C·P·S POLICY CHALLENGE

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WHITHER MONETARISM ?

The Chancellor's Mansion House Speech – with comments by three wise men

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THE CRITICS

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THE CHANCELLOR'S SPEECH

of 17 November 1985

Financial markets, both in London and throughout the world, are in the throes of fundamental and far-reaching changes. Barriers between previously separate markets are coming down. The old institutional distinctions no longer apply. The financial map is being redrawn.

I am not one of those who view these changes with trepidation. I believe that the changes we are seeing are good for Britain, and good for London as a financial centre. For what we are seeing is a radical shift towards the liberalisation of financial markets. One which has brought in its train a new wave of experimentation and innovation.

Free markets have always benefited this country. They will continue to do so. We are an open, trading economy. And one which, despite the strictures of the House of Lords Select Committee on Overseas Trade, makes a good part of its living from the export of financial services.

And while I am on the subject of the House of Lords Report, let me say this. The Government's policy is to create the conditions in which business can thrive and prosper - manufacturers and non-manufacturers alike. And anyone who fails to recognise that British industry as a whole, for all its problems, is in a healthier state today than it was six years ago is simply not living in the real world.

And let me take this opportunity of congratulating all those in British industry who have brought about this improvement.

The Government therefore wholly rejects the mixture of special pleading dressed up as analysis and assertion masquerading as evidence which leads the Committee to its doom-laden conclusion.

We equally reject its principal remedy - that British manufacturing industry should be protected by a cocoon of subsidies - particularly at a time when the rising threat of protectionism of one kind or another throughout the globe represents the gravest single threat to world prosperity and employment.

Meanwhile, the changes we are seeing in the financial markets bring with them the need for institutions, individuals, and financial authorities to adapt their own practices. To acquire new skills; to adopt new methods of working.

We in Britain - and this is as true of the Government as it is of the financial markets themselves - have been in the vanguard of that process of evolution. We have moved further and faster than many of our competitors. But there is much more to do. My theme tonight is the way in which liberalisation and innovation are affecting markets, and the Government's policy towards them.

I shall talk first about the world economy. Then about the institutional changes in London, and how they affect the way in which the authorities view their essential task of supervision. I shall then say a few words about the impact of liberalisation on domestic financial policy. And finally, I will discuss the economic outlook for our country over the next two years or so.

The World

A month ago I was in New York for a meeting of G5, the Finance Ministers and Central Bank Governors of the five major industrial countries.

At that meeting we concluded, first and foremost, that protectionist pressure must be resisted at all costs. The US Administration is as firmly convinced of this as we are, and determined to fight against proposals in Congress for protectionist legislation.

But we recognised that words were not enough. We acknowledged that while there is a limit to what can be achieved by concerted intervention on the foreign exchange markets, we were not impotent; and that we should therefore, acting together, lose no time in helping to bring about an orderly depreciation of the dollar against the other major currencies. In the last four weeks a useful start has been made on this essential process of adjustment. And let me emphasise that the agreement is still firmly in place.

Of course there is more to do.

- First, in correcting domestic imbalances. The US has begun to tackle the fundamental problem of its fiscal deficit, but further progress is clearly needed.

- And second, in maintaining open markets. Japan in particular needs to do more, especially in financial markets. The measures the Japanese authorities have already announced are greatly to be welcomed. But they need to be implemented and made effective without delay.

As you know, I was not able this year to attend the annual Bank and Fund meetings. My presence was required at the seaside. Those who did go to Korea will confirm that the central themes of the Plaza meeting were reaffirmed and underlined at Seoul. In addition, I was glad to see the widespread recognition that the international debt problem is now entering a phase in which the tried and tested case-by-case approach of the IMF needs to be reinforced by a complementary role on the part of the World Bank.

At the centre of discussion at both meetings was recognition of the need to halt the protectionist tide. I come back to this point. Our overriding aim is to maintain a free trading and financial system at home and abroad. A free market system brings benefits for all. The more regulations we can remove, the more barriers we can lower, the more liberal we can make our trading practices, the better off we shall all be.

Supervision

The same considerations apply to our domestic markets, and not least to financial markets. London's market position can never be taken for granted. The City has remained pre-eminent in international banking precisely because it has always struggled for dominance.

All of you here tonight are familiar with the rapid pace of change in London over the last two or three years. I wonder how many of you are in the same organisations, with the same mix of business, as you were three years ago. Whereas two years ago I addressed an audience of stockbrokers, merchant bankers and clearing bankers, tonight I am probably talking to directors of conglomerates and managers of financial supermarkets.

Certainly, this upheaval has posed problems for the authorities. But I believe we have acted promptly to solve them. The Financial Services Bill will provide the necessary legislative framework for the regulation of the securities markets. We have prepared a modern framework for the building societies. The Building Societies Bill will come before the House of Commons very shortly. And we have now begun the process of consultation leading in due course to a replacement for the 1979 Banking Act which has proved to be deficient in some important respects.

Our guiding principles are clear.

Effective and well-operated supervision is an essential element of London's competitive advantage. It must offer reasonable protection for individual depositors and investors. And it must also preserve the stability and integrity of the system as a whole. At the same time we have to devise a system which is flexible enough to allow the markets and the institutions within them to develop.

We must also take notice of the traditions and practices of existing regulation. And build on the City's proven ability to devise and run its own self-regulating mechanisms.

But we cannot ignore the overlap between markets. The possibilities of too much, or too little, supervision for institutions which straddle market boundaries. And the resulting need for adequate co-operation between different sets of supervisors.

The way in which we have chosen to balance these sometimes conflicting constraints and requirements is now clear in the case of building societies and the securities markets.

The way forward for banks is still under active consideration - with the help of advice, both solicited and unsolicited, from many here tonight.

The Johnson Matthey Bankers affair has drawn attention to certain inadequacies in the system of banking supervision. In the wake of that debacle I set up a Review Committee chaired by the Governor of the Bank of England, and the recommendations of that Committee form the basis for the consultation now under way.

We propose to end the two-tier system of regulation, which unwisely assumed that those institutions able to call themselves banks required a less rigorous sytem of supervision. And to strengthen the mechanisms of co-operation between the supervisors and banks auditors.

I attach the highest importance to this latter change. As part of their duties, auditors have to form an independent view of a bank's assets. And of the systems used to manage them. It is vital that the supervisors should be able to draw freely on this information when necessary, and that the auditors should be kept informed by the supervisors of matters of concern which arise at their end. To match these changes in methods of supervision there must, of course, be institutional changes. The Governor has already indicated how he proposes to begin the process of strengthening the supervisory arm of the Bank.

I hope and believe that the new systems of supervision we are now putting in place will reduce risks substantially. But it is impossible to eradicate risk entirely. Nor would it be right to seek to do so. Nor of course does supervision in any way derogate from the overriding responsibility of management for the proper conduct of its business.

Equally, no system of supervision can be proof against deliberate fraud. So we must ensure that where there is fraud it is uncovered in a timely fashion. And that the evidence is acted on expeditiously. This is, of course, absolutely essential if the reputation of the City, both domestically and internationally, is to be protected.

Let me make it quite clear. Financial supervision is a matter the Government takes very seriously indeed. While others are charged with the day-to-day duty of supervision in particular fields, it is the Government's responsibility to ensure that the statutory framework is right, and that overall it is being effectively implemented. We cannot escape from that responsibility - nor would we wish to do so.

Many of the changes I have described have been forced upon us by the liberalisation of markets. But I welcome them wholeheartedly. We are engaged in building a stronger, more competitive set of markets, and a more robust, but no less flexible, set of supervisory bodies to match.

Monetary Policy

It would have been surprising if these changes to market structures, which were accelerated by the action we took in 1979 and 1980 to sweep away a range of outdated controls, had not affected the operation of domestic financial policy - the third area I said I would cover.

Liberalisation and structural change affect financial indicators in a variety of ways. The boundaries of the banking system become blurred as banks and securities houses merge. Longstanding distinctions between different financial assets have become less precise.

Companies can choose between a large number of instruments, currencies and financial centres. For instance ten years ago a British company wishing to borrow sterling would have done so directly, and almost certainly in London. Today the same company might issue dollar commercial paper in New York,and swap the proceeds into sterling. We have recognised the need to take account of these changes in the way that financial policy is operated.

Inevitably, the growth rates and significance of the various measures of money supply have been affected. This has, rightly, been reflected in changes in the way in which we interpret signals from the different financial indicators.

Liberalisation and innovation have made that process more complicated.

What has not changed, however, is the essence of policy. The Government continues to attach the highest priority to the maintenance of sound financial conditions. The aim of monetary policy is to ensure sustained and steady downward pressure on inflation. This can be secured only by delivering an appropriate growth of money GDP over the medium term. And looking back at the implementation of policy it is important always to check whether the outcome for money GDP has been in line with our objectives.

But to achieve this, it remains operationally necessary to conduct monetary policy through the use of intermediate targets - taking account of relevant information such as the behaviour of the exchange rate - rather than by attempting to target money GDP directly.

As I explained in my Budget speech we have found it helpful to target measures of both broad and narrow money.

Broad money measures the liquidity of the economy. An excessive build-up of liquidity supplies a store of purchasing power that can be translated into spending, thus providing an undesired boost to the growth of money GDP and hence to inflation.

The question, however, is what is excessive? In monitoring the growth of broad money it is important to gauge the extent to which the private sector genuinely wants to build up its liquidity on a permanent basis. That inevitably involves an element of judgement.

During the 1970's, with controls in operation and negative real interest rates, the demand for liquidity grew less rapidly than money GDP.

In the 1980's, following the abolition of controls and a return to positive real interest rates, liquidity has grown faster than money GDP. Over the past five financial years, for example, while £M3 has grown by 82 per cent and PSL 2 by 84 per cent, money GDP has grown by only 54 per cent - and prices by 43 per cent. It has become increasingly evident that both individuals and companies wish to hold an increased proportion of savings in liquid form.

In retrospect it is now clear that we have persistently underestimated the strength of this demand. We can maintain, and are maintaining, progress towards our inflation objective while £M3 is growing at a rate well above the top of the range set in this year's Budget Statement. To try to bring it back within the range - which, with the benefit of hindsight, was clearly set too low - would imply a tightening of policy which the evidence of other indicators of financial conditions tells us is not warranted.

I shall as usual be considering what target to set for £M3 for 1986-87 at the time of the next Budget. In the meantime, we shall continue to monitor £M3, and indeed other measures of broad money, as part of the task of forming an overall judgement about monetary conditions. That judgement has to take into account the level of short-term interest rates, where a cautious approach continues to be indicated. It must also be influenced by the behaviour of MO, which, as a relatively undistorted narrow aggregate, is more clearly related to spending patterns. If, contrary to our expectations, the rapid growth of broad money were to show up as higher spending one would expect to see early warning signals in the growth of MO. So far this year, it has stayed very comfortably within its target range.

I realise that MO has not yet acquired many friends in the square mile, despite the evidence of its relatively stable relationship with transactions in the economy and the steady trend in its velocity of circulation. It may not be widely known by those who argue that MO is an excessively narrow aggregate that the German target aggregate, the composite known as Central Bank Money, is in fact slightly over 50 per cent notes and coin.

The other good and early guide to changing financial conditions is the exchange rate. When, as now, signals from the various measures of money become difficult to interpret, the exchange rate inevitably assumes an increased weight in monetary policy decisions. It has a direct impact on the price level and on inflationary expectations. Sharp movements tend to coincide with changes in the market's perception of monetary ease or stringency. Large swings in any case cannot be ignored. The present level of the exchange rate is close to the average level of the past two and a half years.

We will continue to judge monetary conditions in relation to the indicators I have just described. At present I believe that these are consistent with continued lower inflation, which I firmly expect to see. But we will continue to monitor all the evidence. If the performance of one indicator were to deteriorate we would need convincing evidence from the other indicators before concluding that this was acceptable.

There is, essentially, nothing new in this approach to the conduct of monetary policy.

Let me quote, if I may, from a speech I made getting on for four years ago, when I was Secretary of State for Energy - which was subsequently published as a pamphlet. (Financial Discipline Restored, CPC, May 1982.)

> 'It has always been a grotesque caricature of the present Government's economic policy to pretend that it consisted of leaving everything to an automatic pilot known as sterling M3. As far back as March 1980 we published our Green Paper on Monetary Control, in which we explicitly stated that to assess underlying monetary conditions properly it is necessary to take account of the evidence of <u>all</u> the various monetary indicators ...
>
> 'In a world in which the monetary system is in a constant state of evolution, the exercise of judgement and discretion is inescapable. The important question is: who is exercising that judgement and that discretion?
>
> 'If it is being exercised by those who do not really believe in the policy in the first place ...

then any departure from predetermined rules and guidelines will understandably be regarded with the gravest misgivings, since it will as likely as not represent a backsliding from financial discipline as such.

'If, on the other hand, the discretion is being exercised by those whose commitment to the policy, and to the overriding need to maintain financial discipline, is beyond doubt, then there is no cause for such misgivings. On the contrary, the judgement that is being applied, fallible though it may be, is one calculated to minimise the risk of error in carrying through the complex task of sensible monetary control in a financially advanced and sophisticated modern economy'.

That was nearly four years ago. Plus ca change.

It is, I recognise, all frightfully annoying for the young Turks who write the brokers' circulars. I imagine that anyone who reads them must feel rather like the American lady many years ago who, confused about the complexities of foreign policy, was introduced to John Foster Dulles, who courteously took her round the course.

When she emerged she was asked whether all was now clear to her. 'Oh no,' she replied 'I'm just as confused as before. But at a much higher level.'

Funding

The approach I have just outlined to the assessment of monetary conditions also has implications for the conduct of funding policy.

The purpose of funding is, quite simply, to ensure that the Budget deficit is financed in a non-inflationary way.

As I said on this very occasion, two years ago:

> 'The broad aim of funding policy will continue to be to fund the PSBR, by raising finance outside the banking system, from the UK private sector and from external flows ... Over the medium term there should be no systematic tendency either to overfund, or to underfund, the borrowing requirement.'

That was the intention.

But in practice, short-term considerations came to make overfunding almost a way of life. And that cannot make sense. It introduces distortions into the financial markets - not least a rapidly growing bill mountain - which are undesirable in themselves and can make policy harder to operate.

Accordingly, we are no longer seeking to control the recorded growth of £M3 by systematic overfunding. As I have said, we do not believe the recent behaviour of £M3 gives cause for alarm. But should it at any time become desirable to tighten monetary conditions, that would be achieved - and let there be no doubt about this - by bringing about a rise in short-term interest rates. The objective of funding policy is to fund the PSBR over the year as a whole: no more, no less. And that we are doing.

The experience of the last year has also demonstrated once again the value of a clear strategy within which the interpretation of financial conditions can evolve. The Government's firm commitment to the Medium-term Financial Strategy, with its clear route to still lower inflation, has been a source of strength in a changing and sometimes confusing world, in which innovation and liberalisation in financial markets proceed apace.

The UK Economy

I thought it right, on this important City occasion, to discuss the operation of monetary policy in some detail. But the acid test of monetary policy is its record in reducing inflation. Those who wish to join in the debate about the intricacies of different measures of money and the implications they may have for the future are welcome to do so. But at the end of the day the position is clear and unambiguous. The inflation rate is judge and jury.

In short, I take comfort from the fact that we have, over the years, brought about monetary conditions that have delivered lower inflation, despite all the distortions to monetary aggregates.

This year we have seen a temporary 'blip' in the RPI, as I warned in my Budget Speech. This was largely attributable to movements in the mortgage rate and to the temporary fall in the exchange rate earlier this year. Inflation peaked in May at 7 per cent. It is now back down to 5.9 per cent. By the end of this year I expect if to be close to the Budget forecast of 5 per cent, and below 4 per cent by the middle of next year.

Maintaining and improving on that rate through and beyond 1986 depends on continued control of monetary conditions. I am confident that the policies now in place and the techniques of monetary management we are using can ensure that control.

Lower inflation points the way to continuing growth of output.

You may remember that a few years ago a common cry was 'Where is the growth coming from?' We can now see the answer. It came in a balanced way from several sources, with investment and exports growing twice as fast as consumer spending. Over the next year exports and investment may not grow as fast as in the past year, but other components of demand - notably private sector consumption - may contribute more.

So far unemployment has been less affected than might have been expected by the healthy growth rate. This reflects two developments, both of which will be beneficial to the economy in the long run, even though their short-run impact on unemployment is adverse.

The first development has been the rapid growth of productivity, particularly in manufacturing industry - up 30 per cent over the past 5 years.

The second has been the large rise in the number of people entering the labour force, including a growing number of married women not previously registered for work. So that though the number of people in work has risen by some 600,000 over the past two years, that has not brought about a fall in the total of registered unemployed.

Both these developments, however, are generally to be welcomed. They increase the strength, competitiveness and flexibility of the economy. In the years ahead both will add to our productive potential.

But so long as unemployment remains at its present high level we cannot be complacent. There is much still to be done to improve the flexibility and adaptiveness of the labour market. And, meanwhile, employers who concede unnecessarily high pay rises are doing no-one a favour: neither their own firms, nor the competitiveness of the British economy, and certainly not the unemployed.

Given common sense on this front, the omens are good.

At this time of the year it has become customary for the pundits to revise upwards their expectations of growth for the current year. At the same time they invariably conclude that the next year will see a marked slowdown. They have been promising this for the past three years. I suppose if they go on long enough, they are bound to be right eventually. But I see no sign of it yet.

Over the past four years, the economy has been growing at an average rate of 3 per cent a year, with this year the best so far.

That encouraging performance has been achieved, not by so-called reflation. It has been acheved through the pursuit of a prudent fiscal policy and an anti-inflationary monetary policy, against the background of a more competitive, deregulated and productive economy. And that, my Lord Mayor, is the policy I intend to maintain.

CHANCELLOR REAGAN

Jock Bruce-Gardyne

> 'Monetarism': discreetly, at the Mansion House, London, after a long and often painful illness, borne with much bombast, on October 17 1985. The ashes will be cremated and flown to Chicago.'

Such is the obituary pronounced, with glee by some and gloom by others, since Nigel Lawson's address to the Bankers and Merchants of the City of London. Chancellor and Prime Minister have worked overtime to persuade the watching world that 'monetarism' is alive and well and living in Downing Street. They have not found many takers.

The kernel of the Mansion House message - or so it seems to me - was contained in the passage where the Chancellor repeated himself.

> 'In a world in which the monetary system is in constant state of evolution, the exercise of judgement and discretion is indispensible. The important question is: who is exercising that judgement and that discretion'?
>
> 'If it is being exercised by those who do not really believe in the policy ... then any departure from pre-determined rules and guidelines will understandably be regarded with the gravest misgingings ...
>
> 'If, on the other hand, the discretion is

> being exercised by those whose commitment ... to the overriding need to maintain financial discipline is beyond doubt, then there is no cause for such misgivings'.

That, as he reminded the City and the listening world, was what he had told the gnomes of Zurich back in 1981: that the medium is the message. When hardened old sinners like Tony Barber or Denis Healey dump £M3 unceremoniously in the trash-can then we had best fasten our lap-straps. But when the stern unbending team of Thatcher and Lawson execute a similar manoeuvre it only goes to prove their sophistication.

The unseemly mirth which followed was, I suppose, predictable. Yet the Chancellor has a point. When Lord Barber ditched the monetary pilot inherited from Roy Jenkins in the winter of 1979-80 he was all too plainly targeting for 'growth', and to hell with the inflationary implications. Similarly when Denis Healey passed what he elegantly described as 'sod off day' - the day the supervisors from the IMF packed their bags and said goodbye in 1978 - he was all too plainly se[illegible] [illegible]n the primrose path to inflation once again. Now on this occasion that is not the message that the City has absorbed. If it had been, the pound and gilts would surely have been skitterring. I think one can see why.

Paradoxically it could be the dropping of the £M3 pilot which has served to reassure the City. For one of the particularities of sterling M3 is that you have to get it right domestically. When bank lending to the personal sector is growing exponentially, as it has been these three years past, the only way in which the Government can strive to bring £M3 into line is by 'over-funding' - i.e. selling more gilts than it needs to sell just to cover its Budget deficit. But those gilts must be sold to the non-bank British public: i.e. to UK institutions and individuals. Sales to foreigners do not count.

At the Mansion House the Chancellor confirmed what had seemed to be the case for some months previously: that in his view £M3 had become too wayward to mope over, and hence that he had given up the forlorn chase after it with over-funding. In future sales of gilts would roughly match the deficit, and no more. That is not the crucial point. The crucial point is that when he lets £M3 go hang then selling gilts to foreigners is just as good as selling gilts to Brits.

In fact better. For foreigners who buy his gilts must first buy sterling. And if they first buy sterling, that buoys up the exchange rate. Which in turn keeps up the pressure on UK domestic costs, cools inflation expectations, and teaches manners to the members of the CBI if they go on paying themselves and those who work for them way over the odds. Hence - in the short run at any rate - ditching £M3, far from being an inflationary signal, may logically be interpreted as a pointer to more stable UK prices.

The Chancellor is predicting inflation down below 4 percent again by the end of 1986. This forecast has been greeted sceptically. But as he has fairly pointed out, Treasury forecasts - particularly of inflation - have frequently confounded the sceptical in recent years. Given strong sterling and weak commodity prices this one could turn the trick again.

So far, so good. The distant scene is a rather different matter. In the first place while it is true that high real rates of interest have evidently transformed bank deposits from pin-money into stores of value, it would not take much - by way of faster inflation or lower interest rates - to transform them back again. So while £M3 may be misbehaving, it still seems cavalier to despatch it to the salt mines. Then according to the Chancellor there is 'convincing evidence from the other indicators' that monetary conditions are quite as stringent as they should be. Which, pray? MO, certainly; but alas, MO has few suitors far outside Great George Street. Most of the other dials - £M2, PSL2, asset prices - are almost out of sight. Now the Chancellor <u>used</u> to say that, over time, the monetary indicators - subject, agreed to 'judgement and discretion' - were the best guide we had to the future course of prices in the High Street. Some of us still cling to these funny old delusions, and wonder occasionally what we may be stoking up for ourselves in 1987 or 1988.

The Chancellor, for his part (and whatever the Treasury may say to the contrary), is now banking on the exchange rate. As the international punters watch Mr

Volcker and Mr Baker squatting on US interest rates almost as if they were a pat of butter, they get the hint and want to take their money and run. 'Run to London', says our Chancellor. And they seem inclined to do so.

Here we come to problems 2 and 3. Problem 2 is that international sentiment, as we know, is ever more volatile with the passing years. If OPEC were to fail to 'get its act together' come the spring, the long-promised slump in world oil prices could yet be upon us. Under these circumstances it must be doubtful whether Mr Lawson could still get sufficient punters at his stall to keep a firm grip on the exchange rate without a substantial jump in domestic interest rates.

Problem 3 is that if he is successful in tempting in the foreign money the CBI, which is already restive, will begin to get rebