lilley reports that Nick Budgen will base his questions on the attached FT Beenstock article on monetary aggregates. He should be helpful.

John Watts has told Peter he expects the questions broadly to follow those put to officials yesterday.

RS 26/3

With Compliments

Peter Lilley, MP

Nick Budgen intends to refer to this at the TCSC today.
He seems to think it means you should drop £M3 from the Red Book:
(but see final paragraph).

Peter

HOUSE OF COMMONS
LONDON, SW1A 0AA

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F.T. 11-Dec '88

# of Sterling M3

By Michael Beenstock

THERE IS one essential clue which can guide us through the jungle of argument about monetary targets. This is the distinction drawn by modern economic theory between "inside money" and "outside money."

Inside money consists of private sector liabilities, such as bank deposits, while outside money consists of public sector liabilities, such as notes and coin in circulation.

"Mo" consists of notes and coins, plus bankers' deposits at the Bank of England. It is thus a liability of the central bank and, therefore, "outside money."

Other monetary aggregates contain a mixture of the two kinds of money. For instance, £M3 contains not only notes and coin, but also the deposit liabilities of the commercial banks.

If bank deposits do not pay interest, i.e. if inside money is non-interest bearing, it is the broad level of the money stock which includes bank deposits, that influences inflation. If, however, there is no outside money, but the inside money bears a competitively determined rate of interest, the rate of inflation is indeterminate.

The reason for this is that an increase in the quantity of money influences the rate of interest on bank deposits rather than the general level of prices. But as I have explained, outside money does exist in the shape of Mo. So if inside money pays competitive interest rates, it is left to Mo to determine the general level of prices.

We may summarise these theoretical findings as follows. If banks do not compete for sight and time deposits by offering competitive interest rates or realistic bank charges, the rate of inflation will be influenced by rates of broad monetary growth, eg £M3. If, instead, banks set competitively determined interest rates on deposits and bank charges the rate of inflation will be influenced by outside money, ie Mo. End of lecture.

My main thesis is that because the banking system has become increasingly competitive £M3 has become less inflationary than it used to be while the significance of Mo for the control of inflation has been correspondingly increased. The Chancellor has acted wisely in attaching less weight to £M3 and more weight to Mo but he may not have done so for the reasons that I am proposing.

Prior to Competition and Credit Control in 1971 there was little or no competition between banks. Indeed CCC was proposed to correct this but it was not until the second half of the 1970s that genuine competition began to take place. Banks began to offer interest on sight deposits. Today there are almost as many interest bearing sight deposits as non-interest bearing sight deposits. They compete for cheque accounts in terms of service and competitively determined bank charges. The market for time deposits has seen increased competition as well. Whereas time deposit rates were fixed margins over Bank Rate today they are increasingly influenced by market forces as banks compete for liabilities.

The Chancellor has been sleepwalking in the right direction

More recently, competition has spread to building societies. So the market for inside money, in terms of a wide definition, such as PSL2, which includes the societies, has become more competitive as well. So the banks are competing not only with each other, but also with other financial intermediaries. Competition has changed the face of British banking but it has also changed the inflationary significance of M1, £M3 or even PSL2. The supply of £M3 can rise without provoking inflation because competitive interest rates raise the demand for it. As a holder of an interest bearing current account I am now glad to hold more M1, than ever before, but my expenditure is unchanged. Institutional change has raised the demand for money just as surely as deregulation of telecommunications has raised the demand for telephones. "Inside money" is now a store of value as well as a medium of exchange.

Not only does this thesis help explain why relatively rapid rates of "inside money" growth have not induced inflation and why the growth of Mo has become a better indicator of inflationary trends, it also shows why "inside money" has grown so rapidly relative to Mo.

Between 1870 and 1970 the "money multiplier," defined as the ratio of M3 to Mo fluctuated gently between 4 and 5. It used to be one of the great constants of our monetary history. In the past six years it has virtually doubled. Part of the explanation lies with the CCC reforms and those of August 1981 according to which banks were allowed to reduce their reserve ratios. But only 7 per cent of the increase in the "money multiplier" since 1979 has been due to this. The other 93 per cent has come from a 41 per cent fall in the proportion of money the public holds in notes and coin. In other words, the public's demand for "inside money" has greatly increased.

The public is using banks to a greater extent than before because banks are competing to make deposits more attractive in terms of bank charges and competitive interest rates on deposits. Incidentally, this portfolio switch has enabled banks to increase their lending. So the expansion of bank lending is also explained by my thesis, as well as why this lending has not been as inflationary as in the past.

Where does this leave the Chancellor? He has in fact been sleepwalking in the right direction, first by including Mo in the Medium-Term Financial Strategy and more recently by downgrading £M3. Although greatly more competitive than it used to be, the banking system has a long way to go: so he cannot demote £M3 entirely. However, for presentational purposes he should abandon it in favour of Mo. The MTFS path for Mo should be adjusted for the institutional changes I have described.

The author is Professor of Finance and Investment at the City University

Pet pps

INLAND REVENUE
FINANCE DIVISION
SOMERSET HOUSE

FROM: JOHN CRAWLEY

DATE 26 MARCH 1986

FINANCIAL SECRETARY

TCSC

1. You raised two specific points on the text of the draft notes to the TCSC annexed to my note of 11 March (Miss Life's minute of 14 March).

2. First, you expressed concern that by giving figures for the six regions experiencing the highest regional average rates of resignation we might be painting a blacker picture than necessary.

3. The tables annexed to the notes also give the overall average resignation rates for the whole network. One possibility would be simply to quote these. But the Committee know that, in the interests of good management, we are monitoring trends in these regions because of the problems posed by higher than average resignation rates. The Committee asked in fact for a breakdown of the figures in each region. With some 800 local Tax and Collection offices, and several grades of staff involved, the data would be very time-consuming to extract and the papers would be voluminous. This is presumably why the Chairman of the Committee modified the request so that we are only being asked for figures which are available. If we did not offer at least the regional

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c. Chancellor Exchequer
Chief Secretary
Minister of State
Economic Secretary
Sir Peter Middleton
Mr Kemp
Mr Monger
Miss Sinclair
Sir Lawrence Airey
Mr Isaac
Mr Battishill
Mr Rogers
Mr Pollard
Mr Cherry
Mr Crawley
Mr P B G Jones
Mr Roberts
Mr Marshall
Mr Gant
Ms Tyrrell
PS/IR.

averages indicated in the draft, we fear this might provoke the accusation that we were deliberately withholding information. We have, however, revised paragraph 4 of the note (see Annex) to focus on the overall totals. We hope this goes some way to meeting your concern.

4. Second, you asked us to quote an example in paragraph 5 of an area where the resignation rate is lower than average. Brighton and Hove offers an example in the same region of an area where the comparable rate for 1984/85 was much lower and where this represented a decrease by comparison with 1982/83. We have revised paragraph 5 to bring in this example (see Annex).

5. The Annex (paragraphs 6 - 9) now includes a further draft note in response to the third request of the TCSC (paragraph 1 c. of my note of 11 March). This has now been discussed and agreed with Treasury (Pay). There are a number of pay claims currently under discussion with the unions which should help to mitigate wastage, both at clerical and Inspector level. If the Committee pursue the issues, these discussions will have progressed further than at present, and it should be possible at that stage to make good defensive use of them. But there is little that can be said convincingly on the public record now. Treasury (Pay) and we are agreed that the best tactics at this stage is to put the note in as below.

6. The Clerk to the TCSC is now pressing for these notes, and I would be grateful to know if you are content that the notes (as below) can now be sent. The tables to be attached are as in my earlier note of 11 March.

J M CRAWLEY

SUPPLEMENTARY NOTES BY THE INLAND REVENUE

QUESTIONS RAISED AT THE COMMITTEE'S HEARING ON 20 JANUARY 1986

Staff reductions in tax offices

1. Mr Townend referred (Question 3) to the reduction of about 9,000 in staff numbers in the Taxes network (paragraph 2.2 of the Inland Revenue's memorandum). Mr Townend asked what proportion of these reductions was made prior to October 1981, showing the reduction between October 1978 and October 1981, and between the latter date and October 1985.

2. The total reduction in clerical staff numbers in tax offices between October 1978 and October 1985 was 9,336 of which 6,949 (74%) had taken effect by October 1981 (5,511 by April 1981).

Resignations: Regional figures

3. The Committee asked (Questions 20 and 21) for regional figures of resignations, broken down between Inspectors and others, with a breakdown in each region, depending how easily the figures were available.

4. Records are kept for each office of the location of staff who resign for use, eg by those responsible in regional offices and, as appropriate, centrally, for recruitment. Figures for each office, and for each region, showing all resignations in all grades in local offices are not normally collated centrally. But information is available for Taxes and Collection network offices as a whole and for those regions which are experiencing higher than average resignation rates. Table 1 below gives this information for the 4 years 1982/83 to the end of 1985/86 (projected) for Tax Officers (Higher Grade) and Collectors (broadly equivalent to Executive Officer), for Tax Officers and Assistant Collectors (broadly equivalent to Clerical Officer) and for Clerical Assistants in local offices in the Taxes and Collection networks. It shows that resignation rates for the network as a whole are fairly steady in the years 1982/83 to 1984/85, with slight increases at Tax Officer (Higher Grade)/Collector and Tax Officer/ Assistant Collector levels in 1985/86 and a somewhat higher increase (from a higher average rate) for Clerical Assistants. For the regions experiencing higher than national average rates, increases in resignations began generally a year earlier, in 1984/85. Table 2 gives comparable information for fully trained Inspectors (ie, those who do the most complex accounts work) and non-fully trained Inspectors (ie. those who do less complex accounts work). For fully-trained Inspectors the figures show the highest resignations concentrated in the London area (the South East and Eastern Counties are below the national average). For non-fully-trained Inspectors, the national average is considerably below the figures for the London regions and Eastern Counties.

5. Within these regional averages there are wide local variations. For example, in 1984/85 clerical resignations in Guildford and Woking had risen to 16.7% and 11.6% respectively. In 1982/83 the corresponding rates were 3.7% and 8.8%. By contrast, in the Brighton and Hove area the average for 1984/85 was 4.8%, representing a fall from the 1982/83 rate of 8.4%. Taking the network as a whole, the highest resignation rates are at Clerical Assistant level but, whereas CA replacements are expected to be fully effective within a few months, it takes up to 6 years to train a fully-trained Inspector, about 2 years for a non-fully trained Inspector, up to 2 years for a Tax Officer (Higher Grade), and a year for a Tax Officer.

Increased resignations in Tax Offices

6. Mr Wainwright asked (Question 22) whether, looking back to the period since March 1983, the costs which had been incurred as a result of increased resignations were likely to be larger than the savings between actual rates of pay and the rates of pay sought by the unions.

7. The Committee recognised (Question 28) that there might be wider repercussions on the wages side which might need to be taken into consideration.

8. It is impossible fully to quantify the costs in terms of administration and possible revenue loss, of the increased rates of resignation which the Inland Revenue has experienced since March 1983. Nor can one be at all sure what the impact on resignation rates would have been, even if increases in pay sought by the unions had been fully conceded. Other factors are relevant. For example, the IRSF ban on the general working of overtime has affected both the workstate and effective take-home pay. The Inland Revenue recognises that pay rates can be an important factor leading to increased rates of resignation in areas where staff have readily saleable skills and competitors are offering substantially higher remuneration. Looking at such grades in isolation, it is possible that the administration and revenue costs would exceed the money saved on pay.

9. However, both within the Inland Revenue and across the Civil Service as a whole, the existence of a unified civil service and of inherited broad relativities between one group of staff and another, mean that pay rates of individual grades of staff cannot be looked at in isolation. The Civil Service is moving in the direction of more flexible pay determination, but, in the Government's view, over the period covered, it seems likely that, had pay taken a different course, the wider repercussions of higher pay settlements for individual Revenue grades would have involved costs significantly outweighing any Revenue savings. The level of recruitment and retention in the Revenue, however, is kept under constant scrutiny and in the current pay review these points among others are being taken into account.

LR1.35

RM

FROM: MRS R LOMAX
DATE: 27 March 1986

MR SCHOLAR

cc Sir P Middleton
Mr Evans
Mr Odling-Smee
Mr Turnbull
Miss Peirson
Miss Sinclair
Mr Pratt
PS/IR

BUDGET DOCUMENTATION AND THE TCSC

Mr Higgins opened yesterday's TCSC session with fulsome congratulations on the improvements the Treasury had made to the presentation of the Budget documentation this year. The Chancellor undertook to pass these on to the relevant officials.

RL.

RACHEL LOMAX

1-5

1. b/f ~~2/4~~ (Rachel) - to see
2. b/f with response (or 11/4)

FROM: R PRATT
DATE: 1 APRIL 1986

MR EVANS

cc Principal Private Secretary
Sir Peter Middleton
Sir Terence Burns
Sir Geoffrey Littler
Mr Cassell
Mr Odling-Smee
Mr Peretz
Mr Scholar

TCSC BUDGET ENQUIRY: REQUEST FOR FURTHER PAPERS

... I attach copies of two letters we have now received from the Committee, requesting answers to three questions and threatening a fourth.

2. As you will see, the paper which was asked for at the officials' hearing, about the GDP deflator, bears a close relation to the second paper asked for at the Chancellor's session. It will clearly, therefore, make sense for us to return all three notes together. Although the letters from the Clerk asks for these notes to be returned by Thursday 10th and Monday 14 April, I have now negotiated an extension until noon on Wednesday 16th April.

3. I should be grateful if you would arrange for the three notes to be prepared, cleared by the Chancellor and then forwarded to me by close on Tuesday, 15th April. I suspect the same deadline will have to apply to the fourth question which I will circulate as soon as I receive it.

Richard Pratt

RICHARD PRATT

COMMITTEE OFFICE
HOUSE OF COMMONS
LONDON SWIA OAA
01 219 3285 (Direct Line)
01-219 3000 (Switchboard)

TREASURY AND CIVIL SERVICE COMMITTEE

26 March 1986

Dear Richard

The Committee have asked me to thank Michael Scholar and the officials who accompanied him for the evidence which they were kind enough to give yesterday.

You will already have a text of the exchanges, from which it is plain that only one supplementary paper was requested, which is mentioned at Q46, cross referring to Q11-15. Would it be possible to have a copy of the reply by noon on Thursday 10 April?

Yours sincerely
Bill

W R MCKAY
Clerk to the Committee

Richard Pratt Esq
HM Treasury
Parliament Street
SW1P 3AG

COMMITTEE OFFICE
HOUSE OF COMMONS
LONDON SWIA OAA
01 219 3285 (Direct Line)
01-219 3000 (Switchboard)

TREASURY AND CIVIL SERVICE COMMITTEE

27 March 1986

Dear Richard

I have been instructed to ask the Treasury to submit two further brief papers on matters arising from The Budget inquiry. Details are set out on the enclosed sheet. Would it be possible to let me have the submissions by noon on Monday 14 April?

Another paper is to be requested, but the details will have to await the arrival of the transcript of the evidence given by the Chancellor. I anticipate that Members will be interested in an expansion of the evidence given in reply to Mr Mitchell on levels of interest rates and unit wage costs. Once I have seen the transcript, I will be in touch with you again.

Liz Booth

pp W R MCKAY
Clerk to the Committee

Richard Pratt Esq
HM Treasury
Parliament Street
SW1P 3AG

1 Is it the Treasury's view that the change in the volume of exports of manufactures in response to changes in cost-competitiveness, which was mentioned at Q105, will be fully felt in the current year?

2 What are your observations on a calculation made on behalf of the committee that the GDP deflator for the onshore economy is likely to rise by 6.2 per cent, in 1986-87, and only the fall in oil prices reduces the deflator for the whole economy to 3.7 per cent? How can the GDP deflator for the whole economy fall to 3.7 per cent. in 1986-87 if oil prices do not fall further or if wage increases do not moderate?

RT8.71

pa/

FROM: A W KUCZYS

DATE: 4 April 1986

MR PRATT

cc Sir P Middleton
Sir T Burns
Mr Peretz
Mr Ross-Goobey

CHANCELLOR'S EVIDENCE TO THE TCSC

The Chancellor has seen the transcript attached to your note of 1 April (not copied to Mr Ross-Goobey). He has made a number of corrections, and the pages he has amended are attached.

2. He has commented that some of his answers on pages 25 to 42 are highly relevant to the new draft that is urgently required of the Lombard Association Speech. Mr Ross-Goobey is working on this.

AWK

A W KUCZYS

[redacted]

b/f 7/4
(Rachel)

FROM: A W KUCZYS
DATE: 4 April 1986

MR PRATT

cc Sir P Middleton
Sir T Burns
Mr Peretz
Mr Ross-Goobey

CHANCELLOR'S EVIDENCE TO THE TCSC

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2. He has commented that some of his answers on pages 25 to 42 are highly relevant to the new draft that is urgently required of the Lombard Association Speech. Mr Ross-Goobey is working on this.

AWK

A W KUCZYS

-1-4

FROM: R PRATT
DATE: 1 APRIL 1986

PRINCIPAL PRIVATE SECRETARY

cc Sir Peter Middleton
Sir Terence Burns
Mr Scholar
Mr Odling-Smee
Mr Peretz
Mr Monger
Mr Evans

CHANCELLOR'S EVIDENCE TO THE TCSC

.. I attach a transcript of the Chancellor's evidence. Although the covering letter asks that this be returned by April 7, I have asked the Committee Clerk for an extension until 16 April.

2. May I suggest that copy addressees examine the transcript and look through the Chancellor's evidence, as well as (where applicable) their own, making any corrections they feel are necessary. If they could then return their copies to me by close on Thursday, 10 April, I will produce a consolidated corrected version which I can then give to you on the 11 April, for the Chancellor to look at over the weekend. To meet the deadline, I will then need to receive the Chancellor's comments, from you, by close on Monday 14 April.

Richard Pratt

RICHARD PRATT

Ch

You asked to see this.

AJK 3/4

I have corrected this now, as I shall be too busy ~~of~~ over the W/E.

2. Some ~~[illegible]~~ my answers on pp 25-42 are highly relevant to the new draft rule on the majority requirement of the Commons Ass: Spch.

N.

(HJD 27/3

COMMITTEE OFFICE
HOUSE OF COMMONS
LONDON SWIA OAA
01-219 (Direct Line)
01-219 3000 (Switchboard)

TREASURY AND CIVIL SERVICE COMMITTEE

I enclose a transcript of the evidence given by you to the Committee. I should be grateful if you would examine this and make in ink, in your own handwriting, such alterations as are:

i) restricted to the correction of inaccuracies in the reporting of the evidence; or

ii) restricted to the correction of matters of fact which do not materially alter the general sense of any answer.

Minor alterations to the style or grammar of any answer should not be made.

You should not alter any question, and if you wish to explain or give any additional information, you may either submit a footnote to your evidence at the appropriate point, or submit a memorandum.

I should be grateful further if you would return the corrected copy to reach me on 7 April. If special circumstances make this impossible, please let me know, but if I do not hear from you to that effect, and do not receive the corrected transcript within the time indicated, the evidence will be published in its original form.

Although your evidence was taken in public, you should not make any public reference to this transcript without indicating clearly that it is an uncorrected document, and that the final form of its publication has not yet been approved by the Committee.

G E CLAYTON
Assistant to the Clerk to the Committee

Enc.

HOUSE OF COMMONS

MINUTES OF EVIDENCE

taken before the

TREASURY AND CIVIL SERVICE COMMITTEE

WEDNESDAY 26 MARCH 1986

THE RT HON NIGEL LAWSON, MP,
SIR PETER MIDDLETON, KCB, and SIR TERENCE BURNS

Evidence heard in Public Questions 133 - 236

MEMBERS' CORRECTIONS

Any Member of the Committee who wishes to correct the Questions addressed by him to a Witness is asked to send the correction to the Committee Clerk as soon as possible.

Members receiving these Minutes of Evidence are asked to ensure that the Minutes are confined to the object for which they are printed the special use of the Members of the Committee - and are not given wider circulation.

WEDNESDAY 26 MARCH 1986

Members present:

Mr Terence Higgins, in the Chair
Mr Anthony Beaumont-Dark
Mr John Browne
Mr Nicholas Budgen
Mr Mark Fisher
Mr Ralph Howell
Mr Austin Mitchell
Mr John Townend
Mr Richard Wainwright
Mr John Watts

THE RT HON NIGEL LAWSON, a Member of the House, Chancellor of the Exchequer, examined; SIR PETER MIDDLETON, KCB, Permanent Secretary, and SIR TERENCE BURNS, Chief Economic Adviser, HM Treasury, called in and examined.

Chairman

133. Mr Chancellor of the Exchequer, we are most grateful to you and to Sir Peter Middleton and Sir Terence Burns for appearing before us again following a Budget Statement. As you know, the programme has been a little condensed this year because of the intervention of Easter between the beginning of our inquiry and the end, but we hope to take evidence after Easter from the TUC and the CBI and also from the Governor of the Bank of England, before making a Report ahead of the Second Reading of the Finance Bill. There is just one matter which I would like to mention at the beginning. We had occasion, when we discussed the Public Expenditure White Paper, to express appreciation to officials for the way in which they had taken into account the various recommendations which we had made on presentation. I would like on this occasion again to express appreciation for the work which has been

done by the Treasury in making the Red Book more readable and in providing more information on the basis of the recommendations which we had made in previous Reports. We would like you to know that we do think that that is a worthwhile exercise, and we hope we shall continue to make recommendations which are helpful both to the Government and to the House of Commons. That having been said, you are most welcome. Perhaps I might ask you if there are any initial remarks which you would like to make, and then we can proceed straight away to questions?

(Mr Lawson) Mr Chairman, thank you very much. I have no wish to make any initial remarks, save to thank you for what you have just said. We have tried, in a number of ways, to improve the Budget documents so that they do meet some of the points which you have made. I am particularly grateful for your reference to those of my officials who have done the hard work in making these changes. I will certainly see that those remarks are conveyed to them.

Chairman: Thank you very much. We would like to start with some questions on fiscal policy. I call Mr John Browne.

Mr Browne

134. Chancellor, I hope you will accept that I think a large majority of this Committee would support me in saying first of all that I think the Government and its staff deserve not only thanks but congratulations on achieving something which has eluded governments in recent history, and that is a combination of high growth, high job creation or employment and low inflation. Having said that, I would like to ask you this. Given the fact that the Government believe that public expenditure should be dictated by the level of public revenues, of government revenues, and assuming

that a fall in oil revenues would be long term leading to a permanent drop or a long-term drop in government revenue, can we expect future spending plans to be revised downwards? If so, does this mean that we now have an opportunity, if we are prudent, to recast our public expenditure to reflect the changes of the past twenty years, so that they meet the needs of today and tomorrow rather than the needs of yesterday?

(Mr Lawson) Certainly we need to review our public expenditure programmes and priorities all the time, so that they meet (to use your words, Mr Browne) the needs of tomorrow rather than the needs of yesterday. That is something which is done regularly in the annual public expenditure reviews, and it is something which also takes place in specific reviews of particular areas of expenditure which are done at various times within Government. As for the first half of your question, however, about whether the fall in North Sea oil revenue should cause us to reconsider our public expenditure, I see no reason to do that, because, among other things, what has been seen - and it has already emerged from the figures from the PSBR for recent months, and as you see what are projecting ~~in here we projected~~ forward - is that that decline in North Sea oil revenues has been to a very large extent offset by the greater than expected buoyancy of non-North Sea revenues. So there is no great loss of taxation revenues. Indeed, further out from 1986-87 - Sir Terence Burns could comment further on this perhaps - the buoyancy of the non-North Sea oil revenues is likely to exceed the loss from the North Sea. On the whole, I think the framework which we set out in the Green Paper which was published at the time of the Budget in 1984, "Public Expenditure and Taxation into the 1990s", is still valid. In that framework, which is the framework within which we can form a view of what sort of path for public expenditure ~~was~~ is appropriate, we allowed for a diminution in North Sea revenues - a very considerable diminution of North Sea revenues. What has happened of course is that the first half of that, or the first part of that, has come about rather faster, but at the same time the buoyancy of non-North Sea oil revenues has also come about faster. So I do not see that there is any need to change our public expenditure projections on that account.

135. We certainly welcome the rise in non-oil activity in the economy, but if you look at the impact of the oil revenue drop or the oil price drop on world growth, and the relative ability of countries in the OECD to make good in that growth, and if you look at our competitive position with, for example, West Germany where prices rose last year by 1.3 per cent, wages by 3.3 per cent, when our wages rose by 8.6 per cent and our prices by 5 per cent, are we really going to be competitive enough to bear out your optimism in the future on the non-oil sector?

(<u>Mr Lawson</u>) That is a matter for British industry and those ~~who are~~ working in it. It is perfectly true that the fall in the oil price - and I made this clear in my Budget Speech - benefits countries like Germany and Japan much more than it benefits us, even though on balance I believe that taking all things into consideration there is a benefit for us. Nevertheless, there is clearly a benefit; and this clearly benefits the Germans and the Japanese more. But it <u>does</u> give British industry ~~- indeed,~~ a great opportunity. Not only the North Sea oil price, we do not want to be obsessed by that, although that is the biggest single change that has occurred since we last met, ~~er -~~ ~~It is also a question of~~ but also the decline in inflation. The degree of stability, ~~we have got it in, not only~~ the improvement in manufacturing productivity that there has been, and the policies that have been pursued do combine to provide British industry with a tremendous opportunity - a tremendous opportunity in particular over the next twelve months. If in particular British industry is capable of maintaining an adequate control over its wage costs, its pay costs, I believe that we can achieve something of a breakthrough to improved economic performance. The scope for catching up on our competitors was clearly considerable when we took office, and a good deal of that scope has been realised in the sense that our manufacturing productivity in this country, indeed over the whole of the period since 1979, has risen faster than in any of our major European competitors. That was not the old story at all. So we are doing something to catch up, but there is still scope to catch up further, and industry has an opportunity, particularly now, to make good use of that. Whether it does so or not, as I say, is up to industry. I think they are aware of that. I think that we have created a benign climate. World events have also created a relatively benign climate. With that background, it is now up to industry.

136. Chancellor, can I turn briefly to the public sector borrowing requirement? The figures for 1986-87 are lower than in the Red Book last year, but has not the government borrowing, if you represent it by public sector financial deficit, actually increased by £2 billion sterling?

(Mr Lawson) If you look at the public sector financial deficit it has increased, and if you look at the PSBR it has come down. There is no one, unique way of looking at it. I have to take a judgment taking everything into consideration, taking into consideration the composition of the public sector borrowing requirement, if you like, taking account also of what has happened to North Sea oil revenues. There are many people who have been arguing that because North Sea oil revenues have fallen so sharply - a fall of something like £5½ bn, which is rather more than double the increase in the proceeds from privatisation, which ~~goes~~ accounts chiefly ~~to~~ for the change between the PSBR and ~~PSMT~~ PSFD trends - ~~on that account~~ I ought to increase the PSBR for 1986-87 above what was said in the 1985 MTFS. I took the view that it would be safer in an uncertain world - which is always uncertain but particularly at the moment because of the level of oil prices - to have some small reduction from the path of last year's MTFS, but it is a matter of judgment. I readily concede that and everybody has a right to make his own judgment, but that is the judgment, after considering all the factors, that I came to.

Mr Fisher

137. Chancellor, in your last-but-one answer to Mr Browne you appeared to put your faith in cost competitiveness and price competitiveness and the impact of those on wage costs when our economy is going to try and adjust to declining oil revenues. How do you square that confidence with paragraph 3.25 of the Red Book, where the Red Book says: "Price competitiveness in 1986 may be a little different from the average of the last three years". How do those two things equate?

(Mr Lawson) I think the difference boils down to the difference between track record and opportunity. Our track record on labour costs per unit of output in recent years has not been good. During the severe recession I think it was good. Then industry had its back to the wall and they did take a very firm grip of their costs, and you see that wage costs per unit of output rose very little and our relative performance was good. Since then our relative performance has been far less good. In forecasting, since this government took ~~control~~ over from the previous government, where forecasting was simply another name for wishful thinking - we have not gone in for that - we have tried to ~~do~~ give a best guess based on past performance, track record, and that is why it says what it does in 3.25, but there is an opportunity to do far better than that.

138. You do not appear to be putting a great deal of confidence in your answer just now on this element of the economy in trying to cope with the difficulties that are going to follow with the decline of oil. If you do not put any confidence in that and are very cautious on that, what aspects of the economy do you think are going to take up the slack? Are they going to be high technology and information technology, for instance?

(Mr Lawson) I do not know what aspects of the economy are going to take up the slack. The economy is very large and diversified and North Sea oil is only a tiny sector of it, so there will be various parts of the non-North Sea economy which will be going ahead faster than we had previously thought. I do not think it is incumbent upon me to predict which particular sectors they will be.

139. Chancellor, with due respect, I think the country is very anxious to know with the decline in both oil price and oil revenues - and the distinction is not entirely clear in your Budget Statement or the different impact of those two - where the upturn and buoyancy you talk about is coming from. Is it coming from information technology or high technology?

(Mr Lawson) I think it will come generally from the internationally traded sector of the economy, as I said in my Budget speech.

140. Would that be manufacturing industry trading well, do you think?

(Mr Lawson) I think certainly manufacturing industry is likely to have a further good year.

141. A better year than our deficit in the balance of trade of £3½ bn?

(Mr Lawson) But the deficit is not what you want to look at. What you want to look at is what has happened to manufactured exports, manufactured productivity and manufactured output. The fact that there is,as it were, a counterpart to the oil surplus in the form of the imports of manufactured goods is neither surprising nor deplorable. What matters is what is happening to our own manufacturing industry, how it is doing in terms of growth, how it is doing in terms of productivity, how it is doing in terms of exports. On all three fronts it is doing well and I see the latest CBI survey, which was published in this morning's newspapers, is predicting a slightly faster growth of manufacturing output in 1986 than we have done here in the Red Book.

Chairman

142. But if you took the imports as the counterpart of the oil exports would you not then expect the imports to fall, given what has happened to the oil situation, whereas, in fact, they doubled in the Red Book?

(Mr Lawson) Yes, there is a higher rate of imports expected, which is associated, of course, with the quite high rate of growth in the British economy, but the outcome of the whole thing is still quite a substantial current account surplus on the balance of payments for the sixth successive year.

Mr Fisher

143. But, Chancellor, this is exactly what we are trying to address these questions to.

(Mr Lawson) I am not quite clear what point it is you are trying to address.

144. That the balance of payments surplus may not look so rosy in the future years. You say we ought not or do not want to look at the deficit of trade on manufactured goods but I suggest you may not want to look at them because they are extremely embarrassing figures, the first time we are in deficit by an enormous amount in the history of our economy, but it is surely crucially important to try and determine where this buoyancy, this growth in the economy, is coming from in the future? You have not said it is going to come from information technology. I am sure you are right, but the NEDO shows us 24th out of 24 OECD countries in the deficit on information technology, so it is not coming from there. It is not coming from manufactured goods because we have a huge deficit on that. Where is it coming from?

(Mr Lawson) I do not find the deficit of trade of manufactured goods at all embarrassing. I would find it astonishing were that not to be the case, given the very substantial surplus there is on oil account. I am not quite sure what kind of world you are envisaging. It is unrealistic to expect one would have surpluses on ~~any~~ every? part of the balance of payments.

145. So you think, Chancellor, as both revenues and production of oil decrease over the next 25 years, you anticipate with equanimity in your Budget Statement we will then come into a large surplus on manufactured goods trade in that period? Is that what you are saying?

(Mr Lawson) I think we shall remain with a surplus on oil account for many years to come. It will be a smaller surplus than it has been, and as that surplus declines one of the things I would expect to see happening is our balance on manufactured trade improving. But that does not mean it has to go straight into surplus because we shall have a continued surplus on the oil account. I did try at some length to go into this (because it is not a new issue at all) in a speech I made at Cambridge in 1984 on, "What will we do when the oil runs out?" and the analysis has not changed at all.

146. But in that lecture you do not specify how manufacturing industry is to improve and you do not specify what sectors there are to improve. I tried to press you on those points this afternoon but you do not appear to be very anxious to answer them.

(Mr Lawson) If you say how will it improve, it will improve in part by means of a change in the real exchange rate. Then there is the question of how far that implies a change in the nominal exchange rate - and, indeed, there has been some change in the nominal exchange rate - and how far that is achieved by an improvement in industry's control of costs. As I was indicating earlier, there is very considerable scope for industry to improve its control of costs and I hope very much it will take that. Certainly the view of the CBI is exactly the same as mine on this issue, that they believe that industry has a need to control its costs better and that it has a responsibility, indeed, to do so.

Mr Browne

147. Chancellor, given the fact that the oil prices <u>have</u> fallen, there is obviously a tremendous outlook for world growth in which we, if we are competitive, can really benefit, giving the opportunity not only to reduce inflation further but greatly to increase employment above its already increasing levels, to such a point that unemployment can be reduced in a very significant way. Do you share those views? If so, when do you feel this turn in unemployment is likely to occur, given the present state of the world economy and the present price of oil?

(<u>Mr Lawson</u>) The general view you expressed I would share, but on a rather less euphoric level. That is to say, although I think that the fall in the oil price is of benefit to the world economy, it does not suddenly mean that we are going to be in some brave new world in which the sun is always shining and everything is coming up roses all the time. We are still going to be subject to all the old problems and difficulties and so on. But it is going to be better than it would otherwise have been. That certainly means an improved outlook, among other things, for employment. For us there is the added point that as the balance of the economy to some extent shifts at the margin from the oil sector to the much larger non-oil sector, that too will be of benefit from the point of view of jobs, because the non-oil sector is more labour-intensive than the oil sector of the economy. So there are improvements, and it is said, I think, right at the beginning of the Red Book here, in the last sentence of paragraph 3.02: "However, the labour force is now expected to grow less rapidly," - ~~that is~~ and, taking everything into account - ~~"and~~ "prospects for unemployment are better than for some years." I would not wish to be tied down to a more precise statement than that.

(Sir Peter Middleton) Perhaps I could add a comment there, because I have been talking about precisely this point over the last two years in OECD which of course consists mainly of countries who are going to benefit from oil and lower commodity prices to a far greater extent than we shall. There is absolutely no doubt that the fall in prices has improved the mood, and it has also improved the prospects, because what it has done is confirm people in feeling that lower prices will definitely be there. One then gets some benefit from output, and also of course the imbalances in the world look a little bit better too (not all of them, but most of them). So I think the prospect is genuinely better, but one should not get too carried away with it, because oil is not such a large proportion of anybody's GDP.

148. Given the underlying strength of the economy and the outlook for growth due to the price of oil, etcetera, some people have suggested that the public sector borrowing requirement might be increased and still maintain its percentage share or its percent as a level of GDP. If that were put to you, what would your views be as to the effects of any increase under such conditions?

(Mr Lawson) As I indicated earlier, take first of all the performance of the economy. As far as the growth of the economy is concerned over the coming year, short term, it is no different overall than what we were projecting at the time of the Autumn Statement when we were basing it on an oil price of something like $25 a barrel rather than $15. The ~~competition~~ composition has changed quite significantly, with both investment and exports playing a much larger part and consumers' expenditure a rather smaller part. So it has changed the pattern rather than the overall level of growth in the immediate future, although further ahead, beyond that, we actually see an improvement ~~from~~ over that which we had earlier expected. There is also an improvement on inflation, but inflation of course was going to come down anyway; this has just helped it to come down rather more. This is an important feature of the current scene ~~of~~ in the economy. It is not just a matter of high growth by UK standards, but it is also ~~the~~ accompanied by low inflation. Would that be assisted by increasing the public sector borrowing requirement? I do not see that it would. I do not see by what mechanism it would. It seems to me that the level of borrowing which I have judged to be right for this year is one that fits well with the monetary stance - which no doubt we shall come on to in due course - which is designed to keep inflation going down, and that is of fundamental importance for the health of the economy and the prospects for employment. Also - and Sir Terence Burns will have the figures - I think that our fiscal position is pretty well in line with the generality of OECD countries at the present time.

Mr Beaumont-Dark

149. You quite rightly, Chancellor, talked about the scope which you hoped that industry would take advantage of because of the drop in the price of oil which of course has helped them to be more competitive. It is of course a happy accident more than design that that has happened. If you talk about the scope, would you have given them the opportunity to have that scope to become more competitive, or would you have used the money differently and industry would have found itself still deeply in the mire?

(Mr Lawson) I do not accept the last part of your question, Mr Beaumont-Dark. Industry was not deeply in the mire. Industry has been growing at a very satisfactory rate for some years now.

150. Trade has, not industry, Chancellor.

(Mr Lawson) Oh yes, yes, industry-wide. If you look at the growth of manufacturing industry over the past few years - which I know you are particularly concerned about - since the bottom of the recession it has been growing steadily, at a rate well above what ~~has been~~ used to be the norm. Also of course non-manufacturing industry has been growing well from a rather higher relative base. As Sir Peter Middleton has just reminded me, something I have referred to on a number of previous occasions, which is relevant now, is that the profitability of industry has been improving very greatly. There is a graph somewhere here which shows this very clearly. I cannot remember quite where it is.

Mr Budgen

151. Page 33.

(Mr Lawson) Thank you, Mr Budgen! You will see there chart 3.11. Taking ~~it away from~~ the non-North Sea company sector, you see that since 1981 ~~it~~ profitability has been rising sharply and it is now the highest it has been for a very long time, expressed as a return on capital. This is very, very important for the future strength and success of British industry.

The problem that had been reached during the 1970s in particular was a very great decline in profitability. That was what was really making it difficult to invest sufficiently and spend sufficient money on research and development and on training. There has been a transformation in industry's profitability and that, as this chart shows, occurred well before any change in the North Sea oil price.

Mr Watts

152. Chancellor, I would wish to pursue a similar point but from a somewhat less pessimistic viewpoint than Mr Beaumont-Dark. The decline in oil prices and the consequent reduction of £5½ bn in oil tax revenue effectively pre-empted that part of the fiscal adjustment that might have been available to you to oil consumers. What do you estimate is the impact on the economy, and particularly the prospects for growth, of the reduction in costs which comes about as a result of the fall in oil prices?

(Mr Lawson) The reduction of costs from falling oil prices, as I say, does give British industry an opportunity, coupled with what has happened, of course, to inflation, which has come down sharply, coupled with the change there has been in the exchange rate. Normally, of course, what one has seen in the past is that when there has been a fall in the exchange rate that has been offset by inflation rising. What has happened on this occasion for a combination of ~~factors~~ reasons is that industry has the benefit of both ~~the~~ a lower exchange rate and inflation falling, so all these things do give industry an opportunity. However, as I said earlier, the overall rate of growth in 1986-87 which we are forecasting now of 3 per cent. is the same as the rate of growth of 3 per cent. which we were forecasting before the fall in oil price, so I think it is a great mistake to over-emphasise the importance of this oil factor. It has been the most dramatic change, certainly, but the economy is a great deal more than North Sea oil. The non North Sea oil economy matters a great deal more obviously by its very size, quite apart from the fact that the North Sea oil economy over a long period of years ~~has been~~ will be in decline anyway. It is also, of course, the Government's economic policies that matter and that matters far more than anything that is happening on the oil price front. I have to say one sees a curious reversal in a way listening to the discussion so far, which I think reflects a lot of the current discussion outside this forum, too. Until very recently one of the difficulties that we had was that the markets and commentators generally placed a quite inordinate importance on North Sea oil and felt, therefore, that if anything went wrong with North Sea oil there would be doom and disaster for the British economy as a whole. I and a number of others tried to point out that this was getting things totally out of perspective. Now it seems to have gone the other way round. People now feel the drop in price after all may be a good thing, not a bad thing, but because they still exaggerate the role of oil (they exaggerate its likely benefits.) ~~still some people are inclined to think North Sea oil plays an enormously important role~~ in the British economy. It never did dominate the scene in the past in relative terms and it does not now, so I think that while this is perhaps the most interesting event on the economic scene it is not right to say that this is the determinant of our economic future.

153. If I can pose a different scenario, if the oil price had not fallen and you had had that extra £5½ bn of revenue added to your fiscal adjustment, do you believe that the effects of distributing that through the measures that you have shown would have been able to create a better stimulus to the economy rather than the blunt instrument of the market reducing the price of oil and letting the benefit flow where it will?

(Mr Lawson) It is a tantalising thought, is it not, and I shall not torment myself by thinking of what Budget I might have been able to produce had not at least half of the North Sea oil revenues gone down the plughole!

154. The Red Book assumes a price for oil averaging $15 a barrel. Events of recent months have shown what difficulty there is in trying to predict what the value of oil will be. If that turns out not to be the case and there is either a substantial recovery in the price of oil or, alternatively, if it were to stabilise nearer to the bottom end of the range we have seen recently, what would you consider would be necessary in terms of a policy response to that, or could I take it from your replies to my earlier questions that you do not really think that the price of oil is that important an influence on our economic policy?

(Mr Lawson) It is obviously important to the fiscal position. Of course, what we see reflected is the price of oil on the spot market and quotations for various forward months, a price which does not necessarily accurately reflect the price at which oil is actually traded, which is probably slightly higher than that. I do not know what the price of oil is going to be. I still have no reason now to depart from the assumption or best guess of an average price of $15 a barrel over the period from now until the end of the year and, indeed, through 1987, for what that is worth, although it is only the price between now and the end of the year, or rather ~~than~~ the price during calendar 1986, which determines the revenues we get in in 1986-87 because there is a bit of a lag. That said, the question which you posed is something to which I adverted in my Budget speech, when I said: "It may well be that the oil price turns out to be different from the average of £15 a barrel which I have assumed for this year's Budget, but if any departure is wholly short-term it is most unlikely to have any significance for policy."

Mr Beaumont-Dark

155. Can I say when Mr Watts said that I was pessimistic, I can promise you that I am not a pessimist. If you come from Birmingham you tend to be a hopeful and fretful realist, but that is not the same

as being a pessimist. Would you not agree that one of the important things is that when interest rates have doubled in Germany, Japan and the USA, in fact double and treble what they are now, you do tend to be very fretful if not fearful? Do you think along with the fall in oil price we are going to get more fall in interest rates or is that now stopped in its tracks, do you think?

(Mr Lawson) First of all, I am sure you would welcome, fretful though you are, the 1 per cent. fall in short-term interest rates that has already occurred in the ~~week~~ wake of the Budget. If one now looks at the rest of this year one can see that the prospect is of inflation throughout the world and in this country falling and, as was said following the London meeting of G5 quite recently, all things considered the five Finance Ministers thought that there was a good prospect of falling interest rates over the coming 12 months. If that does happen, if we do have inflation around the world falling and if we do have inflation in the UK falling as we envisage, if we have interest rates around the world falling obviously that is a ~~hopeful~~ helpful climate for reductions in interest rates in the United Kingdom, but I obviously have to ensure that nothing is done that will jeopardise falling inflation and that may limit what can be done on the interest rate front. If you say why is it that interest rates in the UK in real terms are higher than they are in most other major countries, I think that is not unconnected with the fact that labour costs per unit of output are rising faster in the Uk than they are in most other major countries.

Chairman

156. How do you see that mechanism operating?

(Mr Lawson) I think there are two ways in which it operates. First of all, if labour costs per unit of output are rising fast or faster than in other countries, as they are, that is a potential threat to inflation. That is a potential inflationary impulse and it is,

therefore, necessary, to ensure that the increase in labour costs is not translated into higher inflation. One needs, therefore, to keep a tight monetary policy in order to prevent that. That is one way of looking at it.

Another way of looking at it is the way you look at it from the point of view of those who are operating in the foreign exchange market. ~~As to those who operate in the foreign exchange market,~~ Their view of the future of sterling is clearly influenced by what is happening to labour costs per unit of output in this country compared with labour costs per unit of output in other countries. Therefore, in order to prevent the exchange rate from depreciating as a result of fears of this kind, it is necessary to maintain interest rates higher than they would otherwise be. So from both these points of view - and I have said this to industry on a number of occasions, including at "Neddy" - the answer to industry's concerns, so eloquently voiced by Mr Beaumont-Dark, about the level of interest rates, lies very much in their hands, because they are responsible for the rate of growth of labour costs per unit of output.

157. But if you do not have a target for the exchange rate, why then is it necessary to keep the interest rates up for the reason you mentioned?

(Mr Lawson) Because we do not have a target for the exchange rate it does not follow that we are indifferent to the exchange rate. Nothing could be further from the truth.

Mr Beaumont-Dark

158. Are not you using it to compensate for the increase in labour costs in that sense? One has got to have a policy towards one or the other. Not even in the modern world can you have it both ways. It is either the pound that one defends or it is interest rates. Which do you think is more important to industry? Because we do need an industrial strategy, do we not?

(Mr Lawson) There are a lot of statements there, and I am not quite sure whether I fully understand the full import

of them. As far as needing an industrial strategy is concerned, if you mean should the Government be far more interventionalist, I do not think that would be helpful at all. I believe that we want to produce what I referred to earlier as a benign climate within which industry can operate. If that is what you mean by an industrial strategy, then we have got it and we will stick to that.

159. I can tell you very briefly what I mean by that question. You quite rightly said - and I do agree with you myself - that oil is not the determinant of the UK economy. In the end, it cannot be. When oil goes you have to decide what is left, do you not? When oil goes would not you agree that tourism and changing guards at Buckingham Palace and the service industries will not be enough, because if we look upon that as enough - we do not care whether it is tourism, service industries, now, as long as we get the money in - does not that mean that we have to have some strategy to make sure that in the future, when oil goes, imports either have to be stemmed by controls (which I do not like) or exports have to be increased by possibly policy to increasing manufacturing industry? As an example of one, why do we have to have an unfair special car tax, for instance, bearing in mind the importance of the car industry? When I say that we have an industrial strategy I mean why do we have to have so many taxes, as against many other countries, upon employing labour in manufacturing industry and the costs of industry? I do not call that an unfair thing.

(<u>Mr Lawson</u>) We do not, as they is the short answer to your question. If you look at ~~the costs of the~~ comparative taxes - and by that I assume you mean National Insurance contributions because there is no tax on employing labour, since the National Insurance Surcharge, which <u>was</u> a tax, has been abolished - but if you look at the level of National

Insurance contributions which employers have to pay in this country, they are well below the average of what other countries pay on employer ~~employed~~ labour. So the first premise of your question is false. So is the other premise that somehow the tax system bears more sharply on manufacturing than it does on the service industries. I am continually pressed every year, for example, to give the industrial buildings allowance to the commercial sector and to the service sector. They say, "It's not fair that you give it to manufacturing and you don't give it to us. What's wrong with us? We employ a lot of people" and so on and so forth. If there is any bias in the tax system at all, it favours manufacturing rather than the service industries. But I must say, I deplore all this, as it were, industrial racism, ~~of~~ implying that one part of industry is superior to another part. I would like to see all parts of British industry flourish.

160. I think that is a superb political point to make at election time, but it does not really wash if you came from the Midlands. I agree, you can blame all manufacturing industry for it. It is never the Government's fault. Only the good things are Government's concern. Manufacturing production, not just because of Government's amd manufacturing industry's own point, is lower than it was eight years ago. The inference somehow or other that manufacturing industry has got what it deserved is something that I would find - even the Institute of Directors would - hardly acceptable. I know they are rather more byzantine, but I think the CBI have taken the view - and Terence Beckett is not some left-wing "coolie" - that manufacturing industry has had it pretty rough. I do not think that just suggesting that we want special privileges because we want manufacturing industry to thrive is terribly fair. You may not have meant it, but that is how it sounded.

(Mr Lawson) The CBI has welcomed this Budget.

161. So do I!

(Mr Lawson) Which was what we were talking about. Manufacturing industry of course has been through a very rough time. This is for a combination of two or three factors: the severity of the world recession and the very, very tough competition it had to face, coupled with the enormous overmanning there was over a wide swathe of British manufacturing industry for many, many years. Manufacturing industry, to its great credit, has improved its performance markedly. I quoted the figures in my Budget Speech of the improvement in manufacturing productivity which governments for as long as I can remember have been calling for, but which has never happened (before) and which now we are seeing. Manufacturing productivity over the past six years has been rising faster than in any of the G5 countries other than Japan. As for ~~getting what we deserve or~~ manufacturing industry getting what it deserves, I suppose that in a sense all of us do, Mr Beaumont-Dark, even you!

Chairman: Chancellor, I think we must move on, because we have a lot of ground to cover still. We would like to turn now to monetary policy. I call Mr Wainwright.

Mr Wainwright

162. You will recall that this Select Committee was born in the same year that Government began to publish its medium-term financial strategy, with the intention, as we are told regularly year by year, of influencing public expectations, so that for seven years now pay negotiators on both sides of the table have been exposed annually to the publication of the Government's financial strategy. Do you think that pay negotiators' expectations have been perceptibly influenced or are currently perceptibly influenced by this publication?

(Mr Lawson) The purpose of the medium-term financial strategy was not simply to influence pay negotiators. It was to give everybody a clear view of the economic policy that Government was going to pursue and stick to, and it is important for businessmen taking a whole range of decisions, not just their pay negotiations. It is important for the financial markets and important for everybody. I think it has had an influence on pay negotiations but I would not like to quantify it.

163. But this year, Chancellor, in this key part of the Red Book and, indeed, in your Budget speech on monetary conditions, M3, the estimate of the aggregate indicators is only down for one year. Can that be of any serious influence on public expectations?

(Mr Lawson) The reason why £M3 is there for one year ahead only is set out very clearly in the Red Book, because of the uncertainty our future ~~of~~ velocity, broadly. As you know, ~~in any event~~ all other ~~countries,~~ well-conducted countries~~,~~ have monetary targets set for one year only and do not set them for any further. You may say why do we have this set out for a period of years, but I think that really goes to the heart of the thinking behind the medium-term financial strategy when it was first conceived and when it appeared in 1980. The plain fact was that well-conducted countries, countries that have been conducting their economies soundly for a long period, such as Germany, have acquired a track record, acquired a reputation, both for consistency of economic policy and for a general anti-inflationary bias in their policy, and that track record, that reputation, was what created confidence both within the country and outside it about the conduct of policy. We had, regrettably, a very different track record in this country. We had a track record of constantly shifting, ~~shifting and changing,~~ chopping and changing, having short-term horizons, not carrying out any policy for any length of time and all the time a tendency to yield to inflationary ~~processes~~ pressures. That is what we faced when we came in, a very bad track record, and we ~~have~~ had to try and change expectations and condition people's thinking, both in this country and overseas, ~~and~~ the medium-term financial strategy played ~~and continues to~~ ~~plays~~ a critically important part in securing that by showing that the Government was firmly committed to carrying out this particular policy and continuing with it right through the medium term and giving people this medium-term horizon. Since then we have been pursuing this policy for the best part of seven years and we now are accumulating and acquiring a track record and reputation which is helpful rather than harmful to the economy, but it will take a further period of time before it can be as beneficial as is the case in a country like Germany, which has had this good track record for very much longer. That is a fundamental difference, but we have never said for a moment that £M3 was the keystone of the medium-term financial strategy.

164. If I may bring you back from seven or eight long years ago to the present situation, when you said in your Budget speech that you had set the range for £M3 at 11 to 15 per cent. I waited fully expecting that, in line with your previous speeches, you would then say: "This range will lead to, provide for or even ensure that inflation will continue on its downward path," but you did not use any of those words. You simply said - and this is a big change - this range of 11 to 15 per cent.

would be consistent with the further decline of inflation. This does mean that M3 has ceased to be the guiding star and is now just a reflected moon of financial condition.

(Mr Lawson) It has never been a guiding star. There has always been a whole range of indicators we look at. Basically, in order to get inflation to come down you have to have monetary conditions that are sufficiently tight. ~~It~~ How tight depends on how fast you want to get it down. We have pursued a gradualist path and, therefore, there has been a gradual winding-down of money GDP and the rate of monetary growth and to achieve that one has to have sufficiently tight monetary conditions. This means that you have to have an interest rate policy which will ~~pursue~~ achieve that. I tried to explain this to some extent in my speech at the Mansion House last autumn and I shall be making a speech on monetary policy in a few weeks' time which will be dealing with this a little more fully and explaining how we pursue monetary policy in this country.

165. Excuse my interrupting, will this be a speech to the House of Commons?

(Mr Lawson) No, it is not a speech to the House of Commons; it is outside the House of Commons, just as the Mansion House speech is outside the House of Commons, but I do find, I must say, from experience that a Budget speech is not the occasion when one gets the most attentive audience for a disquisition on the finer points of monetary policy. Anyhow I shall be making this speech. Let me say before Sir Peter Middleton comes in that, of course, there has been an evolutionary change in the way we conduct monetary policy over the past six or seven years as conditions have changed. It would be surprising were that not so, but it has been a gradual evolutionary change. There has been no sudden change, and it is one which has been explained fully at the time to this Committee and in other ways and one which still leaves the policy recognisably the same as the policy on which we originally embarked, even though there were some misunderstandings about that policy, which it seems have in some quarters persisted. As I say, it is one that we have sought to explain and I have sought to explain as we have gone along and I will be seeking again to do so on a suitable occasion.

166. With respect, the House of Commons is expecting and always receives from this Committee a report on the Budget before the date on which you are going tomake a speech in the City of London, so you do not contest, I take it, that we expect to have as much of the benefit of your wisdom as possible before then?

(Mr Lawson) I am very gratified to hear that, but ~~I think if you want to look basically - and~~ I do not think there are any important new developments that I have to announce, it will just be a fuller exposition, and ~~-~~ if you look at the monetary section of my Mansion House speech last autumn and you add to that the monetary policy section and the MTFS section of the Red Book, there you have a very clear exposition of how we conduct monetary policy and how we propose to conduct it. There was a change during the course of last year which I would have thought was a change this Committee would welcome, which was the abandonment of over-funding. This was something which on a number of occasions this Committee, or at least its predecessor Committee - I am not quite sure which - had itself advocated. We have done that but that key change, of course, was announced ~~has not been~~ in the Mansion House speech.

Chairman

167. What happened to M3 in the Mansion House speech?

(Mr Lawson) What I did was I recognised that the target that had been set was a totally unrealistic one and I said on page 11 of the Treasury handout text of the speech: "I shall as usual have to consider what target to set for £M3 for 1986-87 at the time of the next Budget," and that is precisely what I have done.

168. That is as part of the strategy but the M3 figure in the next one year the strategy goes more than one year?

(Mr Lawson) Yes, indeed, it is, as is clear.

169. What is the point of having M3 if it only goes one year?

(Mr Lawson) I do not see the difficulty. The figures for MO to which I attach considerable importance are illustrative figures for the later years, the only actual target figure is for the figure for the year immediately affected. What is more interesting than the difference between the row of figures for MO and the single year figure for sterling M3 is a difference in the status of those two figures, a difference in the way they will affect policy decisions, which is set out very clearly in the Red Book.

Mr Wainwright

170. This year, Chancellor, pride of place is given to money GDP set out for five years and as the Government's medium term objective. The officials told us, Mr Odling Smee said, on the question of time limits for money GDP figures it might be two or three years or even longer before even reliable figures are available. Is this likely to be a figure to influence public expectations if it is a figure which is not reliably known only two or three years after the event?

(Mr Lawson) As I indicated, what I think influences public expectations myself is our track record. As for money GDP, this has always been there because the objective is to bring inflation down and the way you bring inflation down is by operating within a nominal framework which is money GDP ~~because experience shows~~ (and this is the difference between the policy we are pursuing and the policy ~~the~~ previous Governments have pursued). Money GDP is, if you like, an amalgam of two things, the real rate of growth and the rate of inflation. Previous governments tended to attribute some kind of magical property to money. They felt that by in effect expanding the supply of money, whether you do this directly by monetary means or indirectly by a large Budget deficit, you would therefore magically get a higher rate of real growth. What experience shows is you get a higher rate of money GDP, but only because inflation is higher not because of real growth. Real growth depends on a whole lot of real things which the Government can influence to some extent by its micro-economic policies, supply side policies, if you like. In other words, under our policy the role of money is a much more modest one. It does not have any magical properties. If there is too much of it around it is likely to lead to an excessive rate of inflation. In other words, it is the way in which you squeeze inflation out of the system; your objective is to reduce the rate of growth of money GDP and the way you achieve that is through your monetary policy including, of course, the exchange rate.

171. The trouble with the track record is for almost three years, now perhaps ended, inflation has been going up rather than down and has certainly not moved in correspondence with money GDP.

(Mr Lawson) I do not accept that for a moment.

172. It is in your Book chart 2.1.

(Mr Lawson) The RPI is not the most accurate reflection ~~but~~ in any event because of the curiosity of the mortgate rate being in the RPI (which is not the case in most other major countries, Canada is the only one that has it), ~~this~~ which creates a distorting effect.

Chairman

173. This is part of the cost of living.

(Mr Lawson) You do not expect to get a straight line in life. Inflation goes down but it does not go down in a straight uninterrupted line, I find nothing surprising in that. It has come down from whatever the figure, 20 per cent or so, in 1980 to 5 per cent now and it is going to go down to 3½ per cent by the end of this year. That is what we are forecasting and, of course, money GDP has been going down too. The most interesting and most important chart in all this, if I can find my copy of the Red Book, I do not know where I have put it, is right at the beginning, that is why we put it at the beginning ~~on~~ in? the chapter on medium term financial strategy where you do see a very close correspondence between the rate of growth of money GDP and the rate of change in retail prices but you see no correspondence at all between the rate of growth of money GDP and the rate of growth of real output, QED as they say.

Mr Wainwright

174. Your correspondence is different from mine because GDP is shown as rising towards the end of 1985 with prices falling.

(Mr Lawson) Sir Terence Burns would like to say something.

(Sir Terence Burns) With all the best will in the world, looking at the first frame of chart 2.1 I find it difficult to get the message from this that these two things are moving in two quite different directions. I would have thought the overwhelming impression of these things is the story the Chancellor has explained.

175. The first story is three years of rising RPI.

(Sir Terence Burns) Broadly flat.

176. A mortgage is what secures people a roof over their heads and bedrooms for their children, they have to do that.

(Sir Terence Burns) What this chart shows is that over the last three years the inflation rate has been broadly flat as has been the growth of money GDP.

177. The interpretation of diagrams must have moved on since I was educated!

(Sir Peter Middleton) That is what it does show.

(Mr Lawson) It really does show that, Mr Wainwright. I know you are a very fair minded individual even though you try and conceal this from time to time. The plain fact is that ~~what~~ there has been ~~is~~ a sharp fall in inflation fromthe peak in 1980 to 1983. This was exaggerated, this trough, in 1983 by the mortgage rate factor. I am afraid, although it is a minor issue, it is a fact that although over a period it does not make any difference, in the short run it does distort the ~~thing,~~ trend, sometimes to the advantage of the ~~thing,~~ inflation figure, sometimes to ~~the~~ its disadvantage and it was clearly advantageous in 1983.

Chairman

178. A correlation of interest rates?

(Mr Lawson) You see the thing going down sharply then you have a period in which it has been fairly flat, that is quite remarkable in itself because, of course, that period of flat prices came with the sharp recovery and the sharp period of steady economic growth. If you recall what was said at the time when you only had that first phase when inflation was going down, People said ~~it is~~ then that it was easy to have inflation going down because ~~you have~~ we had this dreadful recession, that ~~is~~ was the only reason it ~~is~~ was going down, but as soon as there is economic recovery although half the people ~~say~~ said economic recovery ~~is~~ was impossible ~~or if it is possible~~ you will have inflation shooting up again~~;~~ In fact we have had the economic recovery, ~~it~~ and inflation has remained broadly flat and ~~it~~ is projected to go lower. If you are a fair minded person ---

179. Would it not be fair minded and more helpful to the House of Commons Committee if you gave us a diagram of the rate of inflation as you think it ought to be compiled?

(Mr Lawson) There is, I believe, a company in the City of London called Phillips & Drew who regularly publish the rate of inflation, the RPI, with mortgage rate knocked out of it and you can see that for yourself if you wish to and see a much smoother path.

180. Not many of my constituents are clients of Phillips & Drew, or any other City stockbrokers. My last question, because time is going on fast, is really to ask you to raise the curtain, at least for the benefit of the House of Commons, on this speech you are to make as late as the middle of April?

(Mr Lawson) I cannot, I have not written it yet!

181. Your passage in your Budget on monetary conditions was much shorter than usual and we would like to know your assessment of current monetary conditions. For instance, are you concerned at all at the build up of private sector liquidity at the present time in spite of extraordinarily high interest rates and low growth rates of M0?

(Mr Lawson) Of course the high interest rate in itself creates a demand for holding these interest bearing forms of money which you refer to as liquidity.

182. Nevertheless, does it cause you any worry that the present liquidity does appear to have built up in volume?

(Mr Lawson) I see no danger in the present level of liquidity.

183. Nor in the trend of it?

(Mr Lawson) No. Clearly I think it is something we need to watch all the time and that is why we retain a broad money target. I see no danger.

(Sir Peter Middleton) The trend is down at the moment. The most recent figures for M3 are down a little. Lots of other countries have got high growths of liquidity; ours is the same as Japan.

184. What about otherindicators that used to be used in the Red Book, the PSL and so on?

(Mr Lawson) There is no great difference between what has been happening to any of the measures of broad money, they show much the same picture for very much the same reason.

Mr Budgen

185. I have four short points. Firstly, your point about your being entitled to draw upon your good record from 1979: in 1979 and for some years after that the general wish of the people was that the control of inflation should be the single most important objective of Government, surely now the objectives of the generality of the population are more various and if you wish the MTFS to have any strength you have to now emphasise not just flexiblity and the room for judgment and manoeuvre but all the rest of the things you constantly put into your speeches so as to give yourself a bit of elbow room but you have to emphasise against the grain, perhaps, of the nation that the control of inflation remains foremost?

(Mr Lawson) I do not believe the nation itself wants to see a resurgence of inflation. I do not believe the change has been as fundamental as you indicate although it is perfectly ture there is a tendency, I think it is a mistaken tendency, in some quarters to take low inflation for granted whereas before in the period of high inflation people were more concerned and worried, particularly the pensioners and the elderly but I think the business community too, as to how they would survive in society like that and where it was going to lead to. I think maybe there is to some extent a taking for granted of the lower levels of inflation we have now which is not warranted. I think still it is clear that people would not wish to see any resurgence of inflation. As to the question of judgment, I can assure you I refer to judgment, Mr Budgen, not to give myself room to be lax, it is not for that reason at all. I refer to judgment because I think it is helpful for you and others to have an honest explanation of how monetary policy actually is operating in the real world and there is nowhere in the real world it can be operated without the exercise of judgment by those responsible for conducting it.

186. Can we now just quickly look at monetary conditions today? Leaving aside the monetary aggregates some of the things you look at are the retail price index, house prices, share prices and wages, let us leave wages out of it because you constantly tell everybody about the importance of wages, if I may so, in a manner almost reminiscent of 1971/72/73 and 1974.

(Mr Lawson) There is an important difference in that because what I have stressed is the link between pay and jobs ~~products~~ which was not expressed in those days at all, it was all about pay and inflation. There is an important difference.

187. Let us look at the RPI. You said a moment ago the RPI was not a wholly satisfactory indicator and, of course, it does refer only to the balance of goods and services. Not only, though, can it be severely changed, as you point out, by changes in interest rates because of the effect on the mortgage interest rate, is it not the case it can look especially favourable if there is a fall in commodity prices?

(Mr Lawson) In the short run it can. The fall in commodity prices~~, it is~~ is itself an interesting ~~question.~~ phenomenon. There is a lot of talk at the present time about how inflation is low worldwide, coming down worldwide, because of the fall in commodity prices. I think that is getting the chain of causation the wrong way round. It is true of course there is some circularity in how that chain works, ~~the cause of the chain,~~ because the causal ~~the cause of~~ nexus works both ways, but I think the fundamental point is that it is because the major nations of the world have been pursuing anti-inflationary policies that we have seen commodity prices come down, just as in the 1970s when everybody was pursuing inflationary prices prices were going through the roof. Not just oil, incidentally: people think there was simply an oil explosion, but that is a myth. If you look at metals, they were rocketing through the roof also.

188. If you look at house prices they, on average, were up 10% in 1985, that may be an indication of loose credit, may it not?

(Mr Lawson) I do not think it is. There has been no acceleration in the rate of growth of house prices and house prices tend, for obvious reasons, to reflect the rate of growth of earnings.

189. What about share prices up over 20% or so this year, is that an indication of loose credit?

(Mr Lawson) I do not think credit is loose. I am sure you will be particularly glad to know what has happened on the stock exchange over the past day or two.

190. Mr Beaumont-Dark tells me it was up 25% but it has now dropped to 22% which is why I used the expression "over 20%".

(Mr Lawson) Let me ask you a question, Mr Budgen.

191. No, no.

(Mr Lawson) I have been very patient.

192. It would be impertinent of me to answer.

(Mr Lawson) Do you think inflationary conditions, ~~the~~ monetary conditions, are lax worldwide, do you think they are lax in Germany, the United States and all other major countries, because we have had this great growth, this great stock exchange boom~~?~~, worldwide?

193. I am not paid to have a view on this, I am a part-timer asking you a few questions.

(Mr Lawson) The answer to your question is no.

(Sir Peter Middleton) I think in one way they are getting tight because there is a chance the OECD deficit will come down in the coming years.

(Mr Lawson) It is not surprising either. I referred earlier to the improvement in profitability, company profitability. Far be it from me to say any particular level of the stock market is right or going to endure but it is not surprising when you ~~take~~ have this great improvement in profitability which we were talking about a little bit earlier ~~which~~ that it is to some extent reflected in the price of shares on the stock exchange.

194. But the profitability itself may be a reflection of credit conditions, may it not?

(Mr Lawson) I think it is unlikely and I do not think it is the case.

195. You rather dismissed a question of Mr Wainwright's a moment ago about liquidity. The Bank in its December quarterly bulletin at page 520 put it rather differently, they said: "The fact that the economy is becoming increasingly liquid means monetary policy will increasingly have to recognise and take account of the risks ..." of the risks "... that this implies."

(Mr Lawson) Of course, we do take account of them.

196. You rather talked them down.

(Mr Lawson) I do not think there are any dangers. We do take account of them. Anyhow, it is the Government and ultimately it is I who ~~interpret and determine~~ (interpret monetary conditions and determine monetary policy). I obviously do listen to the views of the Bank of England who are very expert in money fields but ~~the~~ monetary policy is determined by me.

(Sir Peter Middleton) Could I add a point?

197. Please?

(Sir Peter Middleton) There is in a sense always a riks somewhere inthe monetary field, the question you have to ask yourself is are your defences intact and, of course, M3 is not a defence, it is the first warning signal, there is also MO that you would expect a high level of M3 to show up in and the exchange rate, all of which we take account of in determining interest rates.

198. At any event present credit conditions, which you have to take account of in the many other things you exercise your judgment on, reflect, do they not, the monetary conditions of a period some time before?

(Mr Lawson) Yes.

199. It is possible, is it not, to have, for instance, lax credit at the present time but tight monetary controls or vice versa, you could have tight credit at the present time but lax monetary controls and the risk of inflation for the future?

(Mr Lawson) It is obviously possible that there could be some inflationary risk in the future, say, ~~I do not know what you mean,~~ two years out or something like that, which clearly is unlikely to be indicated by MO or the exchange rate now where the relationship is rather shorter term. But, I have to say I see nothing in current circumstances to indicate an inflationary surge two years out nor indeed to go back to the track record is there anything to suggest that despite pursuing the policy we are pursuing, have pursued in the past and will continue to pursue, you will get a resurgence in inflation.

200. There are many commentators who see yourself as shuffling your way towards getting into the European Monetary System as being something which you regard as, for a number of reasons, a better discipline than the monetary aggregates that you yourself put in place. Is it not now obvious that having attempted to persuade many people, the country and your Cabinet colleagues, of the desirability of joining EMS that you have failed in that endeavour; would it not be better now to recognise that failure and go back to the old discipline?

(Mr Lawson) I do not accept your question.

201. Which parts?

(Mr Lawson) Therefore, I cannot answer it.

202. I will be perfectly prepared to divide it up. First of all, do you agree that by the apparent abandonment of sterling M3 in your Mansion House speech you were saying to the nation: "I now have no satisfactory discipline"?

(Mr Lawson) No, I was not saying anything of the sort.

203. It might have been an interpretation that you were then giving an opportunity for yourself to be able to say: "I am looking for a better discipline"?

(Mr Lawson) In the Mansion House speech, if you read it, it states if very clearly, how we would operate a monetary policy ---

204. I have it here.

(Mr Lawson) It talked about monetary policy, about narrow money ~~monetary~~ --- it talked about the fact that the old broad money target was clearly inappropriate, why it was inappropriate, why it would therefore be inappropriate to try and get it back within the target range, why therefore I was suspending that particular target range and that I would come back at the time of the Budget and set a new one which is precisely what I have done. It also talked about the role of the exchange rate. All those things were set out very clearly. None of that was an abandonment of monetary discipline nor was it contingent on joining EMS.

205. Final question, for instance Mr Leon Brittan (who may well be on this matter close to your thinking) said on Monday that he thought the way to achieve a convincing monetary policy was through the exchange rate and that was part of the first argument going towards EMS. If it be that you are not going to be able to go into the EMS, would it not be better to say

that clearly and openly and to admit (and I know you will not say this) if you have attempted a political persuasion and failed, would it not be better to say that openly than to, for instance, leave it uncertain as to whether you have either a desire to go into the EMS or whether you intend to rely upon the discipline of the monetary aggregates?

(Mr Lawson) No, our policy is not not to go into the EMS, our policy is to join the EMS when the time is right. I have given evidence about that to the Committee.

(Sir Peter Middleton) Could I make a point I have wanted to make on M3 ever since Mr Wainwright spoke. I think I turned up to give evidence at the very first meeting on MTFS to this Committee. As I recall it I was actually at pains to say it was not set in concrete round M3. No one monetary aggregate encapsulates the whole of the monetary conditions and that sort of thing. If you think of the medium term strategy it was inevitable so far as its precise monetary components were concerned, it was bound to evolve. The reason money GDP is there is to emphasise the continuity in MTFS while these aggregates have been changing in significance. M3 and wide aggregates have been changing in significance everywhere. I think there are two reasons for that - and they are common reasons to most countries - one is financial innovation which means both sides of a bank's balance sheet can rise at the same time while taking advantage of a more liberal trading scheme, which does not have any significance of view for the future of inflation, the second one is high real interest rates which influence the demand for M3 as an asset which meant it might be firmly held. Something like the present row of proposed M3 has been there throughout it is just that M3 is only there for one year this year because we are particularly uncertain about it.

Chairman

206. Both Mr Mitchell and Mr Townend wish to ask questions. Could I ask one question: you were asked about policies to join EMS when the time is right, given what has happened, the relevant exchange rate recently, do you think you could find a more appropriate time than the present in which to join?

(Mr Lawson) I think it is true that what has happened on the oil front has to some extent reduced the strength of one of the arguments against joining. On the other hand, we have not yet judged the time to be right.

Mr Mitchell

207. Does that mean you take the exchange rate against the Deutsche Mark particularly, but against the ECU as well - the Deutsche Mark is central - as still overvalued or is it now at a stage that will be compatible with membership of the EMS?

(<u>Mr Lawson</u>) We have been round this course, Mr Mitchell. I do not think it is simply, or even primarily, a matter of judging a particular parity to be right, it is much more questions such as to what extent is sterling different from other currencies and likely to be ~~pooled~~ pulled in a different way; the oil factor is one of them, which I indicated has been weakened; the extent to which the nature of the system would be changed because sterling is not like any of the other currencies in Europe other than the Deutsche Mark, in the sense that these are the two ~~wider~~ widely-held international currencies, is another.

208. Is sterling overvalued against the Deutsche Mark?

(<u>Mr Lawson</u>) I am perfectly happy with the existing pattern of exchange rates.

209. You deplored in an answer to Mr Beaumont-Dark what you call "economic racism" saying you want all parts of the economy to flourish, what about the parts this Government has reached only to clobber?

(<u>Mr Lawson</u>) Such as?

210. Such as the manufacturing industry. We have lost a quarter of our manufacturing industry and 28% of our employment. If that is your desire surely it is different to the experience in Germany and Japan where it was the international trading sector which gave the main drive to economic growth and which received preferential help in terms of investment and exchange rate management which has been the exact opposite of our experience where the international trading sector has suffered most from a policy of high exchange rates

and is still suffering. To help that sector you would have to have competitive exchange rates and lower interest rates.

(Mr Lawson) I am not aware that the successful German economy has been based on a declining exchange rate.

211. It was based initially on a very low exchange rate which gave them a competitive advantage and a stimulus to invest in the manufacturing industry to get into a virtual circle which we have never had.

(Mr Lawson) I do not believe that is the case. ~~If~~ Moreover ~~that were the case~~ we went through a period of very considerable devaluation of the currency in this country and it did not seem to do the trick here.

212. We still seem to have very high interest rates compared to Germany and Japan. We have an exchange rate which, I would say, is overvalued against Germany and Japan, how would you expect the manufacturing industry and the international trading sector to flouris in that situation?

(Mr Lawson) I am glad to say it is flourishing.

213. You said on labour costs and interest rates if labour costs were rising then it would be necessary to maintain interest rates higher than they would otherwise be. In other words if labour costs are going to go on rising, as seems to be the indication from the Red Book, over the year ahead we are going to have high interest rates or interest rates higher than our competitors?

(Mr Lawson) I think there is a simple point really at the bottom of this, an important point, and that is that it is ~~the~~ industry's job to control its own costs in order to be able to compete effectively in world markets against the Americans, the Germans, the Japanese and all the rest. It is not ~~a~~ the route that this Government is going to pursue to say to the manufacturing industry "You do not need to bother about your own costs because however your costs are inflated, we will float you off by depreciation". That is an alternative route, it is the route you espouse and that is the difference between us. What is absolutely clear is the success of the countries you previously mentioned has been achieved by those countries controlling their own costs and making themselves efficient and has not been through the devalulation route which you are recommending.

214. The Japanese domestic inflation has been fairly similar to ours, it has been keeping down costs in the international trading sector.

(Mr Lawson) If you go to Japan and look at ~~the~~ Japanese industry you will see that their efficiency has little ~~it has nothing~~ to do with the exchange rate, although until recently they have hitherto had ~~an~~ a substantially undervalued exchange rate.

215. If the Government is letting the City push up incomes and going for a massive assets speculation, as it is, if wage costs are going to go on increasing in this fashion it follows that wage costs are going to be higher in this country than those of our competitors?

(Mr Lawson) I do not think what is happening in the City has a bearing on this.

216. It does not leave -----

(Mr Lawson) I do not think that because it has been thought ~~it~~ worth paying an astronomical sum to have a young whizzkid foreign exchange dealer it follows that ~~because that has been paid therefore~~ it is sensible, or necessary, for industry to pay over the odds in wages for the workers that it needs.

217. Factually our unit labour costs are increasing more rapidly than those of our competitors, does it follow, therefore, that our interest rates are going to remain higher?

(Mr Lawson) As I said earlier, so long as our labour costs per unit~~s~~ of output are rising faster than our major competitors there will indeed be a tendency, which I regret, for our interest rates to be higher than they would otherwise be and higher than our major competitors.

218. You mentioned the prospect of bringing down interest rates, you mentioned there was a need for competitors to bring them down?

(Mr Lawson) If competitors bring them down that ~~is~~ provides a ~~healthy~~ healthier climate.

219. Does that mean we can bring them down if competitors bring them down but we will keep the differential?

(Mr Lawson) I am not being as precise as that because there are a whole lot of factors ~~we can bring~~ which come into play. I was merely pointing out if interest rates come down worldwide that, for obvious reasons, is a helpful factor in our market.

220. It does look like we shall continue to bear a heavier burden in this country?

(Mr Lawson) We shall see.

221. If interest rates and sterling are, indeed, high as a result of high unit wage costs how on earth are manufacturers going to improve their competitiveness? How are we going to improve the trade surplus in manufactures?

(Mr Lawson) By controlling, in their own interest~~s~~, ~~at these~~ their own costs, ~~but~~ including, ~~in their costs, which~~ and it is a big element, their pay costs. They can do that. There are times ~~at which~~ when they will have to say no, that is really what it boils down to, ~~that~~ it also means improving their productivity and thus being able to operate on both sides. On productivity they have been very successful, and I pay tribute to them, in recent years. On the productivity side there ~~will be~~ is scope for doing better still but they have been very successful on the productivity side. It is on the other side of the equation, ~~with~~ over levels of pay, that they have been less successful compared with our overseas' rivals. There is no reason why that cannot be put right by ~~the~~ industry itself.

222. They have been successful in improving the batting average by shooting the last three batsmen.

(Mr Lawson) That is a very tired ~~adjective~~ simile which probably you were responsible for originally and I am sure it was very good when it was first coined. There is a big difference if you look at the period of the last Labour Government, which you supported, and the period of the present Conservative Government. You will find that during both periodsthere was a decline in the output of ~~the~~ manufacturing industry both over the whole of the Labour Government and the period of Conservative Government so far but in the period of the labour Government this was ~~covered~~ coupled with an abysmal rate of growth of productivity in ~~the~~ manufacturing industry whereas ~~in~~ during this Government it has been accompanied by a very good rate of growth of manufacturing productivity, so that is a big change. You can have a decline in manufacturing output without any improvement in manufacturing productivity, as occurred under the last Labour Government. ~~The~~ Conditions in industry, the competitiveness and the efficiency of British industry, ~~has~~ have improved very considerably and I am sure you welcome that in ~~the~~ manufacturing industry.

223. But if as seems to be the case our exchange rate is higher because our interest rates are higher than our competitors how can you expect manufacturing industry to compete effectively bearing that double burden?

(Mr Lawson) I did not say the exchange rate was higher, the interest rate was higher.

224. Let me ask you: is the exchange rate where you want it to be? It is higher than it was in March last year.

(Mr Lawson) Of course it fluctuates to some extent because we are not in a fixed rate system and of course there have been great gyrations of the dollar over the period to which you are referring but as I said earlier I am perfectly content with the ~~policy~~ pattern of exchange rates we have at the present time, though I think the yen ought to appreciate ~~earlier~~ further.

225. How can industry compete with the ball and chain of higher interest rates and higher exchange rates?

(Mr Lawson) First of all, it is competing quite effectively at the present time. Our exports are rising quite rapidly and ~~certainly~~ are at an all time record, manufactured exports, by a long chalk. What I find puzzling about your approach is you seem to assume that industry itself is quite incompetent to control its own costs ~~and money~~. I do not believe that.

226. I assume in your prediction for a consumer demand in the year ahead you are assuming wage rates and labour costs are going to go up because it is the major part of the stimulus. This is the major part you are looking at for consumer demand. You are saying out of one side of your mouth you are against wage increases and on the other side you are saying we are for it, we are looking for a boost for the year ahead.

(Mr Lawson) Of course if ~~the~~ wage costs per unit of output were going up less then you would find to some extent possibly some slight reduction in the forecast level of consumer demand. It is difficult to say. You would have higher employment and increased consumer demand from those at present unemployed who would then be employed. That would be an important beneficial offshoot and that is what this Government wants to see. Also you would no doubt have a higher level of exports contributing to higher growth. I do not accept for a minute ~~at all~~ that the rate of growth would be any less; indeed, in the medium term it would be greater.

227. The last question in the penultimate waltz, leaving aside the question of whether it is justifiable to sell what belongs to all of us to provide tax cuts for some of us, why did you opt for tax cuts rather than spending the money to stimulate the economy either through public spending or going directly to job schemes of the kind recommended by the Employment Select Committee. The money for that comes out of the reserves, therefore it is not a substantial stimulus to the economy. Why did you opt for that path when the crucial question facing this economy is employment, when all models show that and when all the opinion polls show people are prepared to pay taxes if it helps the unemployed?

(Mr Lawson) I do not think the models that show that are very helpful because they cannot capture the supply side factors which are critical for employment to any worthwhile extent at all. As for the question of why this Budget was largely, not exclusively, about tax rather than public expenditure that is because that is the way we operate things in this country. We have a public expenditure round which is about public expenditure, the results of which are announced in the Autumn Statement, and the Budget is about taxes.

228. Chancellor you have been most generous with your time but Mr Townend has been most patient throughout.

(Mr Lawson) He has indeed and I commend it.

Mr Townend

229. You have made it clear you are concerned that industry should keep its costs down, are you as perturbed as I am in Table 1.2 that the loss of oil revenue seems to be partly balanced by revenue in the corporate sector but also by an increase of estimated receipts from refunds of two billion? This is a cost that the industry cannot control, this amounts to an increase of over 14% which is four times the rate of inflation.

(Mr Lawson) I am sorry?

230. It is an increase of 14% which is four times your estimated rate of inflation which is a burden industry could well do not to have to carry. Does it indicate a failure of the Government's policy to control local government spending?

(Mr Lawson) The control of local government spending has always been the weak link in the Government's overall public expenditure control because of the constitutional autonomy of local government and we have sought various means which have been, I think, more successful than governments in the past past have ~~experienced~~ been in controlling local government, or influencing local government expenditure. But ~~It~~ has been very far from the sort of control we would like to see. There have been quite sizeable overspends in most years and we try and allow for that in the reserve. It is a problem and, of course, it has recently been exacerbated and one of the consequences of this ~~we see~~ is higher rate increases than normal. That is ~~the~~ rather a problem for industry.

231. Four times the rate of inflation is ----

(Mr Lawson) The rate of increase in rates, yes.

232. Four times the rate of inflation.

(Mr Lawson) Not four times the present rate of inflation, four times the rate of inflation by the end of the year. But it ~~That~~ is unsatisfactory.

233. In your Budget there was no mention of the National Insurance contribution, does that mean the Government feels it has now got the balance about right as far as contributions are concerned?

(Mr Lawson) The reform, the restructuring if you like, of National Insurance contributions which I introduced in the 1985 Budget and which was ~~not~~ the first time it had been done ~~but it~~ was a very substantial one, It gave relief at the lower end of the scale for both the employees themselves and the employers who employ people at the lower end of the pay scale ~~which was~~ of well over a billion pounds which was very substantial . I think it is unreasonable to assume that despite the fact that ~~because~~ it was a very substantial change ~~that~~ it is somehow ~~in that~~ only a first instalment. ~~I do not see that they face~~ It was an important change which will have beneficial results.

234. Turning to income tax, I welcome the reduction in the standard rate but people still consider there is a significant "Why work" problem . Do you hope to be able to deal with that in the next Budget?

(Mr Lawson) I see Mr Howell has left us, I do not know if that question is on his behalf. I would like to see - the Government has consistently wished to see since it came to office in 1979 - thresholds raised and the rates of tax, both the higher rates ~~as able to operate because it costs so much~~ and the basic rates, reduced. I would like to see progress on both fronts. If you look at where we are now, we have a threshold which ~~is~~ as a proportion of ~~the~~ average earnings ~~which~~ is roughly in line with the OECD average and, indeed, ~~it is~~ we have now a higher threshold for the married man as a proportion of average earnings than a ~~This is the case~~ in important countries like the United States or Germany. Whereas if you look at the basic rate of income tax, which is the starting rate of tax, ~~it is~~ we have one of the highest starting rates of tax, probably the second highest, of any of the ~~leading~~ OECD countries. ~~It~~ The basic rate is particularly important, too, in that it is the marginal rate of tax for 95% of the population. It is also, of course, the marginal rate of tax for the unincorporated sector of business. It is an important objective to get that down. Each year one has to choose what one's priority is when there is a limited amount, if anything, that can be done.

235. Last point, Chancellor, the change in CTT in the abolition of lifetime transfers has been very much welcomed by private businesses, family business, as a means of continuing from one business to another. It is a little surprising that the changes with regard to discretionary trusts seem to go the other way and indeed make it more difficult to make provision for people dying out of turn. It seems strange having given with one hand you are half taking back with the other. What is the thinking behind that?

(<u>Mr Lawson</u>) ~~There were, first of all, certain changes that were made.~~ I am grateful to you for your remarks about the value to the ~~family,~~ very important family business sector of the economy of the abolition of the tax on lifetime gifts, I, too, think this is important. ~~First of all,~~ But at the same time, there were certain, ~~really~~, avoidance devices which needed to be stopped through the use of trusts and of course if you have an inheritance tax, as we now have, which ~~gets~~ taxes capital at that stage which I think is the least damaging stage if you are going to have any form of capital tax (and it is also a stage, incidentally, where there is no capital gains tax liability whereas with lifetime gifts there is a capital gains tax liability which can in certain cases be rolled forward but it is always contingently there) if you are going to do that it is very important to protect the yield of that tax by not having a loophole through the trust device.

I am all in favour of trusts for the purpose that trusts ~~are~~ were first minors, for example ~~there,~~ if there is a minor and it is right therefore that his capital should be held in trust, or for whatever other reason, but I am not ~~indeed~~ in favour of trusts as a tax avoidance device, that is not what they were originally invented for. So, certain changes had to be made but fundamentally the trust regime ~~had~~ has ~~to be made~~. remained ~~[illegible]~~ as it was.

Chairman

236. We are most grateful to you for giving us such full answers to a number of questions. Now I am tempted to suggest we might have a note on the relevant question of track record against medium term financial strategy, perhaps we will not do that. There are one or two questions as to the way you see the economy working with regard to interest rates. We are most grateful to you and Sir Terence and Sir Peter for coming along this afternoon.

(Mr Lawson) Thank you very much, I have enjoyed your questions and it is always helpful to me to come before this Committee. If there are specific points on which you would like further enlightenment, written enlightenment, as you know you have only to ask.

Chairman: Thank you very much indeed.

Phillips & Drew

ECONOMICS UNIT

THE 1986 BUDGET : AN ASSESSMENT

A memorandum to the House of Commons Treasury and Civil Service Select Committee. Submitted by Bill Martin, Specialist Adviser to the Committee, on 27 March 1986.

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27 March 1986

THE 1986 BUDGET

An assessment for the House of Commons Select Committee on the Treasury and Civil Service by Bill Martin, Phillips & Drew, Specialist Adviser to the Committee.

Loosening the reins

The Budget provides a modest stimulus to the economy. Although the plans indicate that the public sector borrowing requirement (PSBR) will remain at the magical level of £7bn into the unforeseeable future up to 1989/90, the planned public sector financial deficit (PSFD) rises by £2bn, from £10.2bn in 1985/86 to £12.2bn in 1986/87. As a percentage of GDP, the PSFD rises by a little over ¼%

The contrasting movement of PSBR and PSFD reflects the boost to the privatisation programme. 'Net cash expenditure on company securities', largely public sector asset sales, rises from £2.7bn in 1985/86 to a planned £4.8bn in 1986/87. Unlike the PSBR, the PSFD is struck before deduction of privatisation proceeds, and therefore rises even though the PSBR remains broadly flat.

The increase in the PSFD will probably exceed £2bn if oil prices remain below the $15 per barrel assumed in the Treasury calculations. The Chancellor has given no firm indication of how fiscal policy would be re-set in these circumstances. But the general tone of the Budget suggests that he would treat an oil revenue shortfall as water under the bridge. Borrowing would then rise above target.

In addition, public expenditure may well exceed plans in 1986/87 and, more especially, in later years. Although the Chancellor has an unusually large contingency reserve up his sleeve - £4½bn in 1986/87, rising to around £8bn in 1988/89 - it is there for good reason, notably the feeble nature of the plans for local authorities. The reserve will appear as a pot of gold to spending Ministers pressing for increases in programmes in the run-up to the election. Already, £4bn of extra bids for 1987/88 have been rumoured.

Further pressure on borrowing may well come in the wake of the renewed emphasis on the Government's long term aim to bring the basic rate of income tax down to 25p. After he has delivered a £1bn reduction in income tax this Budget, it is difficult to imagine the Chancellor accepting anything less in 1987. At present, he has pencilled in a £2bn 'fiscal adjustment' in 1987/88, followed by a further £4bn in 1988/89, figures consistent with the 25p aim only if public spending pressures are contained.

The impression formed, therefore, is of a small planned easing of fiscal policy in 1986 and the likelihood of an easing rather greater than planned in both 1986 and 1987. We would not be surprised if the PSFD (adjusted for other asset sales, mainly of council houses) rose from under 3½% of GDP in 1985/86 to 4% or over in 1986/87 and 1987/88, assuming oil prices of $15 a barrel. At that percentage of GDP, the budget deficit would be similar to the level reached in 1979.

Further evidence of an easing of the fiscal stance comes from a comparison of last year's and this year's plans for borrowing. This easing occurs despite the fact that the new £7bn PSBR target for 1986/87 is £½bn below the number projected in the 1985 Budget statement.

We look in vain to the Chancellor for a clear explanation of the basis of the revised target. Down a bit for extra privatisation, say some. Up a bit for loss of oil revenues, say others. The Chancellor concluded: 'the wisest course is to stick broadly to our pre-announced figure', though he erred on the side of caution (?) in view of oil price uncertainties. An uncharitable interpretation of the Chancellor's thinking is that it is influenced chiefly by the perceived need to appease financial markets, influenced by the City's 'teenage scribblers', on the one hand, and, on the other, by his need to deliver politically - useful tax cuts.

Adjustments to the original £7½bn PSBR number for 1986/87 ought to have been discussed under three heads. These concern: the extra £2½bn of public sector asset sales announced last Autumn, the £5½bn shortfall in oil revenues in 1986/87 and the upward revision to non-oil tax revenues of nearly £4bn (a figure which allows for the 1p reduction in the income tax rate). In the following, we give an account of our thoughts about how the PSBR target should have been re-assessed.

Asset sales

Asset sales should be treated as financing items and deducted from the PSBR target unless it is believed that the private sector finances such purchases out of **extra** saving. We do not believe this. Treating last year's plan as baseline, we arrive at a revised £5bn PSBR target under the first head.

Oil revenues

Adjustments for changes in tax revenue, whether oil or non-oil, must take account of the reasons for the differences against earlier projections. The oil revenue shortfall in 1986/87, the difference between the £11½bn forecast last year and the £6bn forecast this year, largely reflects the unexpected collapse of oil prices worldwide. £4bn of the £5½bn shortfall is accounted for by lower dollar oil prices. Another £2bn is attributable to the unexpected strength of sterling against the dollar, while higher-than-expected oil production adds around £½bn.

In certain circumstances, it is legitimate to argue that a rise in the budget deficit caused by lower oil revenues will have little stimulating effect on the economy. The argument is often based on the notion that, as a high proportion of North Sea profits are remitted abroad, North Sea taxes have a demand impact, pound for pound, much smaller than that of most other taxes. Lower oil revenues, on this view, do not lead to more money in the pockets of spenders in the UK. This is not the case, however, when the fall in oil revenues results from a fall in dollar oil prices. The counterpart of the reduction in Government oil revenues is a worsening of the UK's balance of payments and an immediate rise in the income of households and, in particular, of non-oil companies, as oil costs fall.

Should the PSBR be allowed to rise in these circumstances? Or should other taxes be raised to compensate for the loss of oil revenue? To our mind the latter course is the correct one though it should be noted that the effect of the oil price boost to company sector incomes will not offset precisely the effect of a tax increase - or reduced income tax cut - hitting the consumer. The differences seen at the level of total demand in the economy are likely to be marginal, however. In general, the contention that, on demand management grounds, the budget deficit should be permitted to rise as the dollar oil price and oil revenues fall is, in our view, unwarranted.

Not only unwarranted, but positively undesirable. The economy may well suffer from too much rather than too little demand following a fall in the oil price. Extra demand for UK goods will result from the consequential decline in sterling and improvement in competitiveness. Foreign demand for UK exports will rise; domestic demand will switch from imports to home-produced substitutes. The danger is that the increase in profits and activity in the manufacturing sector and in other sectors engaged in international trade will lead to the bidding-up of wages and prices.

The problem of too much demand would be lessened to the extent that lower oil prices increased the capacity of the economy to meet extra demand. It may be possible, for example, to bring back on-line any high energy-using plant currently standing idle. Also, expenditure on energy conservation may now be directed more profitably towards boosting industrial capacity. But the size of such supply-side benefits is questionable. To the extent that they exist, they could well take a very long time to emerge.

Overall we take seriously the risks of the economy over-heating following the stimulus provided by a fall in world oil prices. These worries are increased by the Chancellor's decision to relax his fiscal policy stance.

£2bn of the £5½ bn oil revenue shortfall is attributable to the rebound in the sterling-dollar rate. That rebound reflects, though to an exaggerated extent, the tightening of monetary policy last year. It is sometimes argued that fiscal policy can be relaxed in circumstances when monetary policy turns out to be unduly restrictive. This would give fiscal compensation for high interest rates.

The sensible thing to do, however, is to reset the monetary policy dials and thereby bring fiscal and monetary policy back into better balance. Our general view is that fiscal policy is already too lax while the level of real interest rates and the real exchange rate is too high. Consequently, we are not moved by this excuse for fiscal loosening.

The case for a rise in the budget deficit in response to lower oil revenues could be made on other grounds, which have nothing to do with demand management. The approach popularised by Treasury economists, Messrs Odling-Smee and Riley, argues that the budget deficit should be reduced by an amount which reflects the temporary nature of the North Sea windfall. Unlike the proverbial pools winner, the Government would then be wisely saving and investing the cash against the day when the windfall disappears. An implication is that the budget deficit should rise when oil revenues, and so the required level of saving out of oil revenues, fall.

We like this approach. The Chancellor does not. His dislike may owe something to the fact that the required level of saving out of the £11½bn of oil revenues in 1985/86 was probably of the order of £9-10bn. In 1986/87, the required saving level might be half that at around £5bn. This provides a rationale for a £4-5bn rise in the budget deficit but only from a baseline which accurately reflects the need for prudent investment of the oil bonus.

Since the Chancellor regards such calculations of 'no practical use whatsoever', it is legitimate to assume that the PSBR targets laid down and projected in the 1985 Budget took no account whatsoever of the temporary nature of the oil revenues. Had they done so, the £7bn PSBR target for 1985/86 would have been transformed into a target budget surplus - a negative PSBR of £2-3bn. The 1986/87 PSBR figure consistent with last year's projections and the new level of planned asset sales - £5bn - would be reduced to zero by this oil adjustment. No basis here for the announced £7bn target PSBR.

Non-oil revenues

In establishing that target, the Chancellor took advantage of the buoyancy of non-oil taxes (on incomes, expenditure, capital, plus national insurance contributions). It is difficult to make precise calculations of the Treasury's forecast of the appropriate tax base - non-oil money incomes (wages and profits) - and our figures differ a little from those provided by Mr Christopher Johnson in his memorandum. It appears, however, that non-oil taxes in the Treasury's arithmetic are a fairly stable proportion - about 37-38% - of non-oil GDP. Consequently the upward revision to non-oil tax take in 1986/87 largely reflects an upward revision - over 4% - to the projected level of non-oil money incomes.

As a matter of principle, it is perfectly sensible for the Chancellor to take advantage of tax buoyancy in his Budget judgement to the extent that buoyancy reflects a fundamental improvement in the economy's performance. If this is the case, he can contemplate a sustained reduction in tax rates without fear of stoking-up inflation.

The buoyancy of non-oil revenues does not however stem primarily or even largely from this source. Of the extra near £4bn of revenue in 1986/87 around £3bn comes from a higher-than-expected level of domestic prices outside the oil sector; the remainder is due to a higher level of real activity. A higher starting level in 1985/86 helps. Non-oil money incomes may have been 2½-3% higher than the Treasury was expecting in 1985/86. However, probably £1½bn of the extra tax take stems from an upward revision to the forecast for domestically generated inflation and above-normal growth in 1986/87.

In his Spring 1981 Budget Speech, Sir Geoffrey Howe, the then Chancellor, established the principle of adjusting the PSBR target to take account of unexpected changes in economic circumstances. At that time he was concerned to raise the PBSR target on account of lower-than-forecast activity. For consistency's sake, Chancellor Lawson should have reduced his 1986/87 target by around £1½bn because activity and prices are now rising faster than previously thought. The PSBR figure of £7½bn pencilled into last year's plans turns out at £3½bn after adjusting for the new level of planned asset sales and the unexpected buoyancy of non-oil tax revenues.

General observations

As regards fiscal stance, we find there has been a deliberate but modest easing of policy; that, in the event, the easing may well turn out greater than planned; that there is no coherent rationale for the planned budget deficit; that the PSBR target for 1986/87 would have been half the level now planned had the Chancellor sought to ensure consistency with last year's projections; that there is no good reason to raise this target on account of the shortfall in oil revenues in 1986/87, but that there may be good reason to reduce borrowing still further to reflect the temporary nature of the North Sea bonus.

The easing of policy in 1986/87 appears to owe as much to the election cycle as to anything else. Consequently, we expect a further easing of fiscal policy in 1987. This comes at a time when the Chancellor's money supply targets are regarded with either derision (MO) or alarm (£M3). In the absence of an explicit exchange rate target, there exists confusion and uncertainty about the conduct of the Government's monetary policies. On this topic, the exposition in this year's Red Book maintains traditional standards. It makes up in obscurity what it lacks in style.

The absence of formal lines of defence - in the shape of credible money targets for example - leaves the Chancellor's policies vulnerable to flights of financial market confidence. Markets are likely to be most forgiving while inflation falls this year. As Mr Lawson said at last year's Mansion House speech, inflation is 'judge and jury'. We would not wish to quibble with the Treasury's inflation number of 3½% by the end of 1986, nor indeed with its overall growth numbers into 1987.

We part company however on the inflation outlook next year. The Treasury expectation of 3½% or so inflation must surely owe a great deal to an assumed reduction in pay inflation - possibly to 5-5½% in the course of 1987. Low price inflation may encourage wage moderation. But there are very powerful upward pressures on pay now in the system: robust company profits, a weaker exchange rate, a growing economy, a tightening labour market, ample supplies of bank credit. While we welcome the Chancellor's intention to encourage profit-sharing schemes as a means of promoting greater pay flexibility, we fear it will be too little, too late. 1987 may well be a year when the economy begins to over-heat. And the strain will show on pay and on sterling.

Having obtained acquittal in 1986, Mr Lawson will have to hope that neither judge nor jury presses for a retrial in twelve months time.

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CC CHANCELLOR.
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Your reference

Our reference

Date

14 April 1986

Dear Bill

TCSC ENQUIRY INTO THE BUDGET

... I attach a corrected copy of the transcript of the evidence given by the Chancellor, Sir Peter Middleton and Sir Terence Burns to the Committee on Wednesday 26 March 1986.

Yours sincerely

Richard

RICHARD PRATT

[CORRECTED COPY]

HOUSE OF COMMONS

MINUTES OF EVIDENCE

taken before the

TREASURY AND CIVIL SERVICE COMMITTEE

WEDNESDAY 26 MARCH 1986

THE RT HON NIGEL LAWSON, MP,
SIR PETER MIDDLETON, KCB, and SIR TERENCE BURNS

Evidence heard in Public

Questions 133 - 236

MEMBERS' CORRECTIONS

Any Member of the Committee who wishes to correct the Questions addressed by him to a Witness is asked to send the correction to the Committee Clerk as soon as possible.

Members receiving these Minutes of Evidence are asked to ensure that the Minutes are confined to the object for which they are printed the special use of the Members of the Committee - and are not given wider circulation.

WEDNESDAY 26 MARCH 1986

Members present:

Mr Terence Higgins, in the Chair
Mr Anthony Beaumont-Dark
Mr John Browne
Mr Nicholas Budgen
Mr Mark Fisher
Mr Ralph Howell
Mr Austin Mitchell
Mr John Townend
Mr Richard Wainwright
Mr John Watts

THE RT HON NIGEL LAWSON, a Member of the House, Chancellor of the Exchequer, examined; SIR PETER MIDDLETON, KCB, Permanent Secretary, and SIR TERENCE BURNS, Chief Economic Adviser, HM Treasury, called in and examined.

Chairman

133. Mr Chancellor of the Exchequer, we are most grateful to you and to Sir Peter Middleton and Sir Terence Burns for appearing before us again following a Budget Statement. As you know, the programme has been a little condensed this year because of the intervention of Easter between the beginning of our inquiry and the end, but we hope to take evidence after Easter from the TUC and the CBI and also from the Governor of the Bank of England, before making a Report ahead of the Second Reading of the Finance Bill. There is just one matter which I would like to mention at the beginning. We had occasion, when we discussed the Public Expenditure White Paper, to express appreciation to officials for the way in which they had taken into account the various recommendations which we had made on presentation. I would like on this occasion again to express appreciation for the work which has been

done by the Treasury in making the Red Book more readable and in providing more information on the basis of the recommendations which we had made in previous Reports. We would like you to know that we do think that that is a worthwhile exercise, and we hope we shall continue to make recommendations which are helpful both to the Government and to the House of Commons. That having been said, you are most welcome. Perhaps I might ask you if there are any initial remarks which you would like to make, and then we can proceed straight away to questions?

(Mr Lawson) Mr Chairman, thank you very much. I have no wish to make any initial remarks, save to thank you for what you have just said. We have tried, in a number of ways, to improve the Budget documents so that they do meet some of the points which you have made. I am particularly grateful for your reference to those of my officials who have done the hard work in making these changes. I will certainly see that those remarks are conveyed to them.

Chairman: Thank you very much. We would like to start with some questions on fiscal policy. I call Mr John Browne.

Mr Browne

134. Chancellor, I hope you will accept that I think a large majority of this Committee would support me in saying first of all that I think the Government and its staff deserve not only thanks but congratulations on achieving something which has eluded governments in recent history, and that is a combination of high growth, high job creation or employment and low inflation. Having said that, I would like to ask you this. Given the fact that the Government believe that public expenditure should be dictated by the level of public revenues, of government revenues, and assuming

that a fall in oil revenues would be long term leading to a permanent drop or a long-term drop in government revenue, can we expect future spending plans to be revised downwards? If so, does this mean that we now have an opportunity, if we are prudent, to recast our public expenditure to reflect the changes of the past twenty years, so that they meet the needs of today and tomorrow rather than the needs of yesterday?

(Mr Lawson) Certainly we need to review our public expenditure programmes and priorities all the time, so that they meet (to use your words, Mr Browne) the needs of tomorrow rather than the needs of yesterday. That is something which is done regularly in the annual public expenditure reviews, and it is something which also takes place in specific reviews of particular areas of expenditure which are done at various times within Government. As for the first half of your question, however, about whether the fall in North Sea oil revenue should cause us to reconsider our public expenditure, I see no reason to do that, because, among other things, what has been seen - and it has already emerged from the figures

x from the PSBR for recent months, and as you see ~~in here we projected~~ we are projecting forward - is that that decline in North Sea oil revenues has been to a very large extent offset by the greater than expected buoyancy of non-North Sea revenues. So there is no great loss of taxation revenues. Indeed, further out from 1986-87 - Sir Terence Burns could comment further on this perhaps - the buoyancy of the non-North Sea oil revenues is likely to exceed the loss from the North Sea. On the whole, I think the framework which we set out in the Green Paper which was published at the time of the Budget in

x 1984, "Public Expenditure and Taxation into the 1990s", is still valid. In that framework, which is the framework within which we can form a view of what sort of path for public expenditure ~~was~~ is appropriate, we allowed for a diminution in North Sea revenues - a very considerable diminution of North Sea revenues. What has happened of course is that the first half of that, or the first part of that, has come about rather faster, but at the same time the buoyancy of non-North Sea oil revenues has also come about faster. So I do not see that there is any need to change our public expenditure projections on that account.

135. We certainly welcome the rise in non-oil activity in the economy, but if you look at the impact of the oil revenue drop or the oil price drop on world growth, and the relative ability of countries in the OECD to make good in that growth, and if you look at our competitive position with, for example, West Germany where prices rose last year by 1.3 per cent, wages by 3.3 per cent, when our wages rose by 8.6 per cent and our prices by 5 per cent, are we really going to be competitive enough to bear out your optimism in the future on the non-oil sector?

(<u>Mr Lawson</u>) That is a matter for British industry and those ~~who are~~ working in it. It is perfectly true that the fall in the oil price - and I made this clear in my Budget Speech - benefits countries like Germany and Japan much more than it benefits us, even though on balance I believe that taking all things into consideration there is a benefit for us. Nevertheless, there is clearly a benefit; and this clearly benefits the Germans and the Japanese more. But it <u>does</u> give British industry ~~- indeed,~~ a great opportunity. Not only the North Sea oil price, we do not want to be obssessed by that, although that is the biggest single change that has occurred since we last met, ~~It is also a question of~~ but also the decline in inflation. The degree of price stability, ~~we have got it in, not only~~ the improvement in manufacturing productivity that there has been, and the policies that have been pursued do combine to provide British industry with a tremendous opportunity - a tremendous opportunity in particular over the next twelve months. If in particular British industry is capable of maintaining an adequate control over its wage costs, its pay costs, I believe that we can achieve something of a breakthrough to improved economic performance. The scope for catching up on our competitors was clearly considerable when we took office, and a good deal of that scope has been realised in the sense that our manufacturing productivity in this country, indeed over the whole of the period since 1979, has risen faster than in any of our major European competitors. That was not the old story at all. So we are doing something to catch up, but there is still scope to catch up further, and industry has an opportunity, particularly now, to make good use of that. Whether it does so or not, as I say, is up to industry. I think they are aware of that. I think that we have created a benign climate. World events have also created a relatively benign climate. With that background, it is now up to industry.

136. Chancellor, can I turn briefly to the public sector borrowing requirement? The figures for 1986-87 are lower than in the Red Book last year, but has not the government borrowing, if you represent it by public sector financial deficit, actually increased by £2 billion sterling?

(Mr Lawson) If you look at the public sector financial deficit it has increased, and if you look at the PSBR it has come down. There is no one, unique way of looking at it. I have to take a judgment taking everything into consideration, taking into consideration the composition of the public sector borrowing requirement, if you like, taking account also of what has happened to North Sea oil revenues. There are many people who have been arguing that because North Sea oil revenues have fallen so sharply - a fall of something like £5½ bn, which is rather more than double the increase in the proceeds from privatisation, which ~~goes~~ accounts chiefly ~~to~~ for the change between the PSBR and PSFD trends - ~~on that account~~ I ought to increase the PSBR for 1986-87 above what was said in the 1985 MTFS. I took the view that it would be safer in an uncertain world - which is always uncertain but particularly at the moment because of the level of oil prices - to have some small reduction from the path of last year's MTFS, but it is a matter of judgment. I readily concede that and everybody has a right to make his own judgment, but that is the judgment, after considering all the factors, that I came to.

Mr Fisher

137. Chancellor, in your last-but-one answer to Mr Browne you appeared to put your faith in cost competitiveness and price competitiveness and the impact of those on wage costs when our economy is going to try and adjust to declining oil revenues. How do you square that confidence with paragraph 3.25 of the Red Book, where the Red Book says: "Price competitiveness in 1986 may be a little different from the average of the last three years". How do those two things equate?

(Mr Lawson) I think the difference boils down to the difference between track record and opportunity. Our track record on labour costs per unit of output in recent years has not been good. During the severe recession I think it was good. Then industry had its back to the wall and they did take a very firm grip of their costs, and you see that wage costs per unit of output rose very little and our relative performance was good. Since then our relative performance has been far less good. In forecasting, since this government took ~~control~~ over from the previous government, where forecasting was simply another name for wishful thinking - we have not gone in for that - we have tried to ~~do~~ give a best guess based on past performance, track record, and that is why it says what it does in 3.25, but there is an opportunity to do far better than that.

138. You do not appear to be putting a great deal of confidence in your answer just now on this element of the economy in trying to cope with the difficulties that are going to follow with the decline of oil. If you do not put any confidence in that and are very cautious on that, what aspects of the economy do you think are going to take up the slack? Are they going to be high technology and information technology, for instance?

(Mr Lawson) I do not know what aspects of the economy are going to take up the slack. The economy is very large and diversified and North Sea oil is only a tiny sector of it, so there will be various parts of the non-North Sea economy which will be going ahead faster than we had previously thought. I do not think it is incumbent upon me to predict which particular sectors they will be.

139. Chancellor, with due respect, I think the country is very anxious to know with the decline in both oil price and oil revenues - and the distinction is not entirely clear in your Budget Statement or the different impact of those two - where the upturn and buoyancy you talk about is coming from. Is it coming from information technology or high technology?

(Mr Lawson) I think it will come generally from the internationally traded sector of the economy, as I said in my Budget speech.

140. Would that be manufacturing industry trading well, do you think?

(Mr Lawson) I think certainly manufacturing industry is likely to have a further good year.

141. A better year than our deficit in the balance of trade of £3½ bn?

(Mr Lawson) But the deficit is not what you want to look at. What you want to look at is what has happened to manufactured exports, manufactured productivity and manufactured output. The fact that there is, as it were, a counterpart to the oil surplus in the form of the imports of manufactured goods is neither surprising nor deplorable. What matters is what is happening to our own manufacturing industry, how it is doing in terms of growth, how it is doing in terms of productivity, how it is doing in terms of exports. On all three fronts it is doing well and I see the latest CBI survey, which was published in this morning's newspapers, is predicting a slightly faster growth of manufacturing output in 1986 than we have done here in the Red Book.

Chairman

142. But if you took the imports as the counterpart of the oil exports would you not then expect the imports to fall, given what has happened to the oil situation, whereas, in fact, they doubled in the Red Book?

(Mr Lawson) Yes, there is a higher rate of imports expected, which is associated, of course, with the quite high rate of growth in the British economy, but the outcome of the whole thing is still quite a substantial current account surplus on the balance of payments for the sixth successive year.

Mr Fisher

143. But, Chancellor, this is exactly what we are trying to address these questions to.

(Mr Lawson) I am not quite clear what point it is you are trying to address.

144. That the balance of payments surplus may not look so rosy in the future years. You say we ought not or do not want to look at the deficit of trade on manufactured goods but I suggest you may not want to look at them because they are extremely embarrassing figures, the first time we are in deficit by an enormous amount in the history of our economy, but it is surely crucially important to try and determine where this buoyancy, this growth in the economy, is coming from in the future? You have not said it is going to come from information technology. I am sure you are right, but the NEDO shows us 24th out of 24 OECD countries in the deficit on information technology, so it is not coming from there. It is not coming from manufactured goods because we have a huge deficit on that. Where is it coming from?

(Mr Lawson) I do not find the deficit of trade of manufactured goods at all embarrassing. I would find it astonishing were that not to be the case, given the very substantial surplus there is on oil account. I am not quite sure what kind of world you are envisaging. It is unrealistic

X to expect one would have surpluses on ~~any~~ every part of the balance of payments.

145. So you think, Chancellor, as both revenues and production of oil decrease over the next 25 years, you anticipate with equanimity in your Budget Statement we will then come into a large surplus on manufactured goods trade in that period? Is that what you are saying?

(Mr Lawson) I think we shall remain with a surplus on oil account for many years to come. It will be a smaller surplus than it has been, and as that surplus declines one of the things I would expect to see happening is our balance on manufactured trade improving. But that does not mean it has to go straight into surplus because we shall have a continued surplus on the oil account. I did try at some length to go into this (because it is not a new issue at all) in a speech I made at Cambridge in 1984 on, "What will we do when the oil runs out?" and the analysis has not changed at all.

146. But in that lecture you do not specify how manufacturing industry is to improve and you do not specify what sectors there are to improve. I tried to press you on those points this afternoon but you do not appear to be very anxious to answer them.

(Mr Lawson) If you say how will it improve, it will improve in part by means of a change in the real exchange rate. Then there is the question of how far that implies a change in the nominal exchange rate - and, indeed, there has been some change in the nominal exchange rate - and how far that is achieved by an improvement in industry's control of costs. As I was indicating earlier, there is very considerable scope for industry to improve its control of costs and I hope very much it will take that. Certainly the view of the CBI is exactly the same as mine on this issue, that they believe that industry has a need to control its costs better and that it has a responsibility, indeed, to do so.

Mr Browne

147. Chancellor, given the fact that the oil prices <u>have</u> fallen, there is obviously a tremendous outlook for world growth in which we, if we are competitive, can really benefit, giving the opportunity not only to reduce inflation further but greatly to increase employment above its already increasing levels, to such a point that unemployment can be reduced in a very significant way. Do you share those views? If so, when do you feel this turn in unemployment is likely to occur, given the present state of the world economy and the present price of oil?

(Mr Lawson) The general view you expressed I would share, but on a rather less euphoric level. That is to say, although I think that the fall in the oil price is of benefit to the world economy, it does not suddenly mean that we are going to be in some brave new world in which the sun is always shining and everything is coming up roses all the time. We are still going to be subject to all the old problems and difficulties and so on. But it is going to be better than it would otherwise have been. That certainly means an improved outlook, among other things, for employment. For us there is the added point that as the balance of the economy to some extent shifts at the margin from the oil sector to the much larger non-oil sector, that too will be of benefit from the point of view of jobs, because the non-oil sector is more labour-intensive than the oil sector of the economy. So there are improvements, and it is said, I think, right at the beginning of the Red Book here, in the last sentence of paragraph 3.02: "However, the labour force is now expected to grow less rapidly," - and, ~~that is~~ taking everything into account - "~~and~~ prospects for unemployment are better than for some years." I would not wish to be tied down to a more precise statement than that.

(Sir Peter Middleton) Perhaps I could add a comment there, because I have been talking about precisely this point over the last two ~~years~~ days in OECD which of course consists mainly of countries who are going to benefit from oil and lower commodity prices to a far greater extent than we shall. There is absolutely no doubt that the fall in prices has improved the mood, and it has also improved the prospects, because what it has done is confirm people in feeling that lower prices will definitely be there. One then gets some benefit from output, and also of course the imbalances in the world look a little bit better too (not all of them, but most of them). So I think the prospect is genuinely better, but one should not get too carried away with it, because oil is not such a large proportion of anybody's GDP.

148. Given the underlying strength of the economy and the outlook for growth due to the price of oil, etcetera, some people have suggested that the public sector borrowing requirement might be increased and still maintain its percentage share or its percent as a level of GDP. If that were put to you, what would your views be as to the effects of any increase under such conditions?

(Mr Lawson) As I indicated earlier, take first of all the performance of the economy. As far as the growth of the economy is concerned over the coming year, short term, it is no different overall than what we were projecting at the time of the Autumn Statement when we were basing it on an oil price of something like \$25 a barrel rather than \$15. The ~~competition~~ composition has changed quite significantly, with both investment and exports playing a much larger part and consumers' expenditure a rather smaller part. So it has changed the pattern rather than the overall level of growth in the immediate future, although further ahead, beyond that, we actually see an improvement ~~from~~ over that which we had earlier expected. There is also an improvement ~~on~~ in inflation, but inflation of course was going to come down anyway; this has just helped it to come down rather more. This is an important feature of the current scene ~~of~~ in the economy. It is not just a matter of high growth by UK standards, but it is also ~~the~~ accompanied by low inflation. Would that be assisted by increasing the public sector borrowing requirement? I do not see that it would. I do not see by what mechanism it would. It seems to me that the level of borrowing which I have judged to be right for this year is one that fits well with the monetary stance - which no doubt we shall come on to in due course - which is designed to keep inflation going down, and that is of fundamental importance for the health of the economy and the prospects for employment. Also - and Sir Terence Burns will have the figures - I think that our fiscal position is pretty well in line with the generality of OECD countries at the present time.

Mr Beaumont-Dark

149. You quite rightly, Chancellor, talked about the scope which you hoped that industry would take advantage of because of the drop in the price of oil which of course has helped them to be more competitive. It is of course a happy accident more than design that that has happened. If you talk about the scope, would you have given them the opportunity to have that scope to become more competitive, or would you have used the money differently and industry would have found itself still deeply in the mire?

(Mr Lawson) I do not accept the last part of your question, Mr Beaumont-Dark. Industry was not deeply in the mire. Industry has been growing at a very satisfactory rate for some years now.

150. Trade has, not industry, Chancellor.

(Mr Lawson) Oh yes, yes, industry-wide. If you look at the growth of manufacturing industry over the past few years - which I know you are particularly concerned about - since the bottom of the recession it has been growing steadily, at a rate well above what ~~has been~~ used to be the norm. Also of course non-manufacturing industry has been growing well from a rather higher relative base. As Sir Peter Middleton has just reminded me, something I have referred to on a number of previous occasions, which is relevant now, is that the profitability of industry has been improving very greatly. There is a graph somewhere here which shows this very clearly. I cannot remember quite where it is.

Mr Budgen

151. Page 33.

(Mr Lawson) Thank you, Mr Budgen! You will see there chart 3.11. Taking ~~it away from~~ the non-North Sea company sector, you see that since 1981 ~~it~~ profitability has been rising sharply and it is now the highest it has been for a very long time, expressed as a return on capital. This is very, very important for the future strength and success of British industry.

The problem that had been reached during the 1970s in particular was a very great decline in profitability. That was what was really making it difficult to invest sufficiently and spend sufficient money on research and development and on training. There has been a transformation in industry's profitability and that, as this chart shows, occurred well before any change in the North Sea oil price.

Mr Watts

152. Chancellor, I would wish to pursue a similar point but from a somewhat less pessimistic viewpoint than Mr Beaumont-Dark. The decline in oil prices and the consequent reduction of £5½ bn in oil tax revenue effectively pre-empted that part of the fiscal adjustment that might have been available to you to oil consumers. What do you estimate is the impact on the economy, and particularly the prospects for growth, of the reduction in costs which comes about as a result of the fall in oil prices?

(Mr Lawson) The reduction of costs from falling oil prices, as I say, does give British industry an opportunity, coupled with what has happened, of course, to inflation, which has come down sharply, coupled with the change there has been in the exchange rate. Normally, of course, what one has seen in the past is that when there has been a fall in the exchange rate that has been offset by inflation rising. What has happened on this occasion for a combination of ~~factors~~ reasons is that industry has the benefit of both ~~the~~ a lower exchange rate and inflation falling, so all these things do give industry an opportunity. However, as I said earlier, the overall rate of growth in 1986-87 which we are forecasting now of 3 per cent. is the same as the rate of growth of 3 per cent. which we were forecasting before the fall in oil price, so I think it is a great mistake to over-emphasise the importance of this oil factor. It has been the most dramatic change, certainly, but the economy is a great deal more than North Sea oil. The non North Sea oil economy matters a great deal more obviously by its very size, quite apart from the fact that the North Sea oil economy over a long period of years ~~has been~~ will be in decline anyway. It is also, of course, the Government's economic policies that matter and that matters far more than anything that is happening on the oil price front. I have to say one sees a curious reversal in a way listening to the discussion so far, which I think reflects a lot of the current discussion outside this forum, too. Until very recently one of the difficulties that we had was that the markets and commentators generally placed a quite inordinate importance on North Sea oil and felt, therefore, that if anything went wrong with North Sea oil there would be doom and disaster for the British economy as a whole. I and a number of others tried to point out that this was getting things totally out of perspective. Now it seems to have gone the other way round. People now feel the drop in price after all may be a good thing, not a bad thing, but because they still exaggerate the role of oil ~~still some people are inclined to think North Sea oil plays an enormously important role~~ they exaggerate its likely ~~profits~~ benefits in the British economy. It never did dominate the scene in the past in relative terms and it does not now, so I think that while this is perhaps the most interesting event on the economic scene it is not right to say that this is the determinant of our economic future.

153. If I can pose a different scenario, if the oil price had not fallen and you had had that extra £5½ bn of revenue added to your fiscal adjustment, do you believe that the effects of distributing that through the measures that you have shown would have been able to create a better stimulus to the economy rather than the blunt instrument of the market reducing the price of oil and letting the benefit flow where it will?

(Mr Lawson) It is a tantalising thought, is it not, and I shall not torment myself by thinking of what Budget I might have been able to produce had not at least half of the North Sea oil revenues gone down the plughole!

154. The Red Book assumes a price for oil averaging $15 a barrel. Events of recent months have shown what difficulty there is in trying to predict what the value of oil will be. If that turns out not to be the case and there is either a substantial recovery in the price of oil or, alternatively, if it were to stabilise nearer to the bottom end of the range we have seen recently, what would you consider would be necessary in terms of a policy response to that, or could I take it from your replies to my earlier questions that you do not really think that the price of oil is that important an influence on our economic policy?

(Mr Lawson) It is obviously important to the fiscal position. Of course, what we see reflected is the price of oil on the spot market and quotations for various forward months, a price which does not necessarily accurately reflect the price at which oil is actually traded, which is probably slightly higher than that. I do not know what the price of oil is going to be. I still have no reason now to depart from the assumption or best guess of an average price of $15 a barrel over the period from now until the end of the year and, indeed, through 1987, for what that is worth, although it is only the price between now and the end of the year, or rather ~~than~~ the price during calendar 1986, which determines the revenues we get in in 1986-87 because there is a bit of a lag. That said, the question which you posed is something to which I adverted in my Budget speech, when I said: "It may well be that the oil price turns out to be different from the average of £15 a barrel which I have assumed for this year's Budget, but if any departure is wholly short-term it is most unlikely to have any significance for policy."

Mr Beaumont-Dark

155. Can I say when Mr Watts said that I was pessimistic, I can promise you that I am not a pessimist. If you come from Birmingham you tend to be a hopeful and fretful realist, but that is not the same

as being a pessimist. Would you not agree that one of the important things is that when interest rates have doubled in Germany, Japan and the USA, in fact double and treble what they are now, you do tend to be very fretful if not fearful? Do you think along with the fall in oil price we are going to get more fall in interest rates or is that now stopped in its tracks, do you think?

(Mr Lawson) First of all, I am sure you would welcome, fretful though you are, the 1 per cent. fall in short-term interest rates that has already occurred in the ~~week~~ wake of the Budget. If one now looks at the rest of this year one can see that the prospect is of inflation throughout the world and in this country falling and, as was said following the London meeting of G5 quite recently, all things considered the five Finance Ministers thought that there was a good prospect of falling interest rates over the coming 12 months. If that does happen, if we do have inflation around the world falling and if we do have inflation in the UK falling as we envisage, if we have interest rates around the world falling obviously that is a ~~hopeful~~ helpful climate for reductions in interest rates in the United Kingdom, but I obviously have to ensure that nothing is done that will jeopardise falling inflation and that may limit what can be done on the interest rate front. If you say why is it that interest rates in the UK in real terms are higher than they are in most other major countries, I think that is not unconnected with the fact that labour costs per unit of output are rising faster in the Uk than they are in most other major countries.

Chairman

156. How do you see that mechanism operating?

(Mr Lawson) I think there are two ways in which it operates. First of all, if labour costs per unit of output are rising fast or faster than in other countries, as they are, that is a potential threat to inflation. That is a potential inflationary impulse and it is,

therefore, necessary, to ensure that the increase in labour costs is not translated into higher inflation. One needs, therefore, to keep a tight monetary policy in order to prevent that. That is one way of looking at it.

Another way of looking at it is the way you look at it from the point of view of those who are operating in the foreign exchange market. ~~As to those who operate in the foreign exchange market,~~ Their view of the future of sterling is clearly influenced by what is happening to labour costs per unit of output in this country compared with labour costs per unit of output in other countries. Therefore, in order to prevent the exchange rate from depreciating as a result of fears of this kind, it is necessary to maintain interest rates higher than they would otherwise be. So from both these points of view - and I have said this to industry on a number of occasions, including at "Neddy" - the answer to industry's concerns, so eloquently voiced by Mr Beaumont-Dark, about the level of interest rates, lies very much in their hands, because they are responsible for the rate of growth of labour costs per unit of output.

157. But if you do not have a target for the exchange rate, why then is it necessary to keep the interest rates up for the reason you mentioned?

(Mr Lawson) Because we do not have a target for the exchange rate it does not follow that we are indifferent to the exchange rate. Nothing could be further from the truth.

Mr Beaumont-Dark

158. Are not you using it to compensate for the increase in labour costs in that sense? One has got to have a policy towards one or the other. Not even in the modern world can you have it both ways. It is either the pound that one defends or it is interest rates. Which do you think is more important to industry? Because we do need an industrial strategy, do we not?

(Mr Lawson) There are a lot of statements there, and I am not quite sure whether I fully understand the full import

of them. As far as needing an industrial strategy is concerned, if you mean should the Government be far more interventionist, I do not think that would be helpful at all. I believe that we want to produce what I referred to earlier as a benign climate within which industry can operate. If that is what you mean by an industrial strategy, then we have got it and we will stick to that.

159. I can tell you very briefly what I mean by that question. You quite rightly said - and I do agree with you myself - that oil is not the determinant of the UK economy. In the end, it cannot be. When oil goes you have to decide what is left, do you not? When oil goes would not you agree that tourism and changing guards at Buckingham Palace and the service industries will not be enough, because if we look upon that as enough - we do not care whether it is tourism, service industries, now, as long as we get the money in - does not that mean that we have to have some strategy to make sure that in the future, when oil goes, imports either have to be stemmed by controls (which I do not like) or exports have to be increased by possibly policy to increasing manufacturing industry? As an example of one, why do we have to have an unfair special car tax, for instance, bearing in mind the importance of the car industry? When I say that we have an industrial strategy I mean why do we have to have so many taxes, as against many other countries, upon employing labour in manufacturing industry and the costs of industry? I do not call that an unfair thing.

(Mr Lawson) We do not, and that is the short answer to your question. If you look at ~~the costs of the~~ comparative taxes - and by that I assume you mean National Insurance contributions because there is no tax on employing labour, since the National Insurance Surcharge, which was a tax, has been abolished - but if you look at the level of National

Insurance contributions which employers have to pay in this country, they are, as a proportion of GDP, ~~well~~ below the levels in average of what other countries pay on employing ~~employed~~ labour. So the first premiss of your question is false. So is the other premiss that somehow the tax system bears more sharply on manufacturing than it does on the service industries. I am continually pressed every year, for example, to give the industrial buildings allowance to the commercial sector and to the service sector. They say, "It's not fair that you give it to manufacturing and you don't give it to us. What's wrong with us? We employ a lot of people" and so on and so forth. If there is any bias in the tax system at all, it favours manufacturing rather than the service industries. But I must say, I deplore all this, as it were, industrial racism, ~~as~~ implying that one part of industry is superior to another part. I would like to see all parts of British industry flourish.

160. I think that is a superb political point to make at election time, but it does not really wash if you came from the Midlands. I agree, you can blame all manufacturing industry for it. It is never the Government's fault. Only the good things are Government's concern. Manufacturing production, not just because of Government's amd manufacturing industry's own point, is lower than it was eight years ago. The inference somehow or other that manufacturing industry has got what it deserved is something that I would find - even the Institute of Directors would - hardly acceptable. I know they are rather more byzantine, but I think the CBI have taken the view - and Terence Beckett is not some left-wing "coolie" - that manufacturing industry has had it pretty rough. I do not think that just suggesting that we want special privileges because we want manufacturing industry to thrive is terribly fair. You may not have meant it, but that is how it sounded.

(Mr Lawson) The CBI has welcomed this Budget.

161. So do I!

(Mr Lawson) Which was what we were talking about. Manufacturing industry of course has been through a very rough time. This is for a combination of two or three factors: the severity of the world recession and the very, very tough competition it had to face, coupled with the enormous overmanning there was over a wide swathe of British manufacturing industry for many, many years. Manufacturing industry, to its great credit, has improved its performance markedly. I quoted the figures in my Budget Speech of the improvement in manufacturing productivity which governments for as long as I can remember have been calling for, but which has never happened before and which now we are seeing. Manufacturing productivity over the past six years has been rising faster than in any of the G5 countries other than Japan. As for ~~getting what we deserve or~~ manufacturing industry getting what it deserves, I suppose that in a sense all of us do, Mr Beaumont-Dark, even you!

Chairman: Chancellor, I think we must move on, because we have a lot of ground to cover still. We would like to turn now to monetary policy. I call Mr Wainwright.

Mr Wainwright

162. You will recall that this Select Committee was born in the same year that Government began to publish its medium-term financial strategy, with the intention, as we are told regularly year by year, of influencing public expectations,so that for seven years now pay negotiators on both sides of the table have been exposed annually to the publication of the Government's financial strategy. Do you think that pay negotiators' expectations have been perceptibly influenced or are currently perceptibly influenced by this publication?

(<u>Mr Lawson</u>) The purpose of the medium-term financial strategy was not simply to influence pay negotiators. It was to give everybody a clear view of the economic policy that Government was going to pursue and stick to, and it is important for businessmen taking a whole range of decisions, not just their pay negotiations. It is important for the financial markets and important for everybody. I think it has had <u>an</u> influence on pay negotiations but I would not like to quantify it.

163. But this year, Chancellor, in this key part of the Red Book and, indeed, in your Budget speech on monetary conditions, M3, the estimate of the aggregate indicators is only down for one year. Can that be of any serious influence on public expectations?

(<u>Mr Lawson</u>) The reason why £M3 is there for one year ahead only is set out very clearly in the Red Book, because of the uncertainty

over future

X ~~of~~ velocity, broadly. As you know, ~~in any event~~ all other ~~countries~~

X well-conducted countries have monetary targets set for one year only and do not set them for any further. You may say why do we have this set out for a period of years, but I think that really goes to the heart of the thinking behind the medium-term financial strategy when it was first conceived and when it appeared in 1980. The plain fact was that well-conducted countries, countries that have been conducting their economies soundly for a long period, such as Germany, have acquired a track record, acquired a reputation, both for consistency of economic policy and for a general anti-inflationary bias in their policy, and that track record, that reputation, was what created confidence both within the country and outside it about the conduct of policy. We had, regrettably, a very different track record in this country. We had a track record of constantly ~~shifting and changing,~~ shifting, chopping and changing, having short-term horizons, not carrying out any policy for any length of time and all the time a tendency to yield to inflationary ~~processes~~ pressures. That is what we faced when we came in, a very bad track record, and we ~~have~~ had to try and change expectations and condition people's thinking, both in this country and overseas. ~~and~~ The medium-term financial strategy ~~plays~~ played a critically important part in securing that by showing that the Government was firmly committed to carrying out this particular policy and continuing with it right through the medium term and giving people this medium-term horizon. Since then we have been pursuing this policy for the best part of seven years and we now are accumulating and acquiring a track record and reputation which is helpful rather than harmful to the economy, but it will take a further period of time before it can be as beneficial as is the case in a country like Germany, which has had this good track record for very much longer. That is a fundamental difference, but we have never said for a moment that £M3 was the keystone of the medium-term financial strategy.

164. If I may bring you back from seven or eight long years ago to the present situation, when you said in your Budget speech that you had set the range for £M3 at 11 to 15 per cent. I waited fully expecting that, in line with your previous speeches, you would then say: "This range will lead to, provide for or even ensure that inflation will continue on its downward path," but you did not use any of those words. You simply said - and this is a big change - this range of 11 to 15 per cent.

would be consistent with the further decline of inflation. This does mean that M3 has ceased to be the guiding star and is now just a reflected moon of financial condition.

(Mr Lawson) It has never been a guiding star. There has always been a whole range of indicators we look at. Basically, in order to get inflation to come down you have to have monetary conditions that are sufficiently tight. How tight ~~It~~ depends on how fast you want to get it down. We have pursued a gradualist path and, therefore, there has been a gradual winding-down of money GDP and the rate of monetary growth and to achieve that one has to have sufficiently tight monetary conditions. This means that you have to have an interest rate policy which will ~~pursue~~ achieve that. I tried to explain this to some extent in my speech at the Mansion House last autumn and I shall be making a speech on monetary policy in a few weeks' time which will be dealing with this a little more fully and explaining how we pursue monetary policy in this country.

165. Excuse my interrupting, will this be a speech to the House of Commons?

(Mr Lawson) No, it is not a speech to the House of Commons; it is outside the House of Commons, just as the Mansion House speech is outside the House of Commons, but I do find, I must say, from experience that a Budget speech is not the occasion when one gets the most attentive audience for a disquisition on the finer points of monetary policy. Anyhow I shall be making this speech. Let me say before Sir Peter Middleton comes in that, of course, there has been an evolutionary change in the way we conduct monetary policy over the past six or seven years as conditions have changed. It would be surprising were that not so, but it has been a gradual evolutionary change. There has been no sudden change, and it is one which has been explained fully at the time to this Committee and in other ways and one which still leaves the policy recognisably the same as the policy on which we originally embarked, even though there were some misunderstandings about that policy, which it seems have in some quarters persisted. As I say, it is one that we have sought to explain and I have sought to explain as we have gone along and I will be seeking again to do so on a suitable occasion.

166. With respect, the House of Commons is expecting and always receives from this Committee a report on the Budget before the date on which you are going to make a speech in the City of London, so you do not contest, I take it, that we expect to have as much of the benefit of your wisdom as possible before then?

(Mr Lawson) I am very gratified to hear that, but ~~I think if you want to look basically - and~~ I do not think there are any important new developments that I have to announce, it will just be a fuller exposition, ~~a~~ and if you look at the monetary section of my Mansion House speech last autumn and you add to that the monetary policy section and the MTFS section of the Red Book, there you have a very clear exposition of how we conduct monetary policy and how we propose to conduct it. There was a change during the course of last year which I would have thought was a change this Committee would welcome, which was the abandonment of over-funding. This was something which on a number of occasions this Committee, or at least its predecessor Committee - I am not quite sure which - had itself advocated. We have done that but that key change, of course, ~~has not been~~ was announced in the Mansion House speech.

Chairman

167. What happened to M3 in the Mansion House speech?

(Mr Lawson) What I did was I recognised that the target that had been set was a totally unrealistic one and I said on page 11 of the Treasury handout text of the speech: "I shall as usual have to consider what target to set for £M3 for 1986-87 at the time of the next Budget," and that is precisely what I have done.

168. That is as part of the strategy but the M3 figure in the next one year the strategy goes more than one year?

(Mr Lawson) Yes, indeed, it is, as is clear.

169. What is the point of having M3 if it only goes one year?

(Mr Lawson) I do not see the difficulty. The figures for MO to which I attach considerable importance are illustrative figures for the later years, the only actual target figure is for the figure for the year immediately affected. What is more interesting than the difference between the row of figures for MO and the single year figure for sterling M3 is a difference in the status of those two figures, a difference in the way they will affect policy decisions, which is set out very clearly in the Red Book.

Mr Wainwright

170. This year, Chancellor, pride of place is given to money GDP set out for five years and as the Government's medium term objective. The officials told us, Mr Odling Smee said, on the question of time limits for money GDP figures it might be two or three years or even longer before even reliable figures are available. Is this likely to be a figure to influence public expectations if it is a figure which is not reliably known only two or three years after the event?

(Mr Lawson) As I indicated, what I think influences public expectations myself is our track record. As for money GDP, this has always been there because the objective is to bring inflation down and the way you bring inflation down is by operating within a nominal framework which is money GDP ~~because experience shows~~ (and this is the difference between the policy we are pursuing and the policy ~~the~~ previous Governments have pursued). Money GDP is, if you like, an amalgam of two things, the real rate of growth and the rate of inflation. Previous governments tended to attribute some kind of magical property to money. They felt that by in effect expanding the supply of money, whether you do this directly by monetary means or indirectly by a large Budget deficit, you would therefore magically get a higher rate of real growth. What experience shows is you get a higher rate of money GDP, but only because inflation is higher not because of real growth. Real growth depends on a whole lot of real things which the Government can influence to some extent by its micro-economic policies, supply side policies, if you like. In other words, under our policy the role of money is a much more modest one. It does not have any magical properties. If there is too much of it around it is likely to lead to an excessive rate of inflation. In other words, it is the way in which you squeeze inflation out of the system; your objective is to reduce the rate of growth of money GDP and the way you achieve that is through your monetary policy including, of course, the exchange rate.

171. The trouble with the track record is for almost three years, now perhaps ended, inflation has been going up rather than down and has certainly not moved in correspondence with money GDP.

(<u>Mr Lawson</u>) I do not accept that for a moment.

172. It is in your Book chart 2.1.

(<u>Mr Lawson</u>) The RPI is not the most accurate reflection in any event because of the curiosity of the mortgate rate being in the RPI (which is not the case in most other major countries, Canada is the only one that has it), ~~this~~ which creates a distorting effect.

Chairman

173. This is part of the cost of living.

(Mr Lawson) You do not expect to get a straight line in life. Inflation goes down but it does not go down in a straight uninterrupted line, I find nothing surprising in that. It has come down from whatever the figure, 20 per cent or so, in 1980 to 5 per cent now and it is going to go down to 3½ per cent by the end of this year. That is what we are forecasting and, of course, money GDP has been going down too. The most interesting and most important chart in all this, if I can find my copy of the Red Book, I do not know where I have put it, is right at the beginning, that is why we put it at the beginning ~~on~~ in the chapter on medium term financial strategy where you do see a very close correspondence between the rate of growth of money GDP and the rate of change in retail prices but you see no correspondence at all between the rate of growth of money GDP and the rate of growth of real output. QED, as they say.

Mr Wainwright

174. Your correspondence is different from mine because GDP is shown as rising towards the end of 1985 with prices falling.

(Mr Lawson) Sir Terence Burns would like to say something.

(Sir Terence Burns) With ~~[illegible]~~ the best will in the world, looking at the first frame of chart 2.1 I find it difficult to get the message from this that ~~these two things~~ they are moving in two quite different directions. I would have thought the overwhelming impression of ~~these things~~ this frame is the story the Chancellor has explained.

175. The first story is three years of rising RPI.

(Sir Terence Burns) Broadly flat.

176. A mortgage is what secures people a roof over their heads and bedrooms for their children, they have to do that.

(Sir Terence Burns) What this chart shows is that over the last three years the inflation rate has been broadly flat as has been the growth of money GDP.

177. The interpretation of diagrams must have moved on since I was educated!

(Sir Peter Middleton) That is what it does show.

(Mr Lawson) It really does show that, Mr Wainwright. I know you are a very fair minded individual even though you try and conceal this from time to time. The plain fact is that ~~what~~ there has been ~~is~~ a sharp fall in inflation from the peak in 1980 to 1983. This was exaggerated, this trough, in 1983 by the mortgage rate factor. I am afraid, although it is a minor issue, it is a fact that although over a period it does not make any difference, in the short run it does distort the trend ~~thing~~, sometimes to the advantage of the inflation figure ~~thing~~, sometimes to its ~~the~~ disadvantage and it was clearly advantageous in 1983.

Chairman

178. A correlation of interest rates?

(Mr Lawson) You see the thing going down sharply then you have a period in which it has been fairly flat, that is quite remarkable in itself because, of course, that period of flat prices came with the sharp recovery and the sharp period of steady economic growth. If you recall what was said at the time when you only had that first phase when inflation was going down. People said then that it was ~~it is~~ easy to have inflation going down because we had ~~you have~~ this dreadful recession, that was ~~is~~ the only reason it was ~~is~~ going down, but as soon as there is economic recovery although half the people ~~says~~ said economic recovery (~~is~~ was impossible) ~~or if it is possible~~ you will have inflation shooting up again. In fact we have had the economic recovery, ~~the~~ and inflation has remained broadly flat and ~~it~~ is projected to go lower. If you are a fair minded person

179. Would it not be fair minded and more helpful to the House of Commons Committee if you gave us a diagram of the rate of inflation as you think it ought to be compiled?

(Mr Lawson) There is, I believe, a company in the City of London called Phillips & Drew who regularly publish the rate of inflation, the RPI, with mortgage rate knocked out of it and you can see that for yourself if you wish to and see a much smoother path.

180. Not many of my constituents are clients of Phillips & Drew, or any other City stockbrokers. My last question, because time is going on fast, is really to ask you to raise the curtain, at least for the benefit of the House of Commons, on this speech you are to make as late as the middle of April?

(Mr Lawson) I cannot, I have not written it yet!

181. Your passage in your Budget on monetary conditions was much shorter than usual and we would like to know your assessment of current monetary conditions. For instance, are you concerned at all at the build up of private sector liquidity at the present time in spite of extraordinarily high interest rates and low growth rates of M0?

(Mr Lawson) Of course the high interest rate in itself creates a demand for holding these interest bearing forms of money which you refer to as liquidity.

182. Nevertheless, does it cause you any worry that the present liquidity does appear to have built up in volume?

(Mr Lawson) I see no danger in the present level of liquidity.

183. Nor in the trend of it?

(Mr Lawson) No. Clearly I think it is something we need to watch all the time and that is why we retain a broad money target. I see no danger.

(Sir Peter Middleton) The trend is down at the moment. The most recent figures for M3 are down a little. Lots of other countries have got high growths of liquidity; ours is the same as Japan.

184. What about otherindicators that used to be used in the Red Book, the PSL and so on?

(Mr Lawson) There is no great difference between what has been happening to any of the measures of broad money, they show much the same picture for very much the same reason.

Mr Budgen

185. I have four short points. Firstly, your point about your being entitled to draw upon your good record from 1979: in 1979 and for some years after that the general wish of the people was that the control of inflation should be the single most important objective of Government, surely now the objectives of the generality of the population are more various and if you wish the MTFS to have any strength you have to now emphasise not just flexiblity and the room for judgment and manoeuvre but all the rest of the things you constantly put into your speeches so as to give yourself a bit of elbow room but you have to emphasise against the grain, perhaps, of the nation that the control of inflation remains foremost?

(Mr Lawson) I do not believe the nation itself wants to see a resurgence of inflation. I do not believe the change has been as fundamental as you indicate although it is perfectly ture there is a tendency, I think it is a mistaken tendency, in some quarters to take low inflation for granted whereas before in the period of high inflation people were more concerned and worried, particularly the pensioners and the elderly but I think the business community too, as to how they would survive in society like that and where it was going to lead to. I think maybe there is to some extent a taking for granted of the lower levels of inflation we have now which is not warranted. I think still it is clear that people would not wish to see any resurgence of inflation. As to the question of judgment, I can assure you I refer to judgment, Mr Budgen, not to give myself room to be lax, it is not for that reason at all. I refer to judgment because I think it is helpful for you and others to have an honest explanation of how monetary policy actually is operating in the real world and there is nowhere in the real world it can be operated without the exercise of judgment by those responsible for conducting it.

186. Can we now just quickly look at monetary conditions today? Leaving aside the monetary aggregates some of the things you look at are the retail price index, house prices, share prices and wages, let us leave wages out of it because you constantly tell everybody about the importance of wages, if I may so, in a manner almost reminiscent of 1971/72/73 and 1974.

(Mr Lawson) There is an important difference in that because what I have stressed is the link between pay and jobs ~~products~~ which was not expressed in those days at all, it was all about pay and inflation. There is an important difference.

187. Let us look at the RPI. You said a moment ago the RPI was not a wholly satisfactory indicator and, of course, it does refer only to the balance of goods and services. Not only, though, can it be severely changed, as you point out, by changes in interest rates because of the effect on the mortgage interest rate, is it not the case it can look especially favourable if there is a fall in commodity prices?

(Mr Lawson) In the short run it can. The fall in commodity prices, ~~it is~~ is itself an interesting ~~question~~ phenomenon. There is a lot of talk at the present time about how inflation is low worldwide, coming down worldwide, because of the fall in commodity prices. I think that is getting the chain of causation the wrong way round. It is true of course there is some circularity in how that chain works, ~~the cause of the chain, the cause of~~ because the causal nexus works both ways, but I think the fundamental point is that it is because the major nations of the world have been pursuing anti-inflationary policies that we have seen commodity prices come down, just as in the 1970s when everybody was pursuing inflationary prices, prices were going through the roof. Not just oil, inevitably: people think there was simply an oil explosion, but that is a myth. If you look at metals, they were rocketing through the roof also.

188. If you look at house prices they, on average, were up 10% in 1985, that may be an indication of loose credit, may it not?

(Mr Lawson) I do not think it is. There has been no acceleration in the rate of growth of house prices and house prices tend, for obvious reasons, to reflect the rate of growth of earnings.

189. What about share prices up over 20% or so this year, is that an indication of loose credit?

(Mr Lawson) I do not think credit is loose. I am sure you will be particularly glad to know what has happened on the stock exchange over the past day or two.

190. Mr Beaumont-Dark tells me it was up 25% but it has now dropped to 22% which is why I used the expression "over 20%".

(Mr Lawson) Let me ask you a question, Mr Budgen.

191. No, no.

(Mr Lawson) I have been very patient.

192. It would be impertinent of me to answer.

(Mr Lawson) Do you think inflationary conditions, the monetary conditions, are lax worldwide, do you think they are lax in Germany, the United States and all other major countries, because we have had this great growth, this great stock exchange boom~~?~~, worldwide?

193. I am not paid to have a view on this, I am a part-timer asking you a few questions.

(Mr Lawson) The answer to your question is no.

(Sir Peter Middleton) I think in one way they are getting tight because there is a chance the OECD deficit will come down in the coming years.

(Mr Lawson) It is not surprising either. I referred earlier to the improvement in profitability, company profitability. Far be it from me to say any particular level of the stock market is right or going to endure but it is not surprising when you ~~take~~ have this great improvement in profitability which we were talking about a little bit earlier ~~which~~ that it is to some extent reflected in the price of shares on the stock exchange.

194. But the profitability itself may be a reflection of credit conditions, may it not?

(Mr Lawson) I think it is unlikely and I do not think it is the case.

195. You rather dismissed a question of Mr Wainwright's a moment ago about liquidity. The Bank in its December quarterly bulletin at page 520 put it rather differently, they said: "The fact that the economy is becoming increasingly liquid means monetary policy will increasingly have to recognise and take account of the risks ..." of the risks "... that this implies."

(Mr Lawson) Of course, we do take account of them.

196. You rather talked them down.

(Mr Lawson) I do not think there are any dangers. We do take account of them. Anyhow, it is the Government and ultimately it is I who ~~interpret and determine~~ /interpret monetary conditions and determine monetary policy/. I obviously do listen to the views of the Bank of England who are very expert in money fields but ~~the~~ monetary policy is determined by me.

(Sir Peter Middleton) Could I add a point?

197. Please?

(Sir Peter Middleton) There is in a sense always a ~~riks~~ risk somewhere in the monetary field, the question you have to ask yourself is are your defences intact and, of course, M3 is not a defence, it is the first warning signal, there is also M0 ~~that~~ where you would expect a high level of M3 to show up ~~in~~ and the exchange rate, all of which we take account of in determining interest rates.

198. At any event present credit conditions, which you have to take account of in the many other things you exercise your judgment on, reflect, do they not, the monetary conditions of a period some time before?

(Mr Lawson) Yes.

199. It is possible, is it not, to have, for instance, lax credit at the present time but tight monetary controls or vice versa, you could have tight credit at the present time but lax monetary controls and the risk of inflation for the future?

(Mr Lawson) It is obviously possible that there could be some inflationary risk in the future, say, ~~I do not know what you mean,~~ two years out or something like that, which clearly is unlikely to be indicated by MO or the exchange rate now where the relationship is rather shorter term. But, I have to say I see nothing in current circumstances to indicate an inflationary surge two years out nor indeed to go back to the track record is there anything to suggest that despite pursuing the policy we are pursuing, have pursued in the past and will continue to pursue, you will get a resurgence in inflation.

200. There are many commentators who see yourself as shuffling your way towards getting into the European Monetary System as being something which you regard as, for a number of reasons, a better discipline than the monetary aggregates that you yourself put in place. Is it not now obvious that having attempted to persuade many people, the country and your Cabinet colleagues, of the desirability of joining EMS that you have failed in that endeavour; would it not be better now to recognise that failure and go back to the old discipline?

(Mr Lawson) I do not accept your question.

201. Which parts?

(Mr Lawson) Therefore, I cannot answer it.

202. I will be perfectly prepared to divide it up. First of all, do you agree that by the apparent abandonment of sterling M3 in your Mansion House speech you were saying to the nation: "I now have no satisfactory discipline"?

(Mr Lawson) No, I was not saying anything of the sort.

203. It might have been an interpretation that you were then giving an opportunity for yourself to be able to say: "I am looking for a better discipline"?

(Mr Lawson) In the Mansion House speech, if you read it, it states if very clearly, how we would operate a monetary policy ---

204. I have it here.

(Mr Lawson) It talked about monetary policy, about narrow ~~monetary~~ money --- it talked about the fact that the old broad money target was clearly inappropriate, why it was inappropriate, why it would therefore be inappropriate to try and get it back within the target range, why therefore I was suspending that particular target range and that I would come back at the time of the Budget and set a new one which is precisely what I have done. It also talked about the role of the exchange rate. All those things were set out very clearly. None of that was an abandonment of monetary discipline nor was it contingent on joining EMS.

205. Final question, for instance Mr Leon Brittan (who may well be on this matter close to your thinking) said on Monday that he thought the way to achieve a convincing monetary policy was through the exchange rate and that was part of the first argument going towards EMS. If it be that you are not going to be able to go into the EMS, would it not be better to say

that clearly and openly and to admit (and I know you will not say this) if you have attempted a political persuasion and failed, would it not be better to say that openly than to, for instance, leave it uncertain as to whether you have either a desire to go into the EMS or whether you intend to rely upon the discipline of the monetary aggregates?

(Mr Lawson) No, our policy is not not to go into the EMS, our policy is to join the EMS when the time is right. I have given evidence about that to the Committee.

(Sir Peter Middleton) Could I make a point I have wanted to make on M3 ever since Mr Wainwright spoke. I think I turned up to give evidence at the very first meeting on MTFS to this Committee. As I recall it I was actually at pains to say it was not set in concrete round M3: "No one monetary aggregate encapsulates the whole of the monetary conditions" and that sort of thing. If you think of the medium term strategy it was inevitable that so far as its precise monetary components were concerned, it was bound to evolve. The reason money GDP is there is to emphasise the continuity in MTFS while these aggregates have been changing in significance. M3 and wide aggregates have been changing in significance everywhere. I think there are two reasons for that - and they are common reasons to most countries - one is financial innovation which means both sides of a bank's balance sheet can rise at the same time while taking advantage of a more liberal trading ~~scheme~~ regime, which does not have any significance ~~of view~~ for the future of inflation, the second one is high real interest rates which influence the demand for M3 as an asset which meant it might be firmly held. Something like the present row of proposed ~~M3~~ money GDP has been there throughout. It is just that M3 is only there for one year this year because we are particularly uncertain about it.

Chairman

206. Both Mr Mitchell and Mr Townend wish to ask questions. Could I ask one question: you were asked about policies to join EMS when the time is right, given what has happened, the relevant exchange rate recently, do you think you could find a more appropriate time than the present in which to join?

(Mr Lawson) I think it is true that what has happened on the oil front has to some extent reduced the strength of one X of the arguments against joining. On the other hand, we have not yet judged the time to be right.

Mr Mitchell

207. Does that mean you take the exchange rate against the Deutsche Mark particularly, but against the ECU as well - the Deutsche Mark is central - as still overvalued or is it now at a stage that will be compatible with membership of the EMS?

(Mr Lawson) We have been round this course, Mr Mitchell. I do not think it is simply, or even primarily, a matter of judging a particular parity to be right, it is much more questions such as to what extent is sterling different from other currencies and likely to be ~~pooled~~ pulled in a different way. The oil factor is one of them, which I indicated has been weakened. The extent to which the nature of the system would be changed because sterling is not like any of the other currencies in Europe other than the Deutsche Mark, in the sense that these are the two ~~wider~~ widely-held international currencies, is another.

208. Is sterling overvalued against the Deutsche Mark?

(Mr Lawson) I am perfectly happy with the existing pattern of exchange rates.

209. You deplored in an answer to Mr Beaumont-Dark what you call "economic racism" saying you want all parts of the economy to flourish, what about the parts this Government has reached only to clobber?

(Mr Lawson) Such as?

210. Such as the manufacturing industry. We have lost a quarter of our manufacturing industry and 28% of our employment. If that is your desire surely it is different to the experience in Germany and Japan where it was the international trading sector which gave the main drive to economic growth and which received preferential help in terms of investment and exchange rate management which has been the exact opposite of our experience where the international trading sector has suffered most from a policy of high exchange rates

and is still suffering. To help that sector you would have to have competitive exchange rates and lower interest rates.

(Mr Lawson) I am not aware that the successful German economy has been based on a declining exchange rate.

211. It was based initially on a very low exchange rate which gave them a competitive advantage and a stimulus to invest in the manufacturing industry to get into a virtual circle which we have never had.

(Mr Lawson) I do not believe that is the case. ~~If~~ Moreover ~~that were the case~~ we went through a period of very considerable devaluation of the currency in this country and it did not seem to do the trick here.

212. We still seem to have very high interest rates compared to Germany and Japan. We have an exchange rate which, I would say, is overvalued against Germany and Japan, how would you expect the manufacturing industry and the international trading sector to flouris in that situation?

(Mr Lawson) I am glad to say it is flourishing.

213. You said on labour costs and interest rates if labour costs were rising then it would be necessary to maintain interest rates higher than they would otherwise be. In other words if labour costs are going to go on rising, as seems to be the indication from the Red Book, over the year ahead we are going to have high interest rates or interest rates higher than our competitors?

(Mr Lawson) I think there is a simple point really at the bottom of this, an important point, and that is that it is ~~the~~ industry's job to control its own costs in order to be able to compete effectively in world markets against the Americans, the Germans, the Japanese and all the rest. It is not ~~a~~ the route that this Government is going to pursue to say to the manufacturing industry "You do not need to bother about your own costs because however your costs are inflated, we will float you off by depreciation". That is an alternative route, it is the route you espouse and that is the difference between us. What is absolutely clear is the success of the countries you previously mentioned has been achieved by those countries controlling their own costs and making themselves efficient and has not been through the devalulation route which you are recommending.

214. The Japanese domestic inflation has been fairly similar to ours, it has been keeping down costs in the international trading sector.

(Mr Lawson) If you go to Japan and look at ~~the~~ Japanese industry you will see that their efficiency has little ~~it has nothing~~ to do with the exchange rate, although until recently they have indeed had ~~an~~ a substantially undervalued exchange rate.

215. If the Government is letting the City push up incomes and going for a massive assets speculation, as it is, if wage costs are going to go on increasing in this fashion it follows that wage costs are going to be higher in this country than those of our competitors?

(Mr Lawson) I do not think what is happening in the City has a bearing on this.

216. It does not leave -----

(Mr Lawson) I do not think that because it has been thought ~~it~~ worth paying an astronomical sum to have a young whizzkid foreign exchange dealer it follows that ~~because that has been paid therefore~~ it is sensible, or necessary, for industry to pay over the odds in wages for the workers that it needs.

217. Factually our unit labour costs are increasing more rapidly than those of our competitors, does it follow, therefore, that our interest rates are going to remain higher?

(Mr Lawson) As I said earlier, so long as our labour costs per unit~~s~~ of output are rising faster than our major competitors there will indeed be a tendency, which I regret, for our interest rates to be higher than they would otherwise be and higher than our major competitors.

218. You mentioned the prospect of bringing down interest rates, you mentioned there was a need for competitors to bring them down?

(Mr Lawson) If competitors bring them down that ~~is~~ provides a ~~healthy~~ healthier climate.

219. Does that mean we can bring them down if competitors bring them down but we will keep the differential?

(Mr Lawson) I am not being as precise as that because there are a whole lot of factors ~~we can bring~~ which come into play. I was merely pointing out if interest rates come down worldwide that, for obvious reasons, is a helpful factor in our market.

220. It does look like we shall continue to bear a heavier burden in this country?

(Mr Lawson) We shall see.

221. If interest rates and sterling are, indeed, high as a result of high unit wage costs how on earth are manufacturers going to improve their competitiveness? How are we going to improve the trade surplus in manufactures?

(Mr Lawson) By controlling, in their own interest~~s~~, ~~at these~~ their own costs, ~~but~~ including, and it ~~in their costs, which~~ is a big element, their pay costs. They can do that. There are times ~~at which~~ when they will have to say no, that is really what it boils down to. ~~that~~ It also means improving their productivity and thus being able to operate on both sides. ~~They~~ On productivity they have been very successful, and I pay tribute to them, in recent years. On the productivity side there ~~will be~~ is scope for doing better still but they have been very successful on the productivity side. It is on the other side of the equation, ~~with~~ over levels of pay, that they have been less successful compared with our overseas rivals. There is no reason why that cannot be put right by ~~the~~ industry itself.

222. They have been successful in improving the batting average by shooting the last three batsmen.

(Mr Lawson) That is a very tired ~~adjective~~ simile which probably you were responsible for originally and I am sure it was very good when it was first coined. There is a big difference if you look at the period of the last Labour Government, which you supported, and the period of the present Conservative Government. You will find ~~that~~ during both periods there was a decline in the output of ~~the~~ manufacturing industry — both over the whole of the Labour Government and the period of Conservative Government so far — but in the period of the labour Government this was ~~covered~~ coupled with an abysmal rate of growth of productivity in ~~the~~ manufacturing industry whereas ~~in~~ during this Government it has been accompanied by a very good rate of growth of manufacturing productivity, so that is a big change. You can have a decline in manufacturing output without any improvement in manufacturing productivity, as occurred under the last Labour Government. ~~The~~ Conditions in industry, the competitiveness and the efficiency of British industry, ~~has~~ have improved very considerably and I am sure you welcome that in ~~the~~ manufacturing industry.

223. But if as seems to be the case our exchange rate is higher because our interest rates are higher than our competitors how can you expect manufacturing industry to compete effectively bearing that double burden?

(Mr Lawson) I did not say the exchange rate was higher, the interest rate was higher.

224. Let me ask you: is the exchange rate where you want it to be? It is higher than it was in March last year.

(Mr Lawson) Of course it fluctuates to some extent because we are not in a fixed rate system and of course there have been great gyrations of the dollar over the period to which you are referring but as I said earlier I am perfectly content with the ~~policy~~ pattern of exchange rates we have at the present time, though I think the yen ought to appreciate ~~earlier.~~ further.

225. How can industry compete with the ball and chain of higher interest rates and higher exchange rates?

(Mr Lawson) First of all, it is competing quite effectively at the present time. Our exports are rising quite rapidly and ~~certainly~~ are at an all time record, manufactured exports, by a long chalk. What I find puzzling about your approach is you seem to assume that industry itself is quite incompetent to control its own costs. ~~and money~~, I do not believe that.

226. I assume in your prediction for a consumer demand in the year ahead you are assuming wage rates and labour costs are going to go up because it is the major part of the stimulus. This is the major part you are looking at for consumer demand. You are saying out of one side of your mouth you are against wage increases and on the other side you are saying we are for it, we are looking for a boost for the year ahead.

(Mr Lawson) Of course if ~~the~~ wage costs per unit of output were going up less then you would find to some extent possibly some slight reduction in the forecast level of consumer demand. It is difficult to say. You would have higher employment and increased consumer demand from those at present unemployed who would then be employed. That would be an important beneficial offshoot and that is what this Government wants to see. Also you would no doubt have a higher level of exports contributing to higher growth. I do not accept for a minute ~~at all~~ that the rate of growth would be any less; indeed, in the medium term it would be greater.

227. The last question in the penultimate waltz, leaving aside the question of whether it is justifiable to sell what belongs to all of us to provide tax cuts for some of us, why did you opt for tax cuts rather than spending the money to stimulate the economy either through public spending or going directly to job schemes of the kind recommended by the Employment Select Committee. The money for that comes out of the reserves, therefore it is not a substantial stimulus to the economy. Why did you opt for that path when the crucial question facing this economy is employment, when all models show that and when all the opinion polls show people are prepared to pay taxes if it helps the unemployed?

(Mr Lawson) I do not think the models that show that are very helpful because they cannot capture the supply side factors which are critical for employment to any worthwhile extent at all. As for the question of why this Budget was largely, not exclusively, about tax rather than public expenditure that is because that is the way we operate things in this country. We have a public expenditure round which is about public expenditure, the results of which are announced in the Autumn Statement, and the Budget is about taxes.

228. Chancellor you have been most generous with your time but Mr Townend has been most patient throughout.

(Mr Lawson) He has indeed and I commend it.

Mr Townend

229. You have made it clear you are concerned that industry should keep its costs down, are you as perturbed as I am in Table 1.2 that the loss of oil revenue seems to be partly balanced by revenue in the corporate sector but also by an increase of estimated receipts from refunds of two billion? This is a cost that the industry cannot control, this amounts to an increase of over 14% which is four times the rate of inflation.

(Mr Lawson) I am sorry?

230. It is an increase of 14% which is four times your estimated rate of inflation which is a burden industry could well do not to have to carry. Does it indicate a failure of the Government's policy to control local government spending?

(Mr Lawson) The control of local government spending has always been the weak link in the Government's overall public expenditure control because of the constitutional autonomy of local government and we have sought various means which have been, I think, more successful than governments in the past have been ~~experienced~~ in controlling local government, or influencing local government expenditure. But it ~~It~~ has been very far from the sort of control we would like to see. There have been quite sizeable overspends in most years and we try and allow for that in the reserve. It is a problem and, of course, it has recently been exacerbated and one of the consequences of this ~~we see~~ is higher rate increases than normal. That is ~~the~~ indeed a problem for industry.

231. Four times the rate of inflation is ----

(Mr Lawson) The rate of increase in rates, yes.

232. Four times the rate of inflation.

(Mr Lawson) Not four times the present rate of inflation, four times the rate of inflation by the end of the year. ~~That~~ But it is unsatisfactory.

233. In your Budget there was no mention of the National Insurance contribution, does that mean the Government feels it has now got the balance about right as far as contributions are concerned?

(Mr Lawson) The reform, the restructuring if you like, of National Insurance contributions which I introduced in the 1985 Budget and which was ~~not~~ the first time it had been done ~~but it~~ was a very substantial one. It gave relief at the lower end of the scale for both the employees themselves and the employers who employ people at the lower end of the pay scale ~~which was~~ of well over a billion pounds, which was very substantial . I think it is unreasonable to assume ~~because~~ that despite the fact that it was a very substantial change ~~that~~ it is somehow ~~in that~~ only a first instalment. ~~I do not see that they face~~ It was an important change which will have beneficial results.

234. Turning to income tax, I welcome the reduction in the standard rate but people still consider there is a significant "Why work" problem . Do you hope to be able to deal with that in the next Budget?

(Mr Lawson) I see Mr Howell has left us, I do not know if that question is on his behalf. I would like to see - the Government has consistently wished to see since it came to office in 1979 - thresholds raised and the rates of tax, both the higher rates ~~as able to operate because it costs so much~~ and the basic rates, reduced. I would like to see progress on both fronts. If you look at where we are now, we have a threshold which ~~is~~ as a proportion of ~~the~~ average earnings ~~which~~ is roughly in line with the OECD average and, indeed, ~~is~~ ~~is~~ we now have a higher threshold for the married man, ~~This is the case~~ as a proportion of average earnings than in important countries like the United States or Germany. Whereas if you look at the basic rate of income tax, which is the starting rate of tax, ~~it is~~ we have one of the highest starting rates of tax, probably the second highest, of any of the ~~leading~~ OECD countries. ~~25~~ The basic rate is particularly important, too, in that it is the marginal rate of tax for 95% of the population. It is also, of course, the marginal rate of tax for the unincorporated sector of business. It is an important objective to get that down. Each year one has to choose what one's priority is when there is a limited amount, if anything, that can be done.

235. Last point, Chancellor, the change in CTT in the abolition of lifetime transfers has been very much welcomed by private businesses, family business, as a means of continuing from one business to another. It is a little surprising that the changes with regard to discretionary trusts seem to go the other way and indeed make it more difficult to make provision for people dying out of turn. It seems strange having given with one hand you are half taking back with the other. What is the thinking behind that?

(Mr Lawson) ~~There were, first of all, certain changes that were made~~. I am grateful to you for your remarks about the value to the ~~family~~ very important family business sector of the economy of the abolition of the tax on lifetime gifts. I, too, think this is important. ~~First of all~~ But at the same time, there were certain ~~really~~ avoidance devices which needed to be stopped, through the use of trusts and of course if you have an inheritance tax, as we now have, which ~~gets~~ taxes capital at that stage which I think is the least damaging stage if you are going to have any form of capital tax (and it is also a stage, incidentally, where there is no capital gains tax liability whereas with lifetime gifts there is a capital gains tax liability which can in certain cases be rolled forward but it is always contingently there) if you are going to do that it is very important to protect the yield of that tax by not having a loophole through the trust device.

I am all in favour of trusts for the purpose that trusts ~~are~~ were first invented, for example ~~there,~~ if there is a minor and it is right therefore that his capital should be held in trust, or for whatever other reason but I am not ~~indeed~~ in favour of trusts as a tax avoidance device, that is not what they were originally invented for. So, certain changes had to be made but fundamentally the trust regime ~~had~~ has remained as it was ~~to be made~~.

Chairman

236. We are most grateful to you for giving us such full answers to a number of questions. Now I am tempted to suggest we might have a note on the relevant question of track record against medium term financial strategy, perhaps we will not do that. There are one or two questions as to the way you see the economy working with regard to interest rates. We are most grateful to you and Sir Terence and Sir Peter for coming along this afternoon.

(Mr Lawson) Thank you very much, I have enjoyed your questions and it is always helpful to me to come before this Committee. If there are specific points on which you would like further enlightenment, written enlightenment, as you know you have only to ask.

Chairman: Thank you very much indeed.

Terry's ~~draft~~

Draft Reply to TCSC

The lik between rapid growth of unit labour costs and high interest rates was set out clearly in the Chancellor's reply and scarely needs elucidation.

The essence of the Government's monetary policy is that it is geared to the ambition of declining inflation and will not accommodate (and hence validate) potential inflationary impulses.

It follows from this that the greater the strength of the inflationary impulses the higher the short-term interest rate that is likely to be needed to ensure that monetary policy is non-accomodating. Increases in unit labour costs in the UK have often been significant potential inflation impulses and recent years are no exception; but the general principle applies to all inflationary impulses.

A This does not mean that changes in unit labour costs will typically be a trigger for particular interest rate changes. ~~But~~ What it does mean is that interest rates in the UK are likely to be higher than in other countries if, over a period, there is greater pressure from labour costs in the UK than elsewhere.

I fully understand Terry's (& your) worries abt the JO-S draft, wh. I must say adds nothing to what I actually said myself to the Cttee, but simply puts it in a less accurate way.

I shd, therefore, be grateful if Terry cd have a go @ this very high profile exercise himself: it can be v. short (since it shd begin by pointing out that what I sd was pretty clear & scarcely needs elucidation) — tho I agree with you that we shd get a 'more reflective' piece done in our own time & for our own use.

Meanwhile, the point is this.

When we say that inflation is a monetary phenomenon, to be controlled (& eventually eliminated) by monetary policy, we do not mean that previous Govt's have ~~sd~~ always taken the initiative & sd 'Hey, let's get some inflation going & bang up the money supply'. ~~Often~~ More often it has been a case of Govt's monetary policy accommodating inflationary impulses in the economy — & so validating them — (usually for fear of the short-term employment consequences of not doing so).

Our contention was to say that monetary policy wd for non-accommodation, and that people ~~will~~ still appreciate that and act on that knowledge. Hence the MTFS, which is the antithesis of accommodation.

What, then, are the inflationary impulses which we refuse to accommodate (and thus validate)? Foremost among them is rising unit labour costs.

So far so good.

My *first* thesis is ~~that~~ simply that the greater the strength of the inflationary impulse (which could of course equally be external; but here we are focussing on unit labour cost increases), the higher the (short-term) rate of interest you are likely to need to ensure that monetary policy (eg the underlying rate of monetary growth) is non-accommodating.

My *second* thesis, not I think part of the TCSC, but certainly expressed elsewhere (inc. most recently @ the Lombard Assocn) is that it is necessary to make it clear to business and industry that "companies who fail to contain their own costs cannot look to a depreciating exchange rate to bail them out" (Lombard speech). This clearly requires the maintenance of a firm exch. rate by an adequate level of int rates.

And my third thesis, wh. is (to some extent) another way of looking @ the second, & wh. I did put to the Cttee, is that ~~[illegible]~~ the foreign exchange market looks @ unit labour costs when assessing sterling (clearly, since it ~~[illegible]~~ ~~is an index of~~ is one ~~[illegible]~~ important indicator of our likely future competitiveness in world trade, wh. in turn is one important influence on the XR — & there are other linkages, too). Thus we need a higher XR to maintain ~~[illegible]~~ the market's willingness to hold sterling when unit labour costs are rising rapidly than ~~when they~~ we need if they were not rising @ all. (There is, incidentally, a read-across to the old controversy between an accommodating ~~[illegible]~~ and a non-accommodating XR policy — the former consisting of maintaining a constant real XR, the latter a constant nominal XR — & the inflationary, ~~[illegible]~~ & industrial efficiency, consequences of these alternative courses!)

All this answers the first of the Cttee's 2 questions: the 2nd is, of course, merely a silly debating point.

NL.

CHANCELLOR OF THE EXCHEQUER

Ch.

Terry & I have some concern about where this argument is leading. The O-S draft is not bearing as an expression of what you said. But it implies the following chain:-

wages → inflation → higher money supply → lower ER

↓

higher interest rates

All of which implies:-

(a) cost push theory of inflation

(b) ULC should be/are one of the indicators we take into account in setting interest rates.

As alleged by Gavyn Davies.

which can't be true: and which are commonplaces about what happens in the BERB.

We have now to salvage a bit by building on the Governor's later heart-to-heart, which is in terms of (a) inflationary expectations (b) why we can't bring interest rates down faster.

(Of course (a) implies he wants to work on a cost push theory, which may not be totally unfair).

I ~~[illegible]~~

I think I'd prefer to say that the failure of costs to respond to ~~[illegible]~~ tight monetary policy casts doubt on whether the policy is sustainable – because of the implications for unemployment. I'd want to present ULC as a *lagging* not a leading indicator of industry conditions.

I wonder if someone [illegible] be asked to do a more reflective piece.

In the meantime, the shorter we keep the reply to the TCSC the better.

RL.

17/4.

FROM: J ODLING-SMEE
DATE: 16 April 1986

CHANCELLOR OF THE EXCHEQUER

cc. Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir Peter Middleton
Sir Terence Burns
Mr Cassell
Mr Monck
Mr Evans
Mr Peretz
Mr Scholar
Mr Sedgwick
Mr Riley
Mr Pratt

TCSC ENQUIRY INTO THE BUDGET

X The Committee have asked for an explanation of the mechanism whereby rising unit labour costs are translated into higher interest rates (letter attached). They want to follow up something that you said when you appeared on Wednesday, 26 March (extract from transcript attached). They ask whether higher interest rates are an explicit Government policy response to rising unit labour costs; and, if the latter is so, whether such a stance is not inconsistent with the contention that industrial costs are for industry alone to deal with.

2. I attach a draft answer. It follows the answer that you gave fairly closely, while being a little more explicit about the role of monetary policy in bringing about the rise in interest rates following a rise in unit labour costs.

3. In the same letter, the Committee have asked us to say whether any simulations of oil prices exist. It is not clear exactly what scenarios they are trying to specify, but it is unlikely that they correspond exactly to those that we have looked at. I therefore suggest that we refer them to the working paper that was published last year, along the following lines;

"You asked whether we had any simulations of the effects of different oil prices, or whether any could be produced. The Treasury did, of course, publish a working paper by Horton and Powell, which contained simulations of the effects of lower oil prices. Although they were completed over a year ago, the broad picture that they give is still relevant."

4. We have been asked to reply on Friday, 18 April, or at the latest, by noon on Monday, 21 April. It would, therefore, be helpful to have your response this week.

JO-S

J ODLING-SMEE

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TREASURY AND CIVIL SERVICE COMMITTEE

11 April 1986

Dear Richard

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Secondly, Members have asked me to invite the Treasury to say whether any simulations exist or can readily be produced to show the effects on the principal economic indicators (the policy stance being assumed to be unchanged) of (a) a continuation of current oil price levels, and (b) a modest recovery in prices?

As you know, the time scale of the Committee's Budget inquiry is constrained by the date of the second reading of the Finance Bill. A meeting to consider a report will be held on 21 April. May I therefore ask if your submission could arrive not later than noon on that day, or - ideally - on the preceding Friday?

W R MCKAY
Clerk to the Committee

Richard Pratt Esq
HM Treasury
Parliament Street
SW1P 3AG

EXTRACT FROM CHANCELLOR'S TCSC EVIDENCE

154. The Red Book assumes a price for oil averaging $15 a barrel. Events of recent months have shown what difficulty there is in trying to predict what the value of oil will be. If that turns out not to be the case and there is either a substantial recovery in the price of oil or, alternatively, if it were to stabilise nearer to the bottom end of the range we have seen recently, what would you consider would be necessary in terms of a policy response to that, or could I take it from your replies to my earlier questions that you do not really think that the price of oil is that important an influence on our economic policy?

(Mr Lawson) It is obviously important to the fiscal position. Of course, what we see reflected is the price of oil on the spot market and quotations for various forward months, a price which does not necessarily accurately reflect the price at which oil is actually traded, which is probably slightly higher than that. I do not know what the price of oil is going to be. I still have no reason now to depart from the assumption or best guess of an average price of $15 a barrel over the period from now until the end of the year and, indeed, through 1987, for what that is worth, although it is only the price between now and the end of the year, or rather ~~than~~ the price during calendar 1986, which determines the revenues we get in in 1986-87 because there is a bit of a lag. That said, the question which you posed is something to which I adverted in my Budget speech, when I said: "It may well be that the oil price turns out to be different from the average of £15 a barrel which I have assumed for this year's Budget, but if any departure is wholly short-term it is most unlikely to have any significance for policy."

Mr Beaumont-Dark

155. Can I say when Mr Watts said that I was pessimistic, I can promise you that I am not a pessimist. If you come from Birmingham you tend to be a hopeful and fretful realist, but that is not the same

as being a pessimist. Would you not agree that one of the important things is that when interest rates have doubled in Germany, Japan and the USA, in fact double and treble what they are now, you do tend to be very fretful if not fearful? Do you think along with the fall in oil price we are going to get more fall in interest rates or is that now stopped in its tracks, do you think?

(Mr Lawson) First of all, I am sure you would welcome, fretful though you are, the 1 per cent. fall in short-term interest rates that has already occurred in the ~~week~~ wake of the Budget. If one now looks at the rest of this year one can see that the prospect is of inflation throughout the world and in this country falling and, as was said following the London meeting of G5 quite recently, all things considered the five Finance Ministers thought that there was a good prospect of falling interest rates over the coming 12 months. If that does happen, if we do have inflation around the world falling and if we do have inflation in the UK falling as we envisage, if we have interest rates around the world falling obviously that is a ~~hopeful~~ helpful climate for reductions in interest rates in the United Kingdom, but I obviously have to ensure that nothing is done that will jeopardise falling inflation and that may limit what can be done on the interest rate front. If you say why is it that interest rates in the UK in real terms are higher than they are in most other major countries, I think that is not unconnected with the fact that labour costs per unit of output are rising faster in the Uk than they are in most other major countries.

Chairman

156. How do you see that mechanism operating?

(Mr Lawson) I think there are two ways in which it operates. First of all, if labour costs per unit of output are rising fast or faster than in other countries, as they are, that is a potential threat to inflation. That is a potential inflationary impulse and it is,

therefore, necessary, to ensure that the increase in labour costs is not translated into higher inflation. One needs, therefore, to keep a tight monetary policy in order to prevent that. That is one way of looking at it.

Another way of looking at it is the way you look at it from the point of view of those who are operating in the foreign exchange market. ~~As to those who operate in the foreign exchange market,~~ Their view of the future of sterling is clearly influenced by what is happening to labour costs per unit of output in this country compared with labour costs per unit of output in other countries. Therefore, in order to prevent the exchange rate from depreciating as a result of fears of this kind, it is necessary to maintain interest rates higher than they would otherwise be. So from both these points of view - and I have said this to industry on a number of occasions, including at "Neddy" - the answer to industry's concerns, so eloquently voiced by Mr Beaumont-Dark, about the level of interest rates, lies very much in their hands, because they are responsible for the rate of growth of labour costs per unit of output.

157. But if you do not have a target for the exchange rate, why then is it necessary to keep the interest rates up for the reason you mentioned?

(Mr Lawson) Because we do not have a target for the exchange rate it does not follow that we are indifferent to the exchange rate. Nothing could be further from the truth.

Mr Beaumont-Dark

158. Are not you using it to compensate for the increase in labour costs in that sense? One has got to have a policy towards one or the other. Not even in the modern world can you have it both ways. It is either the pound that one defends or it is interest rates. Which do you think is more important to industry? Because we do need an industrial strategy, do we not?

(Mr Lawson) There are a lot of statements there, and I am not quite sure whether I fully understand the full import

DRAFT

UNIT LABOUR COSTS AND INTEREST RATES

The link between rapid growth of unit labour costs and high interest rates
follows from the Government's monetary policy. Short term interest rates are
A relatively
varied to keep monetary conditions on track. Rapid growth of unit labour costs
represents a potential source of inflationary pressure
poses a potential threat to inflation. If that threat was allowed to
materialise, monetary growth would accelerate. Financial markets are likely to
"This may affect
anticpate such a threat. In that case, inflationary expectations rise, leading
putting
to upward pressure on nominal interest rates and downward pressure on the
exchange rate. Faster monetary growth or a depreciating exchange rate would
To prevent
in these circumstances add up to a loosening of monetary conditions. To
remain higher than would otherwise be the case.
prevent this interest rates have to be raised, and hence they tend to be
higher when unit labour costs are growing rapidly.

There is no conflict here with the proposition that industry is responsible for those costs, especially unit labour costs, over which it has direct control. But one of the consequences of the stable and predictable financial framework that the Government's financial policies provide is that industry has an additional incentive to avoid excessive increases in unit labour costs. For by doing so it helps keep interest rates down, from which everyone, industry included, benefits.

PS/Chancellor
PS/CST
PS/FST
PS/EST
PS/MST
Sir P. Middleton
Sir C. Littler
Sir T. Burns
Mr Lavelle
Mr Cassell
Mr Fitchew
Mr Mountfield
Mr Scholar
Mr Peretz

COMMITTEE OFFICE
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TREASURY AND CIVIL SERVICE COMMITTEE

10 April 1986

Richard Pratt Esq
HM Treasury
Parliament Street
SW1P 3AG

Dear Richard

I have to let you know that at a recent meeting the Committee decided to embark on an inquiry into Sovereign Debt, reviewing their 1983 Report in the light of currency movements, commodity values and oil prices since then. Some of the issues raised in their evidence late last year on the Baker Plan will of course be relevant. As yet, we are only at the earliest stage of sketching out the scope of the inquiry and making arrangements for witnesses, meetings and advisers. We are not proposing to make public the Committee's intention for some time. Nevertheless, it seemed that early warning of the proposal would be of assistance to you.

The inquiry is expected to begin immediately after the House returns from the Whitsun adjournment. And the Committee hope to conclude with a report sometime in October. Although as I say no decisions have been taken about the number of witnesses who might be invited to give oral evidence, at the moment we anticipate no more than six to eight sessions of oral evidence. It seems likely that Members may wish to begin with official evidence from the Treasury and to conclude, perhaps, with that of a minister. I have no doubt too that they will shortly be indstructing me to invite you to submit a brief memorandum for consideration at their first meeting. You may also wish to know that a visit, perhaps to the USA and one or two South American debtor nations is being considered. As soon as these plans become more detailed I will be in touch with you and with the FCO again.

Yours sincerely
Bill.

W R MCKAY
Clerk to the Committee

1-26

p.a. 18/4

FROM: R PRATT
DATE: 14 APRIL 1986

MR ODLING-SMEE

cc PS/Chancellor of the Exchequer
PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
PS/Minister of State
Sir Peter Middleton
Sir Terence Burns
Mr Cassell
Mr Monck
Mr Evans
Mr Peretz
Mr Scholar

TCSC ENQUIRY INTO THE BUDGET

... I attach a copy of a letter I have received from the Clerk. As you see he asks for a further Memorandum from the Treasury to discuss the relationship between rising unit labour costs and higher interest rates.

2. Could I ask you to set in hand the preparation of such a Memorandum? As you will see from the timetable set out in the Clerk's letter, we need to submit this note either on Friday 18th, or Monday 21 April. Would it be possible for you to let me have such a note (which would of course have first to be cleared by the Chancellor) by Friday 18 April?

Richard Pratt

RICHARD PRATT

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ynrp.

TRANSCRIPT: For instructions on its use, see below Ev 4

==

Chancellor
Sir P. Middleton
Sir T. Burns
Mr Cassell
Mr Peretz

HOUSE OF COMMONS

MINUTES OF EVIDENCE

TAKEN BEFORE

TREASURY AND CIVIL SERVICE COMMITTEE

MONDAY 14 APRIL 1986

MR R LEIGH-PEMBERTON, MR E A GEORGE and MR J FLEMMING

Yes! ADR's not only sin...

Ch/ See the Gov's remarks on ADRs. He was also asked about the relationship between interest rates + UKC; we also got a note from the TCSC - which I may have shown you - among them a note by officials on the same subject. Quite a sharper ... on broad money / perhaps too lax. RL. 15/4.

Evidence heard in Public Questions 291 - 378

USE OF THE TRANSCRIPT

1. Members and prospective witnesses to whom the transcript is sent in strict confidence, under the authority of Mr Speaker and the Committee, are asked to note that the text is unpublished and that its use is restricted.

2. Members receive copies for the purpose of correcting questions addressed by them to witnesses, and are asked to send any corrections to the Committee Clerk as soon as possible.

3. Prospective witnesses receive copies in preparation for any evidence they may subsequently give.

4. This is an uncorrected and unpublished transcript of evidence taken in public and reported to the House.

5. No public use should be made of the text.

MONDAY 14 APRIL 1986

Members present:

Mr Terence L Higgins, in the Chair
Mr Anthony Beaumont-Dark
Mr John Browne
Mr Nicholas Budgen
Mr Mark Fisher
Mr Ralph Howell
Mr Austin Mitchell
Mr John Townend
Mr Richard Wainwright
Mr John Watts

MR ROBIN LEIGH-PEMBERTON, Governor, MR E A GEORGE, Director responsible for Home Finance and MR JOHN FLEMMING, Economic Adviser to Governor, Bank of England, called in and examined.

Chairman

291. We are most pleased to welcome you and your colleagues this afternoon to give us evidence, the traditional annual evidence on the Chancellor of the Exchequer's budget. I am tempted to begin by asking whether you intend to open on Sundays in future!

(Mr Leigh-Pemberton) You will be surprised how often it is open on Sundays, Chairman!

292. We have, of course, had the benefit of looking at the latest quarterly bulletin, but please do make any general remarks you would like to make at the beginning or, if not, we will proceed to questions.

(Mr Leigh-Pemberton) I would like to say something at the outset about the monetary policy objectives of the budget, which is the area which is closest to my own responsibilities, and I would like to make this statement because I feel this area has been the subject of a certain amount of comment, which I would like to put into perspective. First, I would like to make it quite clear there has been no change either in the course of last year or in the budget in our general approach to monetary policy, whether in relation to the aims of policy or in relation to its implementation. I have explained, as you will remember, to the Committee on earlier occasions, and I think my predecessor has done the same, that the fundamental objective of monetary policy is gradually to squeeze-out inflation and to create a stable framework for the operation of the economy. That remains the overriding objective. It is the greatest contribution that monetary policy can make to promoting our wider national economic goals, because it is a necessary condition for clear price signals and more rational decisions about the resource allocation; for example, decisions about saving and spending or about investment and employment. These are in their own turn essential pre-conditions for more effective working of the economy and the sustainable growth of activity over the medium and long term. In trying to achieve that objective we continue, as in the past, to be guided by the behaviour of the various measures of narrow retail money and of broad money or liquidity, notably the target measures, but we also look much wider than that, at a range of other indicators and these include, importantly, the exchange rate against other currencies but they include too all the other evidence available to us about the actual and prospective development of inflation and the economy. In looking at these various indicators we are concerned not just with the size and speed of movements in them but with what we know about their causes and whether or not they are likely to be sustained. All this, I am sure, is familiar to you; it is the procedure we have followed consistently for many years. Within this general approach, however, there have been changes from time to time to the precise specification of the monetary targets, changing targetted measures or the target ranges, to take account of changes in the financial system which affect the behaviour of monetary aggregates. There have been technical adjustments of this kind on a number of occasions in the past and again this year, with the temporary suspension of the £M3 target last autumn and its re-introduction in the budget with a higher, 11 to 15 per cent, range. I think there is a tendency to over-dramatise technical changes of this kind and these latest steps, for instance, have been described by some people as the death of monetarism. They could only be seen in this light by someone who believed the policy in the past had been operated mechanically in response to movements in £M3, which of course it never has been. Others have inferred that we no longer take broad money seriously and this view is equally mistaken. No monetary policy operating in a highly developed financial system can afford to be indifferent to what is happening to the liquidity of the economy, or to its credit counterparts, though, equally, such developments need to be interpreted with great care, especially at a time of rapid structural change. For this reason it is also mistaken to think a higher target range means ipso facto that policy has been relaxed. It would, of course, be tidier and more convenient if one could avoid having to make these adjustments and I accept technical changes can be mistaken by the unworldly as changes in the general stance of policy, but I have explained they are not. But the real world, unfortunately, is an untidy one and cannot be encapsulated in a few, simple, unchanging rules.

293. Have you much more to say, Governor, because if you have I think it would be better to read it into the record?

(Mr Leigh-Pemberton) Just something about the ending of over-funding and, finally, just to emphasise that important though the monetary framework is, it is not in itself a sufficient condition for achieving wider economic objectives, and we are just as conscious as anybody about the oppresive level of unemployment. I need say no more.

294. Thank you. I wonder if I might ask one question which has arisen quite frequently in the evidence we have heard. The Chancellor told us that interest rates would remain at relatively high levels as long as unit labour costs were rising faster in the United Kingdom than elsewhere, but we were a little unclear precisely how this mechanism in the Chancellor's view, operated. Clearly it is very relevant to your own operations and we wondered whether you could give us an idea of how you saw the relationship between unit labour costs and the interest rates?

(Mr Leigh-Pemberton) The difficulty about our unit labour costs is that I think they are rising much faster in this country than in any of our industrial competitors. Therefore, for the purposes of real growth in the economy, they do represent rather a serious impediment; they represent a potential source of inflationary pressure and, consequentially, I think the monetary authorities take the view that we must set some scene in which, as far as possible, this growth in unit labour costs could be restrained. The ability to pay increased wages is some reflection of the increased liquidity of our companies, and I do not think anybody wishes to object to that; it is a very important development as a reflection of their increased success and their profitability. The important thing is how this surplus is to be used and if it is to be used exclusively in increased wages, then investment will suffer, costs suffer and competitiveness suffers. I think it is simply a function of the tightness of policy which can be discouraging or helpful in making it more difficult to concede these seemingly unjustified wages. That is the sequence of events.

295. Are you saying that if unit labour costs are rising faster than elsewhere, you put up the interest rates?

REFERENCE

ULC +
Interest
rates

(Mr Leigh-Pemberton) I am saying it is some justification for our interest rates being higher than our competitors and until this situation improves, I think it is much more difficult to bring our interest rates down to the same level as our competitors.

296. So it is effectively a mechanism which is a decision to keep interest rates high because of unit labour costs?

(Mr Leigh-Pemberton) No, I do not think it is essentially a mechanism to do that. It is one of the reasons why interest rates, I think, have to remain higher in this country than with our industrial competitors. One of the other reasons why interest rates have to remain higher is that our inflation rate is still that much higher than our main industrial competitors and we have to be extremely cautious about allowing that to reassert itself in any dangerous way. I think we have the further point that the exchange rate, although strong at the moment, is potentially vulnerable and we have had, certainly since I have been Governor, two painful experiences in which there has been a slide in sterling which has had to be corrected rather sharply, and it is better to avoid the heavy over-correction which results from that situation than to allow it to develop. I do not say interest rate levels are solely a mechanism for controlling the wage increases.

297. But it is one of the reasons why they are raised to the levels they are?

(Mr Leigh-Pemberton) I think it is one of the reasons why we have to have them at the present rate or, to put it another way, it makes it more difficult for us to bring them down more quickly. But I do not accept your words "why interest rates are raised", because I do not think we have actually raised interest rates because of the rise in unit labour costs. Could Mr George add something to that?

(Mr George) In a sense it is really a natural consequence of the attempts to preserve a tight nominal framework for policy. Within that, if inflation generally or unit labour costs in particular tend to rise, then that will tend to bring about pressure within a given nominal framework which causes policy conditions to tighten, including interest rates to rise.

Mr Budgen

298. You took the unusual step of reading a long, and I am sure very carefully prepared statement, about monetary policy because you are aware of the very widespread concern about the Government's present monetary policy, are you not?

(Mr Leigh-Pemberton) I am aware that there is some anxiety that the Government's monetary policy has been in some way relaxed but I disagree with that and that is why I wanted to set the scene with the statement.

299. You, in the Bank, have a recurring nightmare that you will acquiesce in loose monetary policy as occurred in 1972, 1973 and 1974, without giving public signals that you have warned against it?

(Mr Leigh-Pemberton) No, I do not suffer from recurring nightmares, either literally or metaphorically. All of us in the Bank remain concerned that policy must not be seen, or be interpreted, to be too lax and to have some of the consquences that we had, say, in January 1985. That is a concern but not a nightmare.

300. I exaggerate, of course, but it is the fact, is it not, that in 1972 and 1973 and early 1974, it was always said that there had been a premanent decline in the velocity of circulation and that the increase in the money supply, however defined over those 2½ years, would not lead through into an increase in inflation later, and those who said that were proved horribly wrong, were they not?

REFERENCE

POLICY LAX/

BROAD MONEY

(Mr <u>Leigh-Pemberton</u>) They were certainly proved wrong then, yes.

301. And during that period, that earlier period, instead of the share index going very high, it happened to be the property index which went very high, but again it was a partiuclar kind of asset which said to be adapting in a systematic way to particular changes in the way that money was used - that was the argument, was it not? We now have, do we not, an increase in at any rate £M3, on an annualised basis in the last month, of 28 per cent (2.2 which annualised up comes to 28 per cent) which has not been followed by increases in interest rates. If there had been any sort of mechanical arrangement after that, one would have expected not a reduction in interest rates with lots of nods and winks to the effect they are coming down further, but one would have expected an increase in interest rates, would one not?

(Mr <u>Leigh-Pemberton</u>) No, because I think the background to the present situation is different from the situation which you have described between 1972 and 1974. The situation we have now, surely, is where interest rates are real, very real, as the Chairman reminded us just now. In those circumstances, it has led me to do one's best to interpret what are the components, what is the cost, for a growth of the broad money aggregate and I think it is perfectly clear there is a tendency for people to burden financial assets within that aggregate, because of the attraction of the real interest rates. That was not the case in 1972 or 1974. Then I think you drew the parallel of the property market and the present share index. I think the present share index reflects the justifiable degree of progress which has been made, both in world economies and in our own economy, at the moment and therefore is much more soundly based than the property boom of the mid-1970s to which you have referred. But the real key here is that this growth in broad money must be seen for what it is, a growth not in transactions money necessarily but a growth in money balances held for savings. I think that is the difference and that is why I think it is acceptable to see £M3 now at a level which may be exceptional for this month but which, over the year, is aimed at about 11 to 15. In this last month to which you rightly refer, there has been an exceptionally high growth and I think it is reasonable to say this is almost entirely bank lending and probably related to the final month, the last month, of the taxation allowances for capital expenditure.

302. I am sure you will not think me offensive, Mr Leigh-Pemberton, when I say that answer was exactly what the Chancellor of the Exchequer would hope you would say, but if you look, however, at what you said in the December 1985 quarterly bulletin, you find there the Bank giving the most heavy warning that you can, since you speak in such (I won't say "refined") a well-bred and cautious way; you gave the most heavy warning to the Government about lax monetary policy. Let us just whip through this quickly, because this comes through time and time again.

W|303

If you look, for instance, at page 503, you say that the declining velocity of broad money implies a potentially worrying build-up of the liquidity of the private sector. You and I know that when The Sun talks about worrying they mean of no importance. When a central bank talks about worrying, they mean the world is about to end, do they not?

(Mr Leigh-Pemberton) Broadly up to nightmare level for ordinary people, I think! And you see how it goes on, though: "There are reasons for believing that this liquidity is willingly held at current prices and interest rates. Were that willingness to start to weaken ... " then perhaps a different situation develops. This goes back to the Chairman's first question to me. This is one of the reasons probably why our interest rates have to be that degree higher than elsewhere. We have a substantial, what you might call overhang in the broad money aggregate. If it remains there in this form of savings money it is perfectly satisfactory. If for some reason the will to hold it in that form were to weaken and this were gradually to turn into what one might call transaction balances, then I think we will have a very different situation on our hands.

303. But you and I know the way this is written. This is all written on the basis that you make an important point on one step and then lots of very clever people decide whether they are going to take it by half a step or two-thirds of a step so they compromise on something between a half and two-thirds and then they all sit down and think how they described it when they were making up their Latin verse before they got their first ingrates and it is all done in a very careful way, but the use of the word "worrying" by the Bank is important, is it not, Governor?

(Mr Leigh-Pemberton) Yes, I accept that. If I may say so, it has the word "potentially" in front of it.

2
ii/304

304. And these sorts of remarks, which certainly give both you and me something to argue about, are continued both at page 514, where the Bank is moved to have a caption at the beginning:"In the economy at large" - then it says in big letters so that everybody can read it - "liquidity continues to expand rapidly," then at pages 519 and 520 the same warnings are repeated again. Indeed, at page 520 the Bank even goes so far as to say: "But the fact that the economy is becoming increasingly liquid means that monetary policy will increasingly have to recognise and take account of the risks" - that is a very big word for a central bank to use, is it not? - "that this implies." I put it to you, Governor, that you, through numerous remarks which are well understood in the circles in which you want them to be understood, gave the Government a very clear warning that monetary policy was verging upon the lax, did you not?

(Mr Leigh-Pemberton) No, I do not think we have given the Goverment that warning for about a year. I certainly would plead guilty to that in January 1985. We are constantly alert to this situation developing and I suppose if anyone were to be thought to be ultra-cautious or a wet blanket in this situation, yes, it is us. But I still stand behind the situation at the moment, which was epitomised in the middle of page 503: "In fact, there are few signs at the moment of untoward developments in asset prices." I accept we used those remarks but I think that situation still prevails. If the situation you are posing really obtained, the policy being unduly lax, we would see this reflected in other indicators at the moment, but would the exchange rate have survived a fall in the oil price in the way it has if, in addition to that fall, monetary policy in this country was seen to be unduly lax in the way that perhaps it was in January 1985? It just does not add up. While we have said that a presumption arises if the aggregates rise above the target zone, that we should be extremely careful about the situation, that presumption can be dispelled by all the other indicators we look at and build in, and I think at present the indicators give us reason to be reasonably confident about the situation. It does mean that our interest rates are somewhat higher than those in other countries but I do not think at the present moment the position is so bad that it excludes further changes in appropriate circumstances and I feel sure that if the situation you are putting to me prevailed we would not see the exchange rate at the level it is now.

*
13/305

Mr Howell

305. Governor, I wonder if you share my view that higher-than-hoped-for wage increases are principally due to our social security system and the index-linked tax-free benefits at 7 per cent., which require apparently a 10 per cent. increase in wages in order to keep up with that, and this is the cause of the jacking-up of wages generally?

(Mr Leigh-Pemberton) I do not know that I would, with respect, completely agree with that. My own feeling about this is it is somewhat understandable for employers in circumstances where companies perform better, profits are higher, productivity has improved, to say that the workforce should share in this generally improved situation. The tendency, however, to overdo this is, I think, a residual effect from, I have called it a malaise in Britain which has never prevailed in Germany or Japan and which has still left us with, however well-meaning, a tendency to be more concessionary in this respect and to give less priority to further investment or lower costs than our industrial competitors. I think this is much more a structural matter than an example of the sort of elements you have described.

Mr Beaumont-Dark

306. Governor, Government has always denied it ever had an exchange rate policy but you mentioned, rather interestingly, that sterling had to be corrected twice rather sharply but that was only when it was coming down and would do industry a bit of good and the competitiveness a bit of good. When sterling was going up to 2.48 in March they never seemed to want to intervene then, so does that mean there is an exchange rate policy and that the main way that is dealt with is by having higher interest rates than we ought to have, which, of course, affects industry in the way ofits costs and its competitiveness overseas, in other words, that we always intervene if it falls and we let it rise to whatever it likes even if it murders half of manufacturing industry?

$ 14/307

(Mr Leigh-Pemberton) I do not want to get drawn into the events of 1980-81 when we hit the 2.48 figure, but I think it would be perfectly fair to say if we see the exchange rate rising in a very sound and convincing fashion it reassures us somewhat in respect of the matters that Mr Budgen has put to me, that policy is adequately tight, maybe tighter than necessary, and, other things being equal, a fall in interest rates would be justified.

Mr Mitchell: But it did not come then.

Mr Beaumont-Dark

307. But is that true?

(Mr Leigh-Pemberton) There have been falls in interest rates.

Mr Fisher: Not in 1980-81.

Mr Beaumont-Dark

308. Surely the point is that the only reason it went up was because of oil? That was really it?

(Mr Leigh-Pemberton) The exchange rate went up?

309. Yes, and that did industry a great deal of harm then. You know from your own experience in the Midlands what it did to manufacturing industry. Now that we have sterling down to a more realistic figure - and many of us think it should be lower anyway - would your view still be that if sterling decided to go up you would let it go up? You would only do anything about it if it were likely to fall?

(Mr Leigh-Pemberton) No, I do not think that is true at all. If it goes up it is a sign, I think, that our policy is tight, tighter than is necessary, that there is confidence overseas in the British economy or British monetary policy, and if it is, as it were, suggesting that conditions are too tight I think we are perfectly content to take that opportunity to lower what are admitted to be high interest rates, which in their turn are an additional cost to industry.

Now, I would accept that as far as possible consistent with policy it would be appropriate to get interest rates down, but I must emphasise consistent with the whole of the rest of the drift of the policy. But when you said that in the past the level of the exchange rate did harm, I think the level of the exchange rate made a considerable contribution to the defeat of inflation. Suppose we had not had the oil, balance of payments crises would have meant the acceptance quite honestly of a lower standard of living in this country, much lower real wages, and I think a more difficult situation in the country than we experienced, say, in the early 1980s. I say more difficult because I think it would be very hard to have got people to accept the consequences of the competitive position of this country without the oil.

310. But you do think there has to be a sensible balance between the needs of those who have to compete in manufacturing industry and the needs of some macho pound? Some people seem to think it must be a marvellous thing if the pound goes up and up.

(Mr Leigh-Pemberton) I do not accept that. I think one of the most encouraging things we have been able to point to recently is the fact that we have been able to accept a degree of fall in sterling as a result of the change in the oil price without having cause to be anxious about the general counter-inflationary stance. Indeed, I think probably the inflationary effects of the fall in the price of oil are probably rather greater than those of the fall in the exchange rate.

311. Can I just pursue one direct question about the Budget and what you think about it? Do you think a reduction in taxation, say, by 1p in the standard rate, has a significant effect on the work ethic of businessmen? In other words, do you think the one thing that is going to get this country galloping forward is 1p or 2p off the standard rate, or do you think better use could

be made of that money?

(Mr Leigh-Pemberton) I think that high levels of personal taxation are discouraging and I think that any move to lowering them is helpful. Whether or not that £950 million this year could have been used more usefully elsewhere is a very much wider subject. I actually support the reduction of direct personal taxation. I sign a monthly cheque in respect of the employees on my farm for PAYE and it amazes me how much tax agricultural workers are still paying.

312. I could not agree with you more. I know you are a generous man but I have a hunch you are not paying your agricultural manager £30,000 a year - or you might be. Do you not think that is the question I asked you? Do you think the standard rate is the best way of reducing taxation?

(Mr Leigh-Pemberton) I think it probably is because I think that is the point at which tax is most felt by most ordinary people. There are very few people, I guess, who,faced with the alternative of doing overtime or not or increasing earnings or not or increased responsibility, are not paying tax at the standard rate. I do not know what the statistics are. I think that is the point of impact that matters.

Mr Fisher

313. Governor, running through your remarks is a strain which says that the high exchange rates that have been experienced in the last few years are in some way an international sign of approval that monetary policy is just about right, if perhaps a little too tough. Is that really what you are saying?

(Mr Leigh-Pemberton) I am not saying that completely. I do say that we ignore market reaction to the level of the exchange rate at our peril. In so far as the exchange rate holds steady in what are otherwise adverse circumstances, for instance, the fall in the oil price, I think one may take that as a form of approbation of both the economic situation of this country and the financial stance.

314. Looking at the high interest rates which are associated with that policy, Mr George I understood to say - and I noted his words - that "the high interest rates were a natural consequence of a tight nominal framework". Is that "tight nominal framework" he is referring to the MTFS?

(Mr Leigh-Pemberton) It is part of the MTFS.

315. So the MTFS is responsible for high interest rates?

(Mr Leigh-Pemberton) If the MTFS is tobe implemented, there will be certain circumstances in which interest rates have to be high. The essence of the MTFS is a continuous downward pressure on inflation till it is squeezed out of the system. If that requires high interest rates, well, high interest rates there will have to be.

316. We certainly know what the effect, particularly on manufacturing industry, of those high interest rates has been. Can we look at an alternative scenario where we might have lower interest rates? Can you remind the Committee what the actual short term interest rates are in the other G5 countries at the moment?

(Mr Leigh-Pemberton) Yes. Let us take the equivalent of somebody paying the blue chip rate at the moment, base rate plus one. I think the equivalents in Germany would be - I am guessing, I am afraid - 7, 6 ----

317. Or 4, 5 ---

(Mr Leigh-Pemberton) Well, it may vary according to their ---

318. And Japan as well? And a little bit more in the States?

(Mr Leigh-Pemberton) Yes.

319. So you would agree that probably the average for other G5 countries is round about 5 or 5½ percent?

(Mr Leigh-Pemberton) I would guess so.

320. That is about half what it is here?

(Mr Leigh-Pemberton) Oh, it is. We have a very severe differential.

321. Is that not a very high premium to investors to invest in the United Kingdom?

(Mr Leigh-Pemberton) Yes, but it brings in some invtment.

322. What rate do you think our pound would be, sterling would be, if our interest rates were the same as the average for the other G5 countries?

(Mr Leigh-Pemberton) If our interest rates were lowered ---

323. Halved here and now.

(Mr Leigh-Pemberton) I think the rest of the world would assume that the Government had abandoned its counter-inflationary stance. What would happen to the exchange rate in those circumstances I find it almost impossible to estimate but it would be a very damaging spiral. If I may say this, if you are leading on to argue that this would be of great assistance to industry, there would be a temporary period when this lower exchange rate was beneficial but do we not know from experience in the past that that is short-lived, that when the time comes to pay for imported raw materials with the devalued currency costs rise and all we have achieved is a very short-lived form of salvation?

324. And exports rise too. What evidence through your business surveys do you have of the effect on manufacturing industry of

these high levels of interest rate? You are not going to suggest they have encouraged investment in our manufacturing industry?

(Mr Leigh-Pemberton) The reaction varies enormously. There are some industrial companies who take the view that they do not mind what the exchange rate is, they will continue ----

325. No, interest rates we are talking about.

(Mr Leigh-Pemberton) Sorry. Well, I think all of them would prefer to see lower interest rates but there are many of them who would say, if the price of lower interest rates is a renewal of inflation, a fall in the value of the pound and increased import costs, they would opt for the present mix. Now, these are the people who claim - and I am sure they can - they export on quality and service and do not need the aid of a devalued currency to make them competitive.

326. Governor, I asked you what evidence the Bank had on the effect of the high interest rates on investment in the manufacturing industry. Have you in the Bank been collecting evidence and doing surveys on the effect of this?

(Mr Leigh-Pemberton) May I consult my colleagues? I cannot think that we have done a survey or that we would produce any real answer to the question.

(Mr Flemming) We have not conducted a survey. We do maintain contact with a number of companies through our agents in the various parts of the country. We also analyse statistical material. You will find in our most recent bulletin a paragraph on page 19 which suggests that fixed capital spending by companies has grown remarkably strongly considering the level of real interest rates.

327. A big consideration?

(<u>Mr Flemming</u>) It was a large number by any standards, 15 percent growth in capital spending. We have also recently published a discussion paper on the effects of interest rates on various items of expenditure as revealed in a number of economic models, but not a survey of the companies' behaviour.

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328. This is why I said that you have not got any firm evidence, or have not sought it, on the impact of interest rates on manufacturing industry. Can I ask if you have on the alternative side of it got any evidence on the impact of those high interest rates on the profitability of the banking sector?

(Mr Leigh-Pemberton) I do not know if we have done a specific survey but I think I can answer that from the point of view of general experience in banking. First of all, higher interest rates do not automatically carry with them higher profits for banks because they pay a higher price for their money and their profitability turns very much on the margin between the two, except in respect of what is called the endowment element of interest-free current accounts. As you know, interest-free current accounts have fallen very much as a proportion of banks' liabilities at the moment, so that a change in bank profitability as a result of a high interest structure or low interest structure is not by any means in direct relation.

329. But they have not done too badly in the banking sector over the last few years. We should not shed too many tears.

(Mr Leigh-Pemberton) No, I am glad you do not have reason to shed tears because I think it is extremely important that banks should make profits, build up their retentions and improve their capital base in a different and risky world. If you think I am referring solely to international debt, may I remind you the largest increase in the provision the big clearing banks have had to make in this last year was in respect of domestic small businesses and private debt.

Mr Browne

330. Governor, further to Mr Fisher's recent questioning on relative interest rates of the UK versus the United States, Japan and West Germany, is it not also very important to take into account the relative real rates net of inflation rather than the relative absolute rates?

Secondly, the use of the proceeds when the Government borrow is not the most important question; it is what they spend the money on which is the most important question, just as in a corporate debt, without approving of the interest applied to the company's debt in comparison with the political risk of involvement in the three countries that were mentioned as compared with us. All the parties are pro-low inflation and disciplined Government spending and in this country that is not true. Surely these factors are taken into account by the world financial community in arriving at buying and selling of sterling which reflects the interest rates?

(Mr Leigh-Pemberton) I think I must agree with you generally, yes.

Mr Browne: On the second point, I may be wrong here but I slightly felt you agreed with what Mr Beaumont-Dark said, that the level of sterling, at 2.48 going towards 2.50, was murdering British industry.

Mr Beaumont-Dark: It did.

Mr Browne

331. If you look at the high interests rates of Japan, West Germany and Switzerland and you see how well those countries have done in the international trading world, surely it is a question not that our goods were less cheap, by maybe 5, 10 or 15 per cent., but they just were non-competitive, they were the wrong designs, wrong quality and were not delivered on time, and this is what was murdering British industry, not the level of sterling?

(Mr Leigh-Pemberton) There was a great deal of truth in that. I am not sure still that those ferocious times exerted a discipline, and I was still on the board of commercial companies at that time and seeing it perhaps more directly than now, but they exerted a very fierce discipline. It was a painful time. My judgment on this - and I make this general comment - is that it was necessary that we should have

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had that stringent time. I do not believe without it the country would have really accepted that real, needed change that we have seen since then.

332. Would you agree that in the early 1970s when the United States, by breaking the gold exchange window and then Great Britain by floating its currency, effectively destroyed the Bretton Woods agreement since then we have seen an era of grotesque volatility in exchange rates, in commodity prices, in interest rates and in growth patterns, and is it the general view of the Bank of England that we should now move towards encouraging, even gradually, a return to fixed or near-fixed exchange rates and even restore a monetary role to gold?

(Mr Leigh-Pemberton) I do not think the answer to that is an unequivocal yes. The first thing about Bretton Woods is that I doubt the Bretton Woods system could have survived the oil shocks we have had.

333. If it had not been demolished by that time could oil have risen to the price that it did? Would the West have paid if exchange rates had been fixed at those prices?

(Mr Leigh-Pemberton) One could debate that but I do not believe, for whatever reason - the reason you give or the one I have suggested - that the fixed rate system could have survived into the volatility of the 1970s and early 1980s. You asked me are we in favour of a return to fixed or near-fixed exchange rates. I do not think we are in favour of returning to fixed or near-fixed ones. We are, however, very much in favour of returning to convergence in economic policies in the main countries of the world, which will take a great deal of the volatility out of the present exchange rates. It is the move towards this underlying convergence of policies in the G5 or the OECD countries that I think has been encouraging in the last few years and which has gone some of the way to removing the extreme volatility of the exchange rates that we knew a fear years ago, but I do not think we are going to do this by establishing a formal system. I think we are going to do this by continuing convergence of economic policies and continued recognition of those opportunities that the central banks through intervention can do what we achieved after the Plaza agreement last autumn. I do not, however, think this is possible as a result of a formal agreement amongst ourselves that such-and-such a thing should happen.

334. I am very pleased to hear what you said about moving towards that regime eventually, but I was slightly perturbed when you said you did not feel fixed exchange rates would weather the storm of the volatility. My point was that the volatility was caused by the floating exchange rate.

(Mr Leigh-Pemberton) May I put the question back to you in this way. I wonder whether it would have been acceptable politically if one really had fixed exchange rates throughout that period and the form of deflation that we have floated in this country particularly and in other countries really would have been acceptable. One of the reasons we moved out of it was that it was becoming less and less acceptable. That Germany had a formal devaluation was a national disgrace, if you remember it.

Mr Browne: Becoming less and less acceptable to the politicians but maybe not to the voters.

Mr Wainwright

335. Arising out of your reply just now to Mr Browne, you spoke warmly of the convergence, which you welcomed, in the economic and monetary policies of the G5 countries. Could you explain that further? What convergence has there been between the policies - the actual policies, not the rhetoric - of the United States, on the one hand, and, for example, Great Britain and Western Germany, on the other?

(Mr Leigh-Pemberton) There is a genuine understanding of the advantages that will flow to all of us if the distortions in the world monetary systems, which are caused by these big disparities in internal economies, could be removed. By these disparities I mean a large Government deficit, high inflation rates in one country, low inflation rates inanother. There has been an improvement in this. The two outstanding difficulties, the US twin deficits, on the one side, and the Japanese surplus, on the other, look, I admit, as hardly a success factor but even there there is a modest degree of progress and the sort of pressure that has been applied on these countries through the IMF surveillance and so on seems to be an indication of the commitment of international financial policy to this convergence. There are modest degrees of progress. I can point to Gram-Rudman or the change in the value of the yen since the Plaza agreement.

336. So what you are welcoming just now in reply to Mr Browne was not so much an achievement as an aspiration?

(Mr Leigh-Pemberton) I think there have been both achievements and continuing aspirations.

Mr Browne

337. Could I ask one question on the European monetary system. Despite the way in which sterling responded to the fall in the price of oil, the Chancellor still maintains that the time is not ripe for British membership. What changes would you see needed tomake the proposition more immediately attractive and how likely are the right circumstances to come in the near future?

(Mr Leigh-Pemberton) Circumstances which would improve or make it more acceptable to join must be the continuing convergence between our own economic performance and that of the Federal Republic of Germany, but we have made progress in that direction. Were that to develop, what are feared to be strains between the German mark and the pound in the system would obviously be less. The other element which, of course, is a difficulty to us - the one you referred to earlier - is unit labour costs, an inherent inflationary tendency which does not prevail with the other memebrs of the ERM except Italy, and in this context one must take note of the performance of France in the last year or two whose inflation rate has much improved. So those are factors which I think would be continuing and I trust would continue to move in the right directions. As they improved, well, the impact on domestic policy and the strain on the way we might have to operate monetary policy would be less.

Mr Browne: But when measured against the acid rule ---

Chairman: We must move on.

Mr Mitchell

338. If I can sum up your philosophy of the exchange rate as I got it from your conversation with Mr Beaumont-Dark, it is this: if it goes up, that is okay, we shall not do too much about it because that represents an approval rating from the rest of the world, we can sit back and bask in that; if it goes down, we might resist it even though it would benefit Britisn industry because that is naughty. Now, that means effectively that the Bank will only try and influence exchange rate movements when the exchange rate is coming down.

(Mr Leigh-Pemberton) No, I do not think so. I think the Bank is ready to accept that a lowering of the exchange rate to an appropriate degree could be helpful to British industry and to the economy in the sense that it improves competition. The point ---

339. But when have you ever intervened to stop it going up or done anything about it going up? Never?

(Mr Leigh-Pemberton) Yes, it has happened. We have brought down interest rates on occasion.

340. When?

(Mr Leigh-Pemberton) In the last month or more. I think, if I can remind you of what seemed an anxious period at the end of January about whether interest rates would have to go up because of the downward pressure on the pound as a result of the change in oil price, we did in fact hold the interest rates there and, if I may say so, got through a difficult situation, I believe, satisfactorily. So that one can say on that occasion that we were content, as it were, to hold our interest rates in the belief that the exchange rate was a change on account of the change in oil price which was acceptable.

341. You said about the fast growth of sterling M3 that that is okay as long as it representes "liquidity willingly held at present interest rates", but it is not okay if it starts to leak into transactions. That means surely that we are stuck with high interest rates because the money will be willingly held as long as real interest rates remain high. The question is, how high and for how long? Does it not mean high interest rates for a long period?

(Mr Leigh-Pemberton) Not necessarily. This is very much a matter of, you might say, the view that investors take of prospects for the economy. If I might take a personal example, in a period of inflation people tend to spend their money now because things will be more expensive in the future. If they believe, however, that we are in for a period of stability, and also increasing industrial prosperity, then there is a better chance that they will invest this money in the medium or longer term and surely one can see this going on at the moment. So that I do not think it necessarily follows that a fall in interest rates will, as it were, melt this overhanging glacier. If the fall in interest rates comes at a time when people remain confident about the future of the eocnomy they will continue to hold longer term financial assets.

342. If it comes at a time like this, when people are not all that confident, if interest rates fall, on your analysis savings balances are going to drop and then spending is going to lead to higher inflation.

(Mr Leigh-Pemberton) I think this is perfectly true, but this is a funciton of confidence.

343. So can interest rates fall in real terms?

(Mr Leigh-Pemberton) I think it is a function of confidence. I think at the moment people are confident and that, to that extent, while one has always got to be alert to this, I have not got undue worries or nightmares about the possibility of the unleashing of this what you might call glacier of tightly held money.

344. Why not get interest rates down?

(Mr Leigh-Pemberton) Because you need to bring interest rates down to help industry to improve the growth in the economy ----

345. Why do you not do that?

(Mr Leigh-Pemberton) That can be done consistently with maintaining credibility of policy if the situation is right.

346. You said that our interest rates are about double those of our competitors. British industry is in a very competitive situation in the international beauty contest. You have already mentioned it is an ugly brute, but the expansion of the non-Samantha Fox parts is undesirable because it increases the unit costs more than those of the competitors. So you are now saying in that sense you are now proposing to kick it in the gut with an overvalued exchange rate and punch it in the face with high interest rates, then say "Go out and win the beauty contest".

(Mr Leigh-Pemberton) The only thing I can say to that is, no, I do not agree.

347. In that case, how can it compete effectively with a burden of interest rates which are double those of competitors and an exchange rate which must *ipso facto* be higher because of those interest rates?

(Mr Leigh-Pemberton) The remarkable thing is that the level of investment is competing quite well.

348. In spite ---

(Mr Leigh-Pemberton) In spite of this, yes. It cannot be because of it, though ----

349. How long can water run uphill?

(Mr Leigh-Pemberton) There is one contribution that this combination makes which is confidence about counter-inflationary policy and stability for the future. If you once weaken that, then a very different state of affairs will prevail. But there is confidence in British industry at the present moment, I believe. The investment levels are encouraging. I do not think therefore the scenario you put to me is valid.

350. That is my last question. If the confidence is there,

it is not manifesting itself in investment growth for the future to compete in the world. What is happening is that companies which have the money, which are making high profits, which could be the situation at the moment, are giving that money in pay increases to managing directors and managers, thus setting an appalling example to the workers to whom they preach "keep wages down" while they are stashing it overseas and going in for a frenzy of take-overs and speculation?

(Mr Leigh-Pemberton) No, I do not accept very much of that scenario. I do think, however, we have a tendency in this country to be more liberal or more lax or more generous in respect of pay increases right across the board in respect of our corporate sector compared with our competitors. May I just say the way you put your questions to me Ithink shows some confusion of cause and effect, if I may put it like that, Mr Mitchell. You see, high labour costs actually damage the competitive spirit and to a degree will also damage confidence. The high interest rates are the consequences of high labour costs. Now, we have go get this somehow round the other way -----

351. That is just compounding our problems.

(Mr Leigh-Pemberton) ---- if we are to retain a competitive position.

Chairman

352. I think Mr Watts has some questions. If I might clarify one point, I was a little worried the metaphors were being mixed between overhanging glaciers on the one hand and page three on the other. Would it be true to say the problem of the overhanging glacier would not be a danger if the glacier in the form of the money stock had not been generated in the first place?

(Mr Leigh-Pemberton) I do not think I would accept that. I think the form of money stock would be perfectly acceptable if that money stock could be seen as being used for medium and long-term investment purposes and did not represent a threat in terms of immediate or medium term consumption. I think that is the real difference in this. We have a larger growth of money stock than other countries for all sorts of reasons, I think it is the use to which it is put or the use for which we have to watch it is not put that matters.

Mr Watts

353. The Bank in its latest quarterly bulletin has been more specific than most commentators in forecasting the impact on the economy of the fall in oil prices and on page 26 anticipate a half per cent addition to GDP this year and one per cent next year and a fall of a quarter of a million in unemployment by 1988: in which particular sectors of the economy do you articipate this additional growth in employment rising?

(Mr Leigh-Pemberton)I think this could be fairly widely spread across the whole of the economy, any part of the economy which has fuel and energy costs as a substantial element in their gross structure.

354. So are these anticipated effects thought to flow mainly from the cost reductions that come from the fall in oil

prices or from the consequential decline in the external value of sterling?

(Mr Leigh-Pemberton) I think they come from cost reduction and I think they may also come from the consequential value of sterling, the fall in the value of sterling. I think you may also detect the private individual will find his costs are less in respect of either petrol in his car or heating in the home which will also help the economy.

355. A final question if I might: how firm are these forecasts and predictions you have made and to what extent do you think they are threatened by recent trends in labour costs?

(Mr Leigh-Pemberton) When you say the "trends", these are the trends and the effects, the trends in oil prices?

356. No. Your anticipation of the effect of the fall in oil prices, the half per cent and one per cent and a quarter of a million off unemployment, to what extent are those threatened by current trends in labour costs?

(Mr Flemming) Perhaps I could answer this one. The reliability of the simulations is not high, the quarter of a million forecast reduction in unemployment is within the margin of error within which we forecast unemployment 18 months or so ahead. The direction is there. The benefits of employment do come largely through gains in competitiveness and those are certainly vulnerable to relative movements in unit labour costs. The rate of inflation in other countries is likely to be reduced more than it is here by the oil price fall because many of our competitors' currencies have appreciated whilst ours has depreciated and if their wages respond to that there is a clear possibility for a deterioration of the rate at which our costs rise relative to theirs which is very important to avert.

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357. If the cost reduction from which industry could benefit is reflected in a greater laxity of wage bargaining these potential benefits could easily disappear?

(Mr Leigh-Pemberton) It would be perfectly easy to fritter away the advantage of the fall in oil prices.

Mr Wainwright

358. To return to pay settlements about which, once again, the Bank's March bulletin is very eloquent, do you believe in pay bargaining that a particularly keen, crucial element is the expectations of the people who are bargaining and on whose half they are bargaining?

(Mr Leigh-Pemberton) Yes, certainly.

359. In that respect what is your feeling? Are you despondent or otherwise about the state of public expectations in this respect and the ways there are of influencing them?

For instance, is it not the case that the Chancellor was able to take a penny off the basic rate of income tax and so on largely because PAYE revenue was based on extraordinarily high earnings, much higher than the rate of increase in RPI and very buoyant VAT revenue due to much higher public spending than was expected or forecast. Those two matters crucially arising from high earnings, as it were, rescued the Budget.

(Mr Leigh-Pemberton) Yes but high earnings could remain perfectly respectable in the context of improved productivity, I think this is the difficulty. If we can have an increase in the total volume of production in the country, and it wants to be less than the corresponding increase in overall earnings, then that would be perfectly acceptable. I think the difficulty, quite honestly, has been a feeling for many many years in this country that at least the change in the cost of living in any one year must be made up, that must be done regardless of the performance of the employing organisation. On top of that where things have gone better in the company there should be an extra point or two, I understand this from the employer's point of view. It is nice to be gracious, to be able to be generous. I just think as a nation we have to somehow move towards greater discipline which is exerted by the Germans and Japanese in this respect. I regard that as a social and political matter as much as an economic one.

360. Do you agree in so far as there is this lack of discipline you have described the Exchequer is in it up to its neck because the Budget depended on these buoyant revenues derived solely from higher earnings?

(Mr Leigh-Pemberton) In so far as revenues are attributable to personal income yes they have an interest.

361. Do you also think the expectations of a reducing or vanishing rate of inflation were severely damaged amongst public and pay bargaining people generally due to the fact since February 1985 the rate of increase of RPI has been higher than it was for instance throughout 1984?

(Mr Leigh-Pemberton) Yes, I think it made it much more difficult to negotiate lower settlements through the middle of last year than otherwise would have been the case.

362. How far do you think public expectations or atmosphere, the indiscipline of which you have just spoken rather forcefully of, was also fed and nurtured by the very well reported increase of top salaries in and around the City?

(Mr Leigh-Pemberton) I imagine this may have had an effect but I wish these salaries in the City could be seen for what they are and in the context in which they are. These salaries are very high, they are being paid to a very small number of very expert and comparatively young people. They are being offered - they are not being, as it were, extracted by negotiation - by employers ---

Mr Mitchell

363. That is different?

(Mr Leigh-Pemberton) It is very different. This is just the point. They are being offered by employers who are competing at the very forefront of international competition in these international markets.

364. That is the situation in manufacturing in an export market.

(Mr Leigh-Pemberton) These employers have taken the view that they can both pay these salaries and they are justified to get the very best people to put them in the best competitive position after the big bang in the City. They may or may not be right about this. I regret the political impact these salaries have had. I have just told you what I have told you because I think it is right the number of people involved and personal circumstances should be put in a better context than is generally presented up to now.

Mr Wainwright

365. Would you agree that sort of situation, or the guts of it, is reproduced in parts of the manufacturing industry also because there are skill shortages due to the lamentable lack of public attention to training? There are now various engineering training skills, and certainly textile skills, in desperately short supply. Does it not seem to you very damaging to the whole expectations theory both in the City and up and down the country there should be situations where employers are offering increases three or four times the going rate for people they desperately need?

(Mr Leigh-Pemberton) I think it is very sad there is such a shortage of these people, whether they are a handful of specialist experts in the City or the skilled textile workers to which you refer. On the whole average earnings have gone up in industry, in contrast to a small number of individual earners. Nobody, incidentially attacks professional footballers or pop singers from this immoralistic stance, I am not sure why the stars of the financial world should not be right to have their probably all too brief opportunity.

366. Without any moral content being imported whatsoever, what I am trying to get at is the expectations theory and in this Committee now for six years we have been told on the highest authority that it is crucial to key pay bargaining. May I just take one final situation to test your feeling on it: when the

medium term financial strategy was first published as a new device you will recall that a great deal of emphasis was put on the effect this would have on inflationary expectations, people would see this strategy set out for three or four years with inflation doing down as a key result of it and would, therefore, modify their pay bargaining expectations. Do you think there is anything whatever left of that expectationary element having regard to the disappearance and reappearance of M3 and importation of MO?

(Mr Leigh-Pemberton) I think there is much less of the expectation left now that the inflation rate is so much lower, I think people are ready to accept a change in the inflation rate of 15/12 to accept pay rises below that because they saw those sort of inflation rates and annual increases were unjustified. I think there is a sound barrier at around 5% where a lot of people feel that is not too bad: "Surely we can have an increase of that sort of level." I think your point on expectations does come out at about the sort of level where we have got to now with our inflation rate and I think it is going to be much more difficult to get down to the general expectation of a two or three per cent increase per annum which is acceptable in Germany and Japan.

367. The expectation aspect has distinctly worn off?

(Mr Leigh-Pemberton) I think it is much more difficult now.

Mr Townend

368. Could I turn to three specific questions? Firstly, the five per cent tax on ADRs, this has been quite widely criticised, it is said to be protectionist and has put British companies that wish to raise equity finances at a disadvantage. What is the Bank's view on that?

(Mr Leigh-Pemberton) The Bank's view of the tax was we were ready to understand the Chancellor's feelings, first of all, that some degree of revenue neutrality was appropriate to these changes in stamp duty; secondly, I think it is perfectly justifiable to argue that people should not, as it were, be able to escape the stamp duty in this country by dealing in shares in the United States and to that extent the ADR must be justifiable.

The difficulty we run into, of course, is the feeling that the present level is enough to be punitive. It will, as it were, kill off investment in British equities in the United States and make raising new capital very difficult. It may well be that something between the two positions is the right answer.

369. You think these criticisms are partially justified ---

(Mr Leigh-Pemberton) Yes, partially.

370. Continuing on the question of the reduction of the stamp duty, do you think it is sufficient to make the City a competitive reserve financial centre after the big bang or do you think this should be the first step?

(Mr Leigh-Pemberton) I would like to think of this in terms of the first step because I think anything that can be done to increase the competitiveness of the City of London in the security industry should be done. We are still somewhat uncompetitive in context terms or stamp duty terms in security transactions at the moment. If the Chancellor can go the other half one might say so much the better.

371. Lastly, the private equity plans (which many of us have mentioned) in the Budget have been criticised because there is no tax allowance on putting money into the schemes and the tax saved on dividends which is the main benefit which goes to small investors already covered by capital gains tax excess is likely to be swallowed up by dealing costs. Do you feel after the big bang we can look forward to a reduction or do you think the reduction will go only to large investors andin small investments the cost will go up?

(Mr Leigh-Pemberton) I think you are absolutely right, the costs could and will go down after the big bang for large investors. For the smaller investor I fear they may well not go down as much or at all. I think the smaller investor very often is content to pay more for good advice with which the big investor is ready to dispense because he is ready to rely on his own expertise. If I may say so your question points up to what is an important challenge for the City and for the securities' industry to come up with a situation which can economically deal with the requirements of the small investor and enable him or her to invest directly in equities and we are putting together a working party and having talks with the Stock Exchange to see whether we can really make this work because I think this is an extremely good opportunity.

Chairman: Some hour or more ago Mr Budgen was going to come in with a supplementary.

Mr Budgen

372. You have helped us very much by your description of money stock as being a glacier frozen by confidence.

(Mr Leigh-Pemberton) Yes.

373. We saw in 1974 and 1975 that the glacier warmed.

(Mr Leigh-Pemberton) Yes.

374. We saw in 1979 and 1980 and 1981 that the glacier was frozen. Both those processes occurred not through market reasons so much as by political reasons. Do you not think that as a central banker as the servant not of the Government but of the State you are being irresponsible in seeing that glacier grow bigger and bigger when you know that in our democracy you cannot control or even much influence most uncertain political changes which might come about in up to two years' time?

(Mr Leigh-Pemberton) I do not accept the word irresponsible and I have to admit that there is a limitation on the value of my metaphor, if that is the right word, because it is not necessarily the purpose of the money in that glacier that it should remain permanently frozen in that way. The ideal use of that money is that if as it liquifies it does not liquify in a torrent down the valley with constructive consumption but (let us go ahead with this) finds its way in the form of water down through a turbine to generate power through the economy, this money should be usefully employed in long term investment and that is what we have got to keep our eye on. In so far as we can relax policy without the disasterous melting then I think it will be acceptable to do so because that will make a contribution to the continuous growth.

375. In answering the point about political danger it does have an effect upon the confidence and over which you have no control and no influence?

(Mr Leigh-Pemberton) I deny I have no influence over political confidence, I think we are well-placed, if necessary, to impress upon the Chancellor and the Treasury the dangers and the consequences of too lax a policy.

Mr Budgen: You cannot decide who is going to win the next election. You do not have a view about who should win in Fulham.

Chairman

376. You will be a little late even if you do! Mr Budgen, I am going to cut you off.

(Mr Leigh-Pemberton) I am talking about current measures rather than future ones.

377. I do not think that can be a fair set of questions. I am a little worried we will end up writing in verse rather than prose. The problem in your melting glacier and the liquidity of them going into more useful purposes is they may indeed be blocked by the high interest rates which had previously been

used to freeze liquidity. I wonder whether without perhaps sustaining the metaphor you can let us have a note on precisely the way the glacier might be overcome?

(Mr Leigh-Pemberton) Yes.

378. The second point: I was sorry at the beginning of the proceedings, I suggested the remarks you have prepared might not be set out in full, not least because you did refer to the question of over-funding, if we could have the note you prepared that would be helpful. As you will have gathered from my colleagues they were very enthusiastic about our asking and answering questions. We are very grateful to you for coming along this afternoon and Mr George and Mr Flemming. We will read very carefully the answers you have given and we are pleased you have been able to help us. Thank you very much.

(Mr Leigh-Pemberton) Thank you, Chairman

CTI

Ch

RR7.70

FROM: MRS R LOMAX
DATE: 22 April 1986

MR ODLING SMEE

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Monck
Mr Evans
Mr Peretz
Mr Scholar
Mr Sedgwick
Mr Riley
Mr Pratt

TCSC ENQUIRY INTO THE BUDGET

The Chancellor has seen your minute of 16 April. He would like to send the attached reply to their question about the relationship between unit labour costs and interest rates. He is content to include your suggested paragraph referring to the Treasury working paper on lower oil prices.

RL

RACHEL LOMAX

RR7.69

DRAFT LETTER TO ~~TCCS~~ TCSC

Thank you for your letter of 11 April.

You asked:

a. whether rising unit labour costs are translated into higher interest rates by explicit government policy;

b. if so, how this is consistent with the contention that industry must deal with its own costs.

The Chancellor said in his Lombard Speech (attached), the Government's policy is to squeeze inflation out of the system, while allowing the economy to expand in real terms. This requires an appropriately restrictive monetary policy. Short term interest rates are the essential instrument of that policy.

The level of short term interest rates at any time is determined by the interaction of the markets and the authorities. But the guiding principle is to maintain, on average, a level that will deliver the monetary conditions needed to reduce inflation.

It is essential that neither rising unit labour costs nor other potential inflationary impulses should be allowed to lead to higher inflation. Higher interest rates are part of the process by which they are prevented from generating excessive money demand and inflation.

This does not mean that changes in unit labour costs typically trigger particular interest rate changes. It means that the average level of interest rates in the UK is likely to be higher than in other countries if, over a period, there is greater pressure from labour costs in the UK than elsewhere.

If, on the other hand, management succeeds in moderating the pace of wage rises, then the prospects for lower interest rates will be much improved - and so will the prospects for employment.

The Chancellor added in the Lombard speech that a firm exchange rate is an important discipline on industrial costs: companies who fail to contain their own costs cannot look to a depreciating exchange rate to bail them out.

H M Treasury

Parliament Street London SW1P 3AG

Switchboard 01-233 3000

Direct Dialling 01-233 ....

Chancellor
Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P. Middleton
Sir T. Burns
Sir P. Littler
Mr Potter
Mr Cassell
Mr Monck
Mr Odling Smee
Mr Evans
Mr Peretz
Mr Culpin

W McKay Esq
Clerk to the Treasury &
Civil Service Select Committee
House of Commons
LONDON SW1A 0AA

22 April 1986

Dear Bill,

TCSC BUDGET ENQUIRY

Thank you for your letter of 11 April:

You asked:

(a) whether rising unit labour costs are translated into higher interest rates by explicit government policy;

(b) if so, how this is consistent with the contention that industry must deal with its own costs.

... The Chancellor said in his Lombard Speech (attached), that the Government's policy is to squeeze inflation out of the system, while allowing the economy to expand in real terms. This requires an appropriately restrictive monetary policy. Short term interest rates are the essential instrument of that policy.

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The Chancellor added in the Lombard speech that a firm exchange rate is an important discipline on industrial costs: companies which fail to contain their own costs cannot look to a depreciating exchange rate to bail them out.

You also asked whether we had any simulations of the effects of different oil prices, or whether any could be produced. The Treasury did, of course, publish a working paper by Horton and Powell, which contained simulations of the effects of lower oil prices. Although they were completed over a year ago, the broad picture that they give is still relevant.

Yours sincerely

Richard

RICHARD PRATT

1-4

CONFIDENTIAL

FROM: R PRATT
DATE: 22 APRIL 1986

MR SCHOLAR

cc Chancellor of the Exchequer
Chief Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Butler
Mr Cassell
Mr Monck
Mr Peretz
Mr Odling-Smee
Mr Evans
Mr Monger
Mr Gray
Mr Culpin

PS. Also v. poor that they appear [illegible] [illegible] [illegible] [illegible] [illegible]

Ch/ Are awful lot here on ULC and interest rates. Note X.

RL 22/4

Very bad. [illegible]. We should get an assurance that this will not occur again.

[illegible] (& [illegible]) 6 X [illegible] p6: it is news [illegible] [illegible] I am [illegible] to [illegible] TCSC a 40-minute! [illegible] statement. NL

TCSC BUDGET ENQUIRY

I attach a copy of the draft TCSC Budget report.

2. The TCSC Clerk had intended to send the draft report to us on Friday (April 18) but, because of a mix-up in his office, failed to do so. There is therefore no opportunity for us to comment on the draft, since it was considered, amended and then agreed, by the Committee yesterday (Monday 21). The attached copy does not include amendments made by the Committee yesterday.

3. I should be grateful if copy addressees would note that the attached copy has been sent to us on a strictly confidential basis and the fact that we have received an early copy should not be disclosed.

Richard Pratt

RICHARD PRATT

IN CONFIDENCE

FOR THE USE OF THE COMMITTEE ONLY

Chairman's Draft Report

THE 1986 BUDGET

IN CONFIDENCE

FOR THE USE OF THE COMMITTEE ONLY

THE 1986 BUDGET

Chairman's Draft Report

INTRODUCTION

1.The oral evidence on which this report on the 1986 Budget relies was given to us by the Chancellor of the Exchequer, Treasury officials, the Governor of the Bank of England and several Bank officials, and representatives of both the Confederation of British Industry and the Trades Union Congress. A number of bodies were good enough to prepare written evidence for us, including Charter for Jobs, Child Poverty Action Group, the Institute of Directors, and the Institute of Fiscal Studies. Their submissions are appended to this report.

2.As in previous years, we have been supplied with a set of alternative forecasts, in order to assess independently the Treasury's Industry Act forecasts. Teams from the Henley Centre, the London Business School, the National Institute for Economic and Social Research and Phillips & Drew submitted two sets of forecasts. The first reflects their own assumptions about major future developments, the second a set of agreed common assumptions.

3.This year our normal procedure has been enhanced in two ways. First, we have published forecasts from the forecasting teams both on the common assumptions and on post-Budget Treasury assumptions. Secondly, the

Parliamentary Unit at the University of Warwick have supplied us with a series of 'ready-reckoners', prepared using computer simulations on the LBS and NIESR models, showing the effects on the main economic indicators of six different fiscal shocks. The accompanying Memorandum from the Unit includes a commentary on policy indications derived from the data. We believe that our presentation of the forecasts is the only one available in a single publication, and we hope the data will prove useful to all serious students of the economy.

4.Our panel of advisers for the Budget inquiry comprised Mr Gavyn Davies, Mr Christopher Johnson, Mr Bill Martin, Dr Bill Robinson, Mr David Savage and Mr Terry Ward. Not only did we enjoy their assistance in preparing for oral evidence on the Budget proposals, but each submitted a Memorandum of comment. All these most helpful papers are attached to this report.

5.In addition to the policy proposals in successive Budgets, we and our predecessor Committee have been interested in improving the presentation and readability of financial documents. Mr Andrew Likierman was good enough to respond once more to our request for assistance, and among the Appendices to this report is his submission on these aspects of the documents released at the time of the Budget. The scope of Mr Likierman's comments is wider than those productions immediately connected with the Budget, but in this report we consider principally the Financial Statement and Budget Report, reserving for later comment progress made in respect of the Supply Estimates and associated papers.

6.Our indebtedness to all those mentioned in previous paragraphs is great, and we are correspondingly glad to
acknowledge it and to thank them. Not for the first time, 5
we believe the House would be wise to pay as much attention to the advice as to the conclusions.

BUDGET DOCUMENTS: FORM AND PRESENTATION

7. As indicated in paragraph 5, our comments on the form and presentation of Budget Papers relate to those directly associated with the Budget Statement. We are not commenting in depth in this report on previous comprehensive recommendations for reform of financial documentation, nor do we take up here issues arising from the Supply Estimates.[1]

8. Our first and very clear impression is of substantial improvement, for which those concerned deserve every congratulation. (Q133) The Red Book (Financial Statement and Budget Report) is much less daunting in appearance and presentation and has benefited from the relegation to annexes of technical detail. It is only necessary to look back a few years to see how great the change has been. Given this improvement in the presentation of the Red Book, however, and the relatively commonplace format of the Economic Progress Report's Budget Supplement, which seems rather left behind in these matters, it may be time for the Treasury to reconsider the functions and target readership of both. There is no doubt a substantial demand for clear, if semi-technical, details of the Budget which is at present met by commercial productions. There seems no reason why the official presentations should not attempt to secure a part of that market, and **we recommend the Treasury, together with HMSO, should look into the possibility of further promotion of the Red Book and a perhaps revised Budget Supplement to the Economic Progress Report.**

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1. For previous discusssions of these matters, see Second Report of 1984-85 (HC 1984-85 110); Seventh Report (HC 1984-85 323); and Tenth Report (HC 1984-85 544).

9.The collection of press notices issued by the Treasury, Customs & Excise and the Inland Revenue, together with such other Departments as may be appropriate in any particular case, is of great use in disseminating the details of the Budget proposal. Its usefulness would indeed be increased by the restoration of a list of contents. In general, however, the collection seems very worthwhile, and we invite the Treasury, as in the preceding paragraph, to consider whether its targeting and impact can be improved. 5

MONETARY POLICY

Policy and Targets

10.The section of the Budget speech devoted to the MTFS, and in particular Monetary Policy, was shorter than in previous years. The Chancellor told the Committee that, "a Budget speech is not the occasion when one gets the most attentive audience for a disquisition on the finer points of monetary policy" (Q165). He added that he would be making a more substantive statement on Monetary Policy outside the House on 16 April. In our Report on the Chancellor's Autumn Statement[2] we expressed our dissatisfaction with this practice. We reaffirm this view. It may very well be true that a statement in the Chamber is not the most satisfactory vehicle for a detailed review of policy or the signalling of a change of emphasis in some important but technical respect. Equally, however, the Chamber is not the only parliamentary opportunity open to the Chancellor, and it remains true that it is to Members' questions on matters of macro-economic policy that the Chancellor should respond first. Statements such as that made recently on Monetary Policy should be made to the House through this Committee.

11.The Chancellor reset monetary targets for the year ahead, 1986-87, both for MO, as a measure of narrow money, and for £M3 as a measure of broad money. MO is targeted to rise by 2-6%, £M3 by 11-15%. In addition Table 2.1 of the Red Book sets out illustrative ranges for MO to 1989-99.

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2. HC(1985-86)57, Second Report from the Treasury and Civil Service Committee, para 17

Unlike previous years, however, target ranges for £M3 beyond 1987 are not given. Para 2.15 of the Red Book justifies this stance on the grounds that "the uncertainties surrounding its velocity trend are at present too great." The Monetary Targets are supplemented by Money GDP figures, although the precise role that this variable will play in the formulation of policy is not made explicit. Para 2.04 of the Red Book establishes that "policy will be directed at maintaining monetary conditions that will bring about a gradual reduction in the growth of money GDP over the medium term, broadly in line with the path shown in Table 2.1." The money GDP figures set out in that table do not however constitute a target; the figure for 1986-87 is only a forecast, and the figures for subsequent years describe the Government's medium term "objective." We find this exposition of the monetary section of the MTFS confusing. Unlike the government, we find it difficult to distinguish between "aims", targets", "forecasts" and "objectives". Moreover we are doubtful about the significance of a 'strategy' in which an important element - £M3 - is targeted for no more than one year ahead.

12.In our Report on the Chancellor's Autumn Statement we recommended that the Government should provide more information on the conduct of monetary policy, and in particular on the role of the exchange rate in monetary policy. At the time it seemed to us that the Government had shifted from a policy of holding money supply growth to some specified target rate to one of concentration on the exchange rate. For the Government to give explicit recognition to this fact would, we felt, be helpful to those who had to take decisions based on government policy. We have not changed our view. Accordingly we are extremely disappointed that the relevant passages of the Red Book are as ambivalent as before on the subject. Paragraph 2.18 states that monetary policy will continue to be determined by reference to the monetary targets. "If the underlying growth of MO or £M3 were to move significantly outside their target ranges, the Government would take action on interest rates unless other indicators suggested that monetary conditions remained satisfactory." We assume that the exchange rate is encapsulated within the term "other indicators" but the exact role that it will play in the assessment of policy remains undefined.

13.The uncertainty concerning the role of the monetary aggregates was not clarified by the Governor of the Bank of England. He told us that:

> "While we have said that a presumption arises if the aggregates rise above the target zone ..., that presumption can be dispelled by all the other indicators we look at and build in." (Q304)

14.In evidence to the Committee the Chancellor was prepared to acknowledge that there had been some change in the way in which monetary policy had been conducted.

> "There has been an evolutionary change in the way we

have conducted monetary policy over the past six or seven years as conditions have changed. It would be surprising were that not so, but it has been a gradual evolutionary change. There has been no sudden change, and it is one which has been explained fully at the time to this Committee and in other ways and one which still leaves the policy recognisably the same as the policy on which we originally embarked, even though there were some misunderstandings about that policy, which it seems have in some quarters persisted" (Q165).

The Governor of the Bank of England concurred with this view (Q292).

15.For the reason outlined above we consider that the change has been more fundamental than the Chancellor and the Governor are prepared to admit. Both the exchange rate and (more recently) the rate of growth of unit labour costs seem to have much more bearing on the conduct of interest rate policy than may be deduced from a straightforward reading of the Red Book's paragraph 2.18. Indeed in evidence the Chancellor seemed to imply that interest rates were directly related to labour costs. He told us that,

"I obviously have to ensure that nothing is done that will jeopardise falling inflation and that may limit what can be done on the interest rate front. If you say why it is that interest rates in the UK in real terms are higher than they are in most other major countries, I think that it is not unconnected with the fact that labour costs per unit of output are rising faster in the UK than they are in most other major countries." (Q155).

Officials from the Bank of England added that high interest rates were:

"a natural consequence of the attempts to preserve a tight nominal framework for policy. Within that, if inflation generally or unit costs in particular tend to rise, then that will tend to bring about pressure within a given nominal framework which causes policy conditions to tighten, including interest rates to rise." (Q297)

16.The shift in emphasis to an interest rate policy which takes explicit notice of the rate of increase of unit labour costs is a novel development and one which we feel needs to be explained more fully by the government. We ourselves have difficulty in following the mechanism by which high interest rates will produce lower wage increases.

17.Both the Chancellor and the Governor of the Bank of England placed the onus on high interest rates in limiting the extent to which companies could pay high wages. According to the Chancellor the mechanism linking wage increases and interest rates operates in two ways:

"First of all, if labour costs per unit of output are rising fast or faster than in other countries, as they are, that is a potential threat to inflation ... it is, therefore, necessary to ensure that the increase in labour costs is not translated into higher inflation. One needs, therefore, to keep a tight monetary policy in order to prevent that ... Another way of looking at it is the way you look at it from the point of view of those who are operating in the foreign exchange market. Their view of the future of sterling is clearly influenced by what is happening to labour costs per unit of output in this country compared with labour costs per unit of output in other countries. Therefore, in order to prevent the exchange rate from depreciating as a result of fears of this kind, it is necessary to maintain interest rates higher than they would otherwise be." (Q156).

The Governor of the Bank added:

"the monetary authorities take the view that we must set some scene in which, as far as possible, this growth in unit labour costs could be restrained. The ability to pay increased wages is some reflection of the increased liquidity of our companies,... The important thing is how this surplus is to be used and if it is to be used exclusively in increased wages, then investment will suffer, costs suffer and competitiveness suffers. I think it is simply a function of the tightness of policy, which can be discouraging or helpful in making it more difficult to concede these seemingly unjustified wages". (Q294)

18.For reasons which we discuss later (paras 47ff.), we think it unlikely that pay increases will decrease significantly from their present levels, in spite of current interest rates. At the same time, however, as we have indicated on many previous occasions, high interest rates bring in their train a number of damaging effects. Industry exposed to international competition is rendered less competitive, through the twin burden of higher interest costs and lower selling prices, via higher exchange rates. High interest rates will also discourage investment. The opportunity, of which the Chancellor has made much, of improving the position of those parts of the economy exposed to international competition may be lost, as the government attempts to gain relatively small cuts in inflation at the expense of further increases in output and employment.

19.The reduced role of the monetary targets was further illustrated by more recent post-Budget experience. Despite the growth of £M3 in banking March at a year-on-year rate of 16.5%, a rate already in excess of that announced in the 1986 MTFS, interest rates in the market initially fell. Indeed the reduction in rates was thwarted only by the Bank of England's unwillingness to lower its discount rate. It thus seems difficult to justify the practice of giving continued recognition in the MTFS to the monetary targets.

20.Treasury officials seemed to justify the practice of setting targets on the grounds that this was an internationally accepted convention. We were told that

> "Like many countries we have two target aggregates and we thought it sensible to have one for broad money and one for narrow money. ... There have been different targets over the years. We look at each year quite carefully [and consider] what is the best target for the year ahead in the light of experience in the past. The conclusion this year was that it was right to stick with MO and £M3 as the two main target aggregates as they have been for the previous two years". (Q41)

The fact is, however, that these two targets - and their target ranges - are now regarded with considerable scepticism by commentators in the City and elsewhere.[3]

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3. See Appendices 1 to 6.

£M3

21.Scepticism at the continued use of £M3 as a target variable stems in part from the fact that the authorities now seem to have virtually no control over it. One of the original justifications behind the move to intermediate targeting was that such targets were considered more controllable than other final targets such as nominal GDP or the RPI.[4] In practice, broad money as measured by £M3 seems to be uncontrollable, a fact implicitly given recognition by the Treasury. Paragraph 2.18 of the Red Book notes that £M3 is not particularly responsive to changes in short term interest rates. The practice of overfunding moreover has now been abandoned.

22.Nonetheless the Chancellor has persisted in setting a target for £M3 despite the fact that it had to be suspended as a formal target in the course of the last financial year.

23.In his Mansion House speech the Chancellor explained that the 1985 target for £M3 "had clearly been set too low." There was no explanation of why it was so obvious that the range had been set too low. Para 2.12 of the Red Book attempts some explanation by pointing out that:

> "High real interest rates have increased the relative attractiveness of financial assets; and financial liberalisation and increased competition between banks and building societies have led to a rapid build-up of both liquidity and debt."

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4. See Memoranda on Monetary Policy HC(1979-80)720 "Memorandun by HM Treasury," (p8.ff) and "Memorandum by the Bank of England, " (p.17 ff.)

As the same paragraph indicates, and as Chart 2.3, which shows the velocity of circulation profile demonstrates, these factors have been present for some considerable time. Accordingly it is not clear, and it is certainly not explained, why they were not taken into consideration in the setting of the £M3 target last year. The downward trend in the velocity of £M3 has proceeded at a fairly constant rate since mid-1979, and there seems little reason why the Treasury should now decide to concern itself about a long-standing trend.

24.Indeed, given the nature of the velocity trend since 1979, it could be argued that in the interests of consistency, the Treasury should have set a much tighter target for £M3. A 4% decline in velocity since 1979 would justify an increase in the target range from the 4-8% set in the 1985 Budget for 1986/87 to a maximum of 8-12%. The range set was of course 11-15%. The Red Book acknowledges that forecasting the velocity trend of £M3 is an uncertain business - something which would not preclude a further acceleration in velocity, and hence lead to a higher growth of £M3. However it is difficult not to believe that a very high £M3 target was set so that the authorities could be assured of achieving growth within the target range.

25.Whatever target was set, the fact remains that broad money has grown at a considerable rate over the last year. Indeed to some commentators the situation is reminiscent of the early 1970's when there was a similar period in which broad money expanded very rapidly. The Bank of England drew attention to the build up of private sector liquidity in the December edition of its Quarterly Bulletin and expressed some concern. Both the Chancellor and his officials were more sanguine on the subject. The Chancellor told us that, "I see no danger in the present level of liquidity" (Q182), although he added that "it is something we need to watch all the time and that is why we retain a broad money target" (Q183). Sir Peter Middleton again referred to international experience. "Lots of other countries have got high growths of liquidity; ours is the same as Japan." (Q183)

26.We are aware that the build up of liquidity, which reflects both high real rates of interest and financial innovation, need not have inflationary consequences, provided that the income velocity of circulation for £M3 continues to fall and that the extra liquidity is not translated into "transactions balances" for goods and services. And of course, if high real rates of interest persist, then the velocity trend may continue to hold. **Nonetheless we recommend that the situation should be carefully monitored.**

<u>MO</u>

27.The behaviour of the broad money aggregates puts a greater onus on the narrow money indicators and in particular MO. However this measure has been treated with even greater scepticism than £M3. The Treasury makes the point in the Red Book that:

> "Ideally, the target aggregate for narrow money should reflect these (principally non-interest bearing) assets that are directly used for making transactions; should respond unambiguously, but not be over-sensitive, to interest rates changes; and should have a stable relationship with money GDP. In practice, however, there is no single measure of narrow money that meets all these criteria." (para 2.10)

28.Accordingly, MO, the amount of notes and coin in the economy, is very much a second best measure although the Treasury notes that, "MO has proved a good indicator of monetary conditions in recent years and remains the best choice of narrow aggregate for target purposes." (para 2.11) Moreover the trend in velocity has remained fairly predictable over a period of 15 years. The Treasury also argues that MO is an acceptable <u>control</u> variable since it responds fairly predictably to changes in interest rates. Events over the last two years have not however borne out this argument. Despite a sharp rise in real interest rates over the last two years, the velocity trend has remained constant.

29.There are other objections to the use of MO as a target variable. It seems to respond to money GDP changes with a lag, rather than leading changes in nominal income, and even if it can be controlled this may well be meaningless, since control may be exercised simply by producing shifts between holdings of cash and interest - bearing sight deposits.

Money GDP

30.This year, in addition to target ranges for the monetary aggregates, the government produced a range of objectives for money GDP for the years ahead. Despite the precedence given to money GDP figures in the table detailing the monetary targets, Treasury officials insisted that these have not attained the status of targets. We were told that,

> "There has been no change in the role of money GDP in the MTFS, and so there is no intention to target money GDP in the formal sense, and nor has there been inthe past. That is always the same. Money GDP represents a broad objective for the medium term, as it has done in the past. The question of the timeliness and the reliability of the statistics is of course something which the Government has considered, and it is one of the reasons why the Government would not want to try to target money GDP. The figures are available some time in arrears; they are subject to considerable revision after they have first appeared, so that it might be two or three years or even longer, before

> reliable figures are available. Also of course it takes some time for any policy response that might be considered, because of what is apparently happening to money GDP, actually to take effect on the economy." (Q3)

Nonetheless in subsequent questioning we were told that:

> "If money GDP were growing much faster than intended, and it was fairly clear that that was because of excessive inflationary pressures, then the Government would seek to raise interest rates or reduce the fiscal deficit or both. The exact mix would depend on the circumstances and so on, and vice versa. If money GDP were growing more slowly, the Government would seek to ease policy, in order to bring money GDP growth back - if again the aberration were on the price side rather than the output side. I think that is fairly straightforward." (Q9).

What does appear to be straightforward is that the Government seems to have an inflation target rather than a pure Money GDP aim or objective. In so far as this couched in terms of money GDP however it seems of little relevance in the short term.

THE EXCHANGE RATE

31.We return to our original point in para.12. The Government should have produced more information about the way in which monetary policy is to be conducted. At present, given the information that has been published we can only conclude that monetary policy as originally propounded is in abeyance.

32. The government seem to have abjured full membership of the EMS. The Chancellor told us that, even though exchange rate relativities were more favourable, the time was still not ripe for the assumption of full membership. (Q205) The Governor pointed to the need for greater convergence between the UK's economic performance and that of the Federal Republic of Germany and a reduction in the rate of growth of unit costs before full membership could be contemplated (Q337). Nevertheless, in the absence of participation in the exchange rate mechanism we consider than an exchange rate target would be desirable. It is a conclusion we have reached before in a number of contexts, including that of international monetary arrangements.[5] In present circumstances, given the behaviour of broad money, it is hard to justify the absence of an explicit target for the exchange rate. If the overall aim is to reduce uncertainty about financial prospects, and if interest rate policy is guided by the exchange rate as well as by everything else, then surely it would help exporters to know the exchange rate objective.

5. Twelfth Report for the Treasury and Civil Service Committee, 1984-85 (HC1984-85 405)

FISCAL POLICY

33.The major change in the backdrop to policy-making since the last Budget has been the rapid fall in oil prices. Prices for North Sea oil on the spot market have fallen from approximately $26 a barrel in October to about $12-13 a barrel in early April. At one point the price dropped below $10. The outlook remains highly uncertain, with further dramatic falls seen as possible by some, due to continued disunity within OPEC; while some recovery from current prices is thought likely by others. However a significant drop in real oil prices has occurred, and they are not likely to return to levels seen in recent years for some considerable time.

34.The decline in prices began too late to have any appreciable effect on government revenue in 1985. However, oil revenue in 1986/87 and beyond will be substantially below previous expectations. The Treasury has assumed an average price for 1986/87 of $15 a barrel, $10 below their previous assumption. On this basis, and the Treasury's usual assumption about exchange rates movements, oil revenues in 1986/87 are now expected to be £6 billion, £5½ billion less than in last year's PSBR. For the years 1987/88 to 1989/90 oil revenue is expected to be £4 billion per annum.

35.Despite this loss of revenue, the planned PSBR has been reduced from £7½ billion to £7 billion and a tax cut, albeit substantially lower than implied in last year's

FSBR, of £1 billion has been delivered. This was made possible by two factors. Planned privatisation proceeds for the coming year have increased by £2.75 billion. This reduces planned expenditure by £1 billion, which would otherwise have increased by £1 3/4 billion. This increase is not explained by the budget measures, which have been funded from the Reserve. The forecast for non-oil revenues has increased by £3 billion. This is due to stronger earnings growth than expected last year leading to increased direct tax and VAT revenue. Local authority rates are also expected to increase by 14%, a large real increase over expected inflation.

36.The outlook for future years is even more optimistic. By 1989-90, non-oil revenue is projected to rise from £118 billion for the current year, 1986-87 to £139 billion. This, coupled with a reiteration of its intention to hold expenditure broadly level in real terms, and a planned PSBR of £7bn until the end of the current planning period, 1988-89, may allow the government scope for tax cuts of £2bn for 1987-88, £4 billion for 1988-89, and £3 billion for 1989-90. Alternatively, the possibility may exist for further reductions in the PSBR or increased expenditure.

37.While the PSBR has been reduced by £½ billion for the current year, the Public Sector Financial Deficit, which most outside commentators consider to be a more satisfactory measure of the Government's borrowing requirement, has increased by £2 billion from £10.2 billion to £12.2 billion. The immediate response to a fall in oil revenues would appear to have to increase government borrowing. On this basis it appears that the fiscal stance has been eased slightly.

38.The rationale for this response to the decline in oil revenues was given little attention, either in the Red Book, or the Budget Speech. In his Budget Speech the Chancellor said that,

> "Some would argue that, in the light of the £2½ billion increase in projected privatisation proceeds, I ought to aim well below [a PSBR of £7½ billion]. Others on the other hand would claim that, since the sharp drop envisaged in oil revenues is more than double the rise in privatisation proceeds, a higher figure would be appropriate. As last year, my judgement is that the wisest course is to stick broadly to our pre-announced figure."[6]

39.The basis of this judgement would seem to be that to stick closely to previously announced PSBR figures is the best way to maintain market confidence. Considering the amount of attention that has been given to adjusting the PSBR for privatisation proceeds and other distortions, and the apparent consensus elsewhere that the Public Sector Financial Deficit gives a truer picture of the Government's funding requirement, this argument would seem to have little force. An alternative explanation of the general acceptance of the Budget figures in financial markets is that the adjusted figures appear to be a reasonable

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6. HCDeb (1985-86)94, c. 171

response to the oil price shock and that the underlying fiscal position, while slightly more lax, is little changed from previous expectations.

40. We asked the Chancellor whether we could expect a downward revision of existing spending plans in the wake of the loss of oil revenue on the basis of his dictum that 'revenue should determine expenditure.' In reply the Chancellor said:

> "I see no reason to do that, because, among other things, what has been seen - and it has already emerged from the figures from the PSBR for recent months, and as you see we are projecting forward - is that the decline in North Sea oil revenues has been to a very large extent offset by the greater than expected buoyancy on non-North Sea revenues. So there has been no great loss of taxation revenues" (Q134)

The source of these more buoyant revenues is the higher than expected outturn for non-oil money GDP in 1985-86, due to the fact that the non-oil GDP deflator increased by about 7 1/4% rather than 5 1/4%. Similarly for 1986/87 the non-oil deflator may increase 1½% more than previously expected.[7] Because of the progressive nature of the tax system, it is not surprising that non-oil revenues are higher than previously expected. This is not the same, however, as lower revenue from the North Sea being offset by increased real activity in the rest of the economy.

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7. See Appendix 1.

41.The lack of a satisfactory explanation by the government of its response to the oil revenue loss is disappointing. There are a number of alternative approaches to setting public borrowing in response to changing oil revenues.[8]. These include considering the effects on aggregate demand; attempting to smooth the economy's adjustment to a major shock; ensuring that nominal GDP objectives are achieved; and considering the long term effects of a fall in the value of a national asset. None of these arguments was employed by the government to explain its response.

42.Similarly, during questioning we were unable to ascertain from the Chancellor or officials what would be the further response of the government if oil prices stabilised at their present level, somewhat below the Budget assumption. The Chancellor did, however, indicate that a divergence from the Budget assumption which the government judged to be temporary would be met by increased borrowing (Q154).

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8. See Appendices 5 and 6

ECONOMIC PROSPECTS AFTER THE OIL PRICE FALL

Short Term Outlook

43.The decline in oil prices has had a marked effect on the Treasury's view of the short-run prospects for the economy. Real GDP growth is expected to be 3% in 1986/87. This is the same as the Autumn Statement forecast, but the composition of growth is significantly different, as shown in Table 1. Non-oil exports are predicted to rise by 5% rather than 2%, because of the lower exchange rate and higher growth in export markets, both consequences of lower oil prices. Import growth may only partially offset this by increasing by 6% rather than 4%. Overall, the forecast balance of payments current account surplus has been reduced only by £½ billion to £3½ billion. Investment is forecast to increase by 5% rather than 3½%, encouraged by high corporate profitability and in spite of high real interest rates. The forecast increase of consumer spending is unchanged at 4%, fuelled by earnings increases apparently little different from levels experienced recently and well above those experienced by other industrial nations. The inflation forecast is reduced a little to 3½% rather than 3 3/4%. Unit labour costs are forecast to increase several times faster than in other industrial countries, and allowing for recent exchange rate movements, price and cost competitiveness in 1986 may be little changed.

Table 1

Changes in Treasury Forecast
Percentage Changes

	Autumn Statement	FSBR 1986/87	Change
Consumers' expenditure	4	4	0
General Government consumption	½	1	+½
Fixed investment	3½	5	+1½
Change in stocks (% of GDP)	½	0	-½
Exports of goods and services	2	5	+3
Imports of goods and services	4	6	+2
Gross Domestic Product	3	3	0
Retail Prices to 1986 Q4	3 3/4	3½	-1/4
GDP deflator 1986/87	4	3 3/4	-1/4
Balance of Payments current account (£bn)	4	3½	-½

Source: Appendix 1.

44. The short term outlook is, perhaps, surprisingly optimistic given the extent to which oil prices have fallen, the fears which have been expressed about the economy's ability to adjust to even a gradual fall in oil revenues and the inevitable loss of national income which has occurred. The Chancellor expressed some understandable satisfaction on this point:

"If we can survive unscathed the loss of half our

North Sea revenues in less than 25 weeks, the prospective loss of the other half over the remainder of the next 25 years should not cause us undue concern"[9]

However, the important characteristic of the current situation is that it is the dollar price of oil which has fallen rather than the UK's output which has declined in the presence of continued high oil prices. The boost to industry from dramatically reduced input costs and increased overseas demand is fortuitous for the economy. Whether the relatively smooth adjustment in financial markets to the oil price fall over recent months is followed by a similar adjustment in the rest of the economy over the longer term remains to be seen.

Longer Term Prospects

45.The government take the view that beyond the adjustments to the economy contained in their forecasts - some improvement in the outlook for the tradeable goods sector, and manufacturing, in particular - the drop in oil prices, falling inflation and a lower exchange rate provide "an outstanding opportunity both to increase [industry's] exports and to reduce import penetration in the home market."[10] In the Chancellor's view, industry has an opportunity to reduce relative unit labour cost increases below those experienced recently and thereby achieve a further fall in the real exchange rate to improve the competitiveness of the tradeable-sector of the economy (Q135).

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9. HC Deb (1985-86) 94, c. 168.
10. HCDeb (1985-86)94, c.169.

"If, in particular, British industry is capable of maintaining an adequate control over its wage costs, its pay costs, I believe that we can achieve something of a breakthrough to improved economic performance. (Q135)

This opportunity is not attributed solely or even primarily to the oil price fall:

"I think it is a great mistake to over-emphasise the importance of this oil factor. It has been the most dramatic change, certainly, but the economy is a great deal more than North Sea Oil. It is also, of course the Government's economic policies that matter and that matters far more than anything that is happening on the oil front" (Q152).

46.The responsibility for grasping this opportunity lies solely with industry itself. The Chancellor told us that, "as I say, it is up to industry. I think they know it" (Q135) The government's implicit view appears to be that the exchange rate reaction to the oil price fall has already occurred; further improvements in competitiveness should not be expected from this source.

47.However, the government do not seem to have much confidence in a fall in unit labour costs. The Treasury's forecasts do not show any improvement in competitiveness, of which it is said "may be little different from the average of the last three years" (FSBR paragraph 3.25)

Similarly, the CBI's forecast for underlying inflation is little different from the Treasury's. The Chancellor responded that the budget forecast was a best guess based on the economy's recent track record which has been "far less good" since the 1979-81 recession, but that, nevertheless, the opportunity for improvement existed. (Q137)

48. The likelihood of industry's responding quickly to this opportunity is in our view remote for a number of reasons. We asked the CBI about expectations concerning pay increases and they told us that:

> "I think, still looking at it from a management point of view, there is a determination to try and hold the line" but;

> "I think there is perhaps a not surprising pressure on wage negotiators to try to get the thing moving again"

> and;

> "I think, certainly on the part of labour, there is an expectation moving upwards at this stage." (Q265)

The Governor of the Bank told us:

> "I think there is a "sound barrier" at around 5% where a lot of people feel that it is not too bad: 'Surely we can have an increase of that sort of level' ... I

think it is going to be much more difficult to get down to the general expectation of a two or three per cent increase per annum which is acceptable in Germany and Japan" (Q366)

49. Moreover, as both the Chancellor and the Governor acknowledged, a large overhanging 'glacier' of presently frozen liquidity has built up (Q). A proportion is likely to be in the hands of firms with substantial cash mountains. These balances earn interest, thus making it easier to pay higher wages. The situation is exacerbated because many of the firms concerned are large, and may well be wage-leaders in their respective industries.

50. High interest rates may even have perverse effects on pay pressures. The CBI told us that:

> "A lot will depend on the level of interest rates and the level of mortgage rates which are really rather important in the context of wage negotiations" (Q265).

51. We see no cause to alter our earlier view that the contention that keeping interest rates high in order to deter pay increases is at best not proven.

THE MEASURES

52.It is our usual practice not to offer lengthy comments on the Budget measures, in the knowledge that they will be thoroughly examined in Committee of the whole House or in Standing Committee. We believe it may be helpful, nevertheless, to make a few observations on certain salient issues among the Budget measures: help for the unemployed, business and enterprise, savings and investment, charities and personal taxation.

<u>Help For the Unemployed</u>

53.The government has consistently argued that the problems of unemployment can be resolved only by the market. It has often pointed to the need for greater flexibility in the labour market and in particular has drawn attention to the link between wages and unemployment and the pernicious effect that rising labour costs can have on employment. In addition, the government now seems to be arguing that there is an equally pernicious link between the current high real rates of interest and wages growth (see paras).

54.Despite this concern with the rate of increase of wages, the government has remained faithful to the principle that there is little that it can do directly to influence wages other than to settle the broad monetary and fiscal parameters within which the economy functions. We were therefore pleased to note that the government is considering the introduction of a profit-sharing scheme.

If successful this may have some bearing on the current impasse in the wages field, particularly the upward pressure on the real wage. It may also mitigate the effects of unemployment in times of recession. Profit related remuneration automatically adjusts real wages downwards in recession, thus cutting labour costs and limiting the need for lay-offs.

55. We asked the TUC what they felt about profit-sharing schemes. Their response was encouraging.

> "When the Chancellor says he wants to have preliminary discussions on the subject, the short answer is that we are willing to have these preliminary discussions. Anything which claims to solve totally the problems of unemployment and inflation at once is something which perhaps has to be looked at seriously but perhaps also with some scepticism. We will certainly examine it and discuss it with the Chancellor" (Q288).

56. The government also announced two new schemes to assist the unemployed. The first was directed primarily at the long-term unemployed. A "jobstart" allowance of £20 a week will be paid for six months to those long term unemployed who take a job at less than £80 a week. In addition a new counselling scheme was announced. The Chancellor told the House that, "this means that every single one of the long-term unemployed throughout the land will be offered individual help and advice in finding a job" [OR 18/3/1986 col 173]. The second, "the new workers scheme," was

directed at the 18 to 20 year olds. Any employer who takes on an 18 or 19 year old at up to £55 a week or a 20 year old at up to £65 a week will be eligible for a payment from the government of £15 a week for a year.

57.In addition an expansion of the Community programme was announced together with an enlargement of the enterprise scheme.

58.The net effect of these measures is estimated at £100 million in 1986-87 and £165 million in 1987-88. Since this will be financed from the reserve it will not constitute a net addition to planned public spending.

59.We welcome these measures.

Business and Enterprise

60.The Chancellor announced that the Business Expansion Scheme will be extended indefinitely, though in a modified form. Companies which hold more than half their net assets in the form of land and buildings will now be excluded from the scheme, as will companies whose main purpose is to invest in objects, such as fine wines. The Loan Guarantee Scheme, which makes it easier for small firms to obtain finance is also extended for a further three years.

61.The most significant element in the Business and Enterprise measures was the announcement of the abolition of tax on lifetime gifts to individuals. The tax on lifetime gifts is considered to be a significant constraint on the ease with which family businesses can be transferred from one generation to another. To the extent that the removal of the tax will help small, family businesses the measure it is to be welcomed. Nonetheless we consider that the Government should consider the position as it affects discretionary trusts where the donation of gifts, where the donor continues to enjoy the benefit, will be treated for the purposes of death charges as made when the reservation was released.

Savings and Investment

(i) ADRs and Stamp Duty

62. Stamp duty on share transactions has been halved to ½% from the time of the 'big bang'. The scope of the tax has been widened so that the change is broadly "revenue neutral". A special 5% rate has been introduced on UK shares converted to depository receipts (ADRs). These moves are intended to improve the competitiveness of the City vis-a-vis other financial centres in the wake of the 'big bang' and to discourage avoidance of stamp duty by moving transactions offshore. There has been some criticism of the special rate on ADRs as discouraging the raising of equity capital offshore. The CBI told us:

> "... there is considerable concern, particularly with companies who are interested in raising funds in American markets, at the effect of the 5% import and

we fully understand why it has been done, whether it will have its desired effect is another matter. I think it is debatable whether it will achieve what it sets out to achieve" (Q226)

The Governor agreed, partially, with this criticism:

"The Bank's view of the tax was we were ready to understand the Chancellor's feelings, first of all, that some degree of revenue neutrality was appropriate to these changes in Stamp Duty; secondly, I think it is perfectly justifiable to argue that people should not, as it were, be able to escape the Stamp Duty in this country by dealing in shares in the United States and to that extent the ADR may be justifiable. The difficulty we run into, of course, is the feeling that the present level is enough to be punitive. It will, as it were, kill off investment in British equities in the United States and make raising new capital very difficult. It may well be that something between the two positions is the right answer" (Q368)

(ii) Personal Equity Plans

63.The government announced the introduction of Personal Equity Plans to encourage direct investment in British equities. The scheme is intended to encourage small savers, in particular, to become equity owners. Shares held in each plan will be exempt tax on both capital gains and reinvested divident income if the investment is held for a minimum period of between one and two years. Investments of up to £2400 a year will be permitted.

64.The PEP scheme differs from schemes such as the French loi Monory or the American IRA Scheme in that these are "front end loaded" schemes in which taxation relief is given on entry, whereas under PEP benefits are provided on exit. We were told that the decision to opt for this type of scheme was taken on the basis of ease of administration and lower likelihood of abuse (Q132).

65.We are somewhat sceptical of the degree to which the scheme will be utilised by small savers. The returns which a small saver might expect from any equity investment are likely to be less than the existing exemption limit from capital gains tax. Secondly, comparison of the returns from relatively small investments with dealing costs may also make these unattractive investment options for small savers. We were told by the Governor of the Bank (Q371) that this situation would be unlikely to change after the "big bang", which is most likely to benefit large investors. However, we note the Bank's efforts to encourage new, low-cost methods of equity dealing for small investors and hope they are successful.

Personal Taxation

66.The Chancellor announced a reduction in the Standard Rate of Income Tax of 1p in the £, thus continuing the government's commitment to a reduction in the level of personal taxation. In the past there has been much discussion about the relative merits of tax cuts as opposed to other methods of dispensing the fiscal adjustment such as reductions in Employers' National Insurance Contributions (NICs). With unemployment at its present level these discussions have intensified. The debate echoes through much of the written evidence we received, particularly that derived from economic models. It is only fair to record the Chancellor's doubt whether the models could provide a fully satisfactory guide to anti-unemployment measures. He said:

> "I do not think the models are very helpful because they cannot capture the supply side factors which are critical for employment to any worhtwhile extent at all" (Q227).

IN CONFIDENCE

FOR THE USE OF THE COMMITTEE ONLY

RR7.73

CONFIDENTIAL

FROM: MRS R LOMAX
DATE: 23 April 1986

PWR

MR PRATT

cc Chief Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Peretz
Mr Scholar
Mr Culpin

TCSC BUDGET ENQUIRY

The Chancellor has seen your minute to Mr Scholar of 22 April, attaching a copy of the draft TCSC Budget report. He has commented that it is very poor that they appear not to have waited for the note on unit labour costs and interest rates which they themselves had asked for. And very bad indeed that they failed to give us an opportunity to comment on the draft. He thinks we should ask for an assurance that this will not occur again.

2. Meanwhile, he trusts that Mr Culpin has noted the Committee's complaints on page 6: it is news to the Chancellor that he is invited to give the TCSC a 40 minute opening statement!

RL.

RACHEL LOMAX

CONFIDENTIAL

FROM: DAVID PERETZ
24 April 1986

MR CULPIN

cc Principal Private Secretary
PS/Chief Secretary
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Scholar
Mr Pratt
Mr Walsh

TCSC BUDGET INQUIRY: MONETARY POLICY

Apart from the general shortcomings of the monetary policy section of this report, you might like to note that there seems to be a particular howler at the end of paragraph 28. This attempts to dismiss our argument that MO responds fairly predictably to changes in interest rates by saying that "despite a sharp rise in real interest rates over the last two years, the velocity trend has remained constant".

2. We are not of course arguing that we expect the <u>velocity trend</u> in MO to be greatly affected by interest rates. What we are arguing is that we expect interest rates to influence MO (after allowing for the velocity trend) and money GDP in much the same way: that is the value of MO as a target. In fact over the last two years MO growth has slowed (12 month basis) from 5-6% at the end of 1984 to 3-4% now: as we would expect it to do given past relationships between M0 growth and interest rates.

3. More generally, I assume the main comment to make on this section of the report - if one is required - is that it is overtaken by the Lombard Association Speech; and that the one recommendation they make (that £M3 should be carefully monitored) is something we have said time and again that we intend to do.

DLP

D L C PERETZ

2155/37

RP

FINANCIAL SECRETARY TO THE TREASURY

FROM: VIVIEN LIFE
DATE: 23 April 1986

MISS O'MARA

cc PS/Chancellor
PS/Chief Secretary
PS/Economic Secretary
PS/Minister of State
Sir P Middleton
Mr Scholar
Mr Monger
Miss Sinclair
PS/IR

BUDGET BRIEF

1. I thought I should let EB know how very useful we have found the Budget Brief this year.

2. As you know, in preparing for his wind up in the Budget Debates the Financial Secretary relied almost exclusively on the relevant sections from the Brief.

3. Since then he has needed to brief himself on a variety of aspects of the Budget for a number of occasions. This evening, for instance, he gave a short speech to the Backbench Smaller Business Committee. On all these occasions I have found that the sections from the Budget Brief have provided material he requires in a format which he finds easy to use.

4. Not only has this saved time and effort in this office in reformulating material for his use it has also, I am sure, made life easier for FP who have often been able to refer me to the brief when I have made requests to them.

5. Finally, you may like to know that following the Financial Secretary's speech this evening Barry Henderson MP rang, anxious to have a copy of the note from which the Financial Secretary spoke (Section K3 of the Brief). Would there be any objection to our sending it to him?

VL

VIVIEN LIFE

273/005

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

24 April 1986

Sir Eldon Griffiths MP
House of Commons
LONDON
SW1

Dear Eldon

Thank you for your letter of 29 March enclosing a cutting from the Wall Street Journal of 26 March - and for your kind comments about the Budget.

Needless to say, we do have well worked estimates of the likely effects of tax reductions on revenue, taking supply side and other indirect effects into account. It is obviously true that tax reductions have beneficial effects on the working of the economy and indeed that is the main reason why they are central to our policy. The question in practice is how great we can safely assume these effects to be, especially in the first few years. Their size and timing are much more uncertain than the Wall Street Journal allows. What is quite clear is that tax cuts reduce tax revenues in the short run, and even a temporary move towards a higher Budget deficit would have obvious risks. It therefore seems right to reduce taxes gradually on realistic estimates of supply side effects and to make further cuts taking advantage of greater supply side effects as and when these effects occur.

The plain fact is that the Wall Street Journal has long been committed to (and is now almost the last bastion of) the extreme "Lafferite" proposition that tax reductions increase tax revenues even in the short term. This has already been disproved in the context of the much more dynamic US economy, as the size of their Budget deficit bears eloquent witness.

That said, I agree that there is much further to go in cutting tax rates - and I hope to make futher progress this Parliament.

Yours
Nigel

NIGEL LAWSON

Debbie

CHANCELLOR OF THE EXCHEQUER

HONI SOIT QUI MAL Y PENSE

c/

You asked to be reminded of this.

D
14/4

draft reply [illegible] letter

pse [illegible] 2 [illegible]

yesterday or today

6.30
7.30

ELDON GRIFFITHS BF14/4 to DL. Personal

HOUSE OF COMMONS
LONDON SWIA OAA

29 March
1986

Dear Nigel.

I would reply on return from the U.S. ~~[illegible]~~. PL remind me.

The attached strikes me as a refreshing – if harsh – critique of the Budget. I recognise the constraints on you, and immensely admire the courage and skill you displayed; but it is perhaps useful to see just how far a benevolent? outsider believes we still have to go. I do hope you will P.T.O.

Read this personally.

[illegible]

British Show Little Interest in Dropping Tax Rates

LONDON – When Nigel Lawson produced the 1986 budget from his tattered briefcase earlier this month, all Britain seemed united on one assumption: Whatever disagreements there might be on the merits, it was a supply-side, tax-cutting document.

An article in the Times stated simply that "the Chancellor's measures . . . make up a 'supply-side' budget," while the Financial Times ran an editorial under the headline "A supply-side mini-budget." The

Europe

by William McGurn

Guardian carried a front-page story called "Marching to the taxcutters' dream." All this for a budget that cut merely one percentage point off the basic income-tax rate of 30% and left the punitive rates intact. No wonder Chancellor Lawson was smiling.

But to an American visitor evidence of a supply-side campaign looks thin in a nation where people earning more than $61,500 are in the top 60% marginal rate and the lowest wage earners will be paying 29% even after the chancellor's ballyhooed cuts. Some four years after Ronald Reagan's across-the-board tax-cutting program brought down inflation and unemployment and set America off on a productive binge, Margaret Thatcher is saddled with 13.2% unemployment and a system that discourages risk. Far from launching a supply-side program, the Tories have yet to grasp its fundamental distinction between tax rates and tax revenues. By continuing to present tax-rate cuts as straight percentage drops in revenue yield that must be made up elsewhere in the budget, the Tories may have missed their chance to launch a real supply-side initiative.

"The net result of the Thatcher years is that the administration has actually increased the tax burden on the economy," says Ronald Burgess of the Economic Study Association.

This was not what the Tories promised when they assumed office in 1979, when Geoffrey Howe in the first Thatcher budget slashed the highest marginal rates from 98% on unearned income and 83% on earned income down to what is now the top marginal rate of 60% for both. The reasoning was that this would spur productivity and that no one in his right mind was actually paying 98% on income.

Curiously, the British don't appear to have checked whether any of this worked. According to the "static analysis" rules of the British Treasury, these first cuts in income tax (including a reduction of the basic rate to 30% from 33% and the raising of thresholds) were accounted for in the 1979 budget as "costing" 860 million pounds ($1.78 billion at May 1979 exchange rates) in revenue in the first full year, to be made up elsewhere. So the Tories jacked up the value-added tax. But the central question is left unasked: Did the revenue from income decline by the predicted 860 million pounds? Did it decline at all?

Checking with the government is little help. The Central Statistics Office refers a reporter to the Treasury, which refers him to Inland Revenue, which says it doesn't keep revenue figures by bracket. Nor does anyone have even the real, inflation-adjusted figures for revenue.

One person who has looked at the 1979 tax cuts from this perspective is U.S. journalist George Gilder, who notes that revenue from income tax did not go down by 860 million pounds—it went up, even in the midst of recession. From the other end, he points out, despite increases in social security tax and VAT rates, "real social security revenues actually dropped" and VAT revenues rose by only a fraction of what was expected.

Yet this year's budget continues to talk about tax cuts in terms of static analysis "cost." The drop in the oil price to about $15 a barrel is said to have left the chancellor with little "room" for tax cuts, since it will mean only $9 billion in revenue from North Sea oil instead of the $17.2 billion expected last year. So the chancellor's decision to cut one point off the basic rate anyway, in the teeth of pressure to "make up" for the oil losses, was thus hailed by Tories as a victory. It seems to have escaped everyone's notice that one reason the chancellor went through with his modest tax cut is that revenues from sources other than North Sea oil—including corporate-tax revenue, whose rates have been declining these past few years—showed an unexpected increase of a few billion pounds. And there is little appreciation for the similar incentive effects on the economy from lower energy costs.

Nor is there any discernable move to lower the marginal tax rates further, since the cut in only the basic rate actually makes the curve more progressive. Moreover, by not raising the thresholds in line with inflation the tax burden has actually increased at the higher levels. Here the Tories will point to their 1979 cuts on the top rates, but these only brought Britain down from ridiculous levels. According to a report this year by the Organization for Economic Cooperation and Development, in 1983 dollars Britain's marginal rates still ranked among the world's highest. Supporters of the present budget argue that this is not as important as the basic rate, where the majority of British taxpayers are. No connection is drawn between penalizing high earnings and driving away people who make them.

Not that the basic rate does not need cutting as well; Britain also has one of the highest taxes on low-income wage earners. The Tories hope to continue cutting the basic rate—ultimately to their 1979 goal of 25%—primarily to pull people out of the "poverty trap" by making work marginally more attractive. Under the present arrangement, the welfare structure and tax system together act as a powerful disincentive to seeking work. As the Economist reported in its March 22-28 issue, "before the budget, a married man earning 5,000 pounds ($7,500) a year faced a marginal tax-plus-national-insurance rate of 39% in Britain compared with only 7% in America and 10% in Japan."

The upshot of all these changes is that despite the Tory government's success in eliminating some capital taxes and bringing down some of the most stifling rates, it has not significantly changed Britain's status as one of the most highly taxed nations in the world. Yet, as the chancellor made clear, despite these high rates and an unemployment figure that has doubled since their time in office, the Tories' priorities remain inflation and the deficit. Indeed, back in December the prime minister stated that although she wanted to lower taxation because she recognized that the current rates are disincentives, the Tories are "not prepared to risk our paramount objective of lower inflation." In practice this means that the Tories will restore incentives to produce after people start producing.

Even a number of those who enthusiastically support the present budget—such as the president of the Adam Smith Institute, Madsen Pirie—recognize that it leaves Britain's counterproductive tax system unchanged. "The higher tax rates in Britain have nothing to do with economics or the money brought in," says Mr. Pirie, "because they don't bring in that much revenue. They are simply a manifestation of the politics of envy."

Until Mrs. Thatcher's chancellor introduces a budget that turns these distortions around, the supply-side revolution in Britain awaits its first shot.

Mr. McGurn is editorial features editor of The Wall Street Journal/Europe.

The Annual Re
of America's Leading

COMMITTEE OFFICE
HOUSE OF COMMONS
LONDON SW1A 0AA
01-219 5766 (Direct Line)
01-219 3000 (Switchboard)

PWA

cc Chancellor, Chief Secretary, Financial Secretary, Economic Secretary, Minister of State, Sir P. Middleton, Sir G. Littler, Sir T. Burns, Mr Butler, Mr Anson, Mr Cassell, Mr Lovell, Mr Turnbull, Mr Odling-Smee, Mr Evans, Mr Monger, Mr A. Edwards, Mr Kitcatt, Mr Sholan, Mr Tolkien (Intl Payments)

TREASURY AND CIVIL SERVICE COMMITTEE

PRESS NOTICE

The 1986 Budget

The Treasury Committee's Report and associated evidence on the Chancellor's 1986 Budget will be published at 12 noon on Friday 25 April, available from HMSO. (Fourth Report from the Treasury and Civil Service Committee, HC(1985-86)313).

European Community Budgetary Discipline

The Treasury Committee's Report on budgetary discipline in the European Communities will be published at 12 noon on Wednesday 7 May. Confidential Final Revise copies will be available on the usual basis at 12 noon on Tuesday 6 May, from room 309, St Stephen's House, Embankment SW1 and in the Press Gallery, House of Commons. A press conference will be held at 12 noon on 7 May in Committee Room 6 at the House of Commons. (Fifth Report from the Treasury and Civil Service Committee, HC (1985-86) 203).

Supply Estimates 1986-87

Witnesses representing HM Customs and Excise will give oral evidence before the Treasury and Civil Service Committee at 4.45 pm on Tuesday 6 May in Committee Room 15 at the House of Commons, in public.

S PRIESTLEY
Clerk

24 April 1986

8-45

I agree

MCS 25/4

FROM: R PRATT
DATE: 25 APRIL 1986

1. MR SCHOLAR

2. CHIEF SECRETARY

cc Chancellor of the Exchequer
Financial Secretary
Economic Secretary
Minister of State
Sir Peter Middleton
Sir Terence Burns
Mr Butler
Mr Cassell
Mr Odling-Smee
Mr Evans
Mr Peretz
Mr Monger
Miss Sinclair
Miss Peirson
Mr Gray
Mr Culpin

TCSC BUDGET REPORT

I understand that you would like a short passage on the TCSC report for possible inclusion in your speech on the Finance Bill second reading.

2. The report was published at noon today, and we have not yet had the opportunity to consider it in any detail. It consists largely of a commentary on monetary policy, with a short section on fiscal policy and on economic prospects. There is nothing about tax changes.

3. The report has just three recommendations - that the Government should consider the possibility of further promotion of the Red Book and EPR Supplement; that the list of contents of press notices should be reinstated; and that £M3 should be monitored. It concludes that the overall tone of the Budget is "appropriate" given growth and inflation prospects; that monetary policy is unclear, but has changed substantially since its inception; and that the build up of liquidity should be monitored.

4. Given that the report is critical, and concentrates on monetary policy to the exclusion of any reference to tax changes, you may feel it unnecessary to mention it at all on Finance Bill Second Reading. If you do wish to include a reference, I suggest:

"In their report on the Budget, which was published with their usual impressive speed last Friday, the Treasury and Civil Service Select Committee acknowledged that the prospect for the next 12 months is one of continued economic growth and lower inflation. Today is not the time to discuss their report in detail, which makes no comment on the tax changes in the Budget, but concentrates on the conduct of monetary policy, which my RHF discussed comprehensively in a speech on April 16th. The Government will respond to the Committee's recommendations in due course.

5. We are providing a brief commentary and line to take on the Report but for the most part there is no need to go beyond the formulation that: "The Government are considering the report and will respond to the recommendations in due course."

Richard Pratt

RICHARD PRATT

255/24.ms

RP

FINANCIAL SECRETARY TO THE TREASURY

FROM: N WILLIAMS
DATE: 29 April 1986

MR PRESCOTT IR

cc PS/Chancellor
PS/CST
PS/EST
PS/
MST
Mr Monger
Miss Sinclair
Mr Cropper
Mr Lord
Mr Graham (OPC)
Mr Lewis IR
PS/IR

TAXATION OF LUMP SUMS FROM EMPLOYMENT

1. The Financial Secretary was grateful for your minute of 8th April.

2. We agreed that the Financial Secretary would wait until after the Ministerial discussion of Golden Hellos and Handcuffs before taking a final view on this subject.

3. The Financial Secretary's view is that because of the link with Golden Hellos etc any changes made in this area are likely to lead to a disproportionately lengthy debate.

4. Mainly because there is no evidence of the two aggregation defects being exploited at present, the Financial Secretary would not in the normal course of events want to take action on these points in their own right.

5. We have since discussed this, however, and you explained that it is necessary to take the corrective action described in paragraph 9 of your minute because of its relation to the earlier decision to correct the main defect in the "handshakes" legislation.

6. On this basis, the Financial Secretary is content for you to deal with this aggregation point in the New Clause which is to be introduced at Committee Stage.

N Williams

NIGEL WILLIAMS
(Assistant Private Secretary)

1-39

FROM: R PRATT
DATE: 10 JUNE 1986

I agree MLS 10/6

1. **MR SCHOLAR**

2. **CHANCELLOR OF THE EXCHEQUER**

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir Peter Middleton
Sir Terence Burns
Mr F E R Butler
Mr Cassell
Mr Monger
Mr Odling-Smee
Mr Peretz
Mr Turnbull
Miss Kelley
Mr Culpin

Ch OK? RL 10/6

I agree with your analysis @ X. I would not propose to comment on monitoring until I have seen advice as to precisely what we in practice mean by monitoring. It is probably OK, but there is no sense in not looking before we leap. NL

TCSC BUDGET REPORT: GOVERNMENT OBSERVATIONS

... I attach a draft of the Government response to the TCSC Budget Report.

2. The Report contains just three formal recommendations:

(1) We should look into the possibility of promoting the FSBR and perhaps a revised EPR supplement

(2) We should put a contents list on the press notices issued on Budget Day

(3) We should monitor the monetary situation.

3. The normal convention is that we respond only to those recommendations which are addressed to the Government and do not make any other comment, unless it is in our interests to do so. In this case, there seems no need to comment on anything in the Report apart from the three formal recommendations - all of which we can accept. (see my reservation on (2), which would probably necessitate work in this Office)

4. In their commentary on the presentation of Budget documents, the TCSC give the Government 'every congratulation' for 'substantial improvement'. It would seem rather ungracious not to acknowledge this unusually fulsome plaudit, and so the draft response thanks the TCSC for their comments.

5. The rule for replying to Select Committee Reports is that we should do so within 2 months if at all possible. In this case, we should therefore aim to get the response to the TCSC before Wednesday 25 June.

Richard Pratt

RICHARD PRATT

DRAFT

GOVERNMENT OBSERVATIONS ON THE FOURTH REPORT FROM THE TCSC - 1986 BUDGET

"The Treasury, together with HMSO, should look into the possibility of further promotion of the Red Book and perhaps a revised Budget supplement to the Economic Progress Report."

The Government welcomes the Committee's interest in the improved presentation of Government financial documents, and thanks the Committee for its comments.

The Government accepts the Committee's recommendation that it should examine the possibility of further promotion of the FSBR and an improved version of the EPR supplement.

X

(I suppose so - given X)

"The usual list of contents should appear, in future, on the front of the collection of press notices issued by the Treasury."

A very large quantity of material is prepared for Parliament and the press on Budget day, some of it at a late stage and to a tight timetable. This imposes a number of practical constraints; but, ~~subject to them,~~ the Government ~~accepts~~ will look sympathetically at the Committee's recommendation.

X

[illegible] be [illegible]: [illegible] we should absolutely promise this.

"We are aware that the build up of liquidity, which reflects both high real rates of interest and financial innovation, need not have inflationary consequences, provided that the income velocity of circulation of £M3 continues to fall and that the extra liquidity is not translated into "transactions of balances" for goods and services. And of course if high real rates of interest persist, then the velocity trend may continue to hold. Nonetheless, we recommend that the situation should be carefully monitored."

The Chancellor has emphasised[1] that, while in the Government's judgement the growth of £M3 reflects a genuine desire on the part of the private sector to increase its liquidity on a lasting basis, and does not therefore presage higher inflation, that judgement must be continuously tested against other evidence.

The Government is monitoring and will continue to monitor the situation carefully and therefore accepts the Committee's recommendation.

[1] Speech to the Lombard Association on 16 April 1986

RR7.26

pmf

FROM: MRS R LOMAX

DATE: 11 June 1986

MR PRATT

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Mr F E R Butler
Mr Cassell
Mr Monger
Mr Odling-Smee
Mr Peretz
Mr Scholar
Mr Turnbull
Miss Kelley
Mr Culpin

TCSC BUDGET REPORT: GOVERNMENT OBSERVATIONS

The Chancellor was grateful for your minute of 10 June.

2. He is content with the attached draft of the Government response to the TCSC Report, subject to one small change:-

- Response to second recommendation, second sentence redraft as follows "This imposes a number of practical constraints; but the Government will look sympathetically at the Committee's recommendation".

3. The Chancellor thinks that the second recommendation is probably acceptable, but he would be reluctant for us to commit ourselves too firmly until we know precisely what in practice would be involved.

RL

RACHEL LOMAX

cc CHANCELLOR.
CST FST.
EST MST.
SIR. P. MIDDLETON
SIR. T. BURNS
MR. F.E.R. BUTLER.
MR. CASSELL.
MR. MONGER
MR. ODLING-SMEE.
MR PERETZ
MR. TURNBULL.
MR. SCHOLAR.
MISS. KELLEY.
MR. CULPIN

p/v

H M Treasury

Parliament Street London SW1P 3AG

Switchboard 01-233 3000
Direct Dialling 01-233 ....

W McKay Esq
Clerk to the Treasury
and Civil Service Select Committee
St Stephen's House
St Stephen's Parade
LONDON SW1

11 June 1986

Dear Bill

TCSC REPORT ON THE 1986 BUDGET

... I attach the Government's observations to the TCSC's Fourth Report.

Yours sincerely

Richard

RICHARD PRATT

GOVERNMENT OBSERVATIONS ON THE FOURTH REPORT FROM THE TCSC - 1986 BUDGET

"The Treasury, together with HMSO, should look into the possibility of further promotion of the Red Book and perhaps a revised Budget supplement to the Economic Progress Report."

The Government welcomes the Committee's interest in the improved presentation of Government financial documents, and thanks the Committee for its comments.

The Government accepts the Committee's recommendation that it should examine the possibility of further promotion of the FSBR and an improved version of the EPR supplement.

"The usual list of contents did not appear on the front of this year's press release and we recommend that it should do so in future."

A very large quantity of material is prepared for Parliament and the press on Budget day, some of it at a late stage and to a tight timetable. This imposes a number of practical constraints; but the Government will look sympathetically at the Committee's recommendation.

"We are aware that the build up of liquidity, which reflects both high real rates of interest and financial innovation, need not have inflationary consequences, provided that the income velocity of circulation of £M3 continues to fall and that the extra liquidity is not translated into "transactions balances" for goods and services. And of course, if high real rates of interest persist, then the velocity trend may continue to hold. Nonetheless, we recommend that the situation should be carefully monitored."

The Chancellor has emphasised[(1)] that, while in the Government's judgement the growth of £M3 reflects a genuine desire on the part of the private sector to increase its liquidity on a lasting basis, and does not therefore presage higher inflation, that judgement must be continuously tested against other evidence.

The Government is monitoring and will continue to monitor the situation carefully and therefore accepts the Committee's recommendation.

[(1)] Speech to the Lombard Association on 16 April 1986

1-25

Personal

FROM: R PRATT
DATE: 30 JUNE 1986

MR SCHOLAR

cc Chancellor of the Exchequer
Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir Peter Middleton
Sir Terence Burns
Sir Geoffrey Littler
Mr F E R Butler
Mr Cassell
Mr Anson
Mr Turnbull
Mr Peretz
Mr Culpin
Miss O'Mara

GOVERNMENT OBSERVATIONS ON THE TCSC REPORT ON THE 1986 BUDGET

The TCSC are publishing the Government's observations on their Budget Report on Friday 4 July. The TCSC are not adding any further comments of their own and there will be no press conference.

Richard Pratt

RICHARD PRATT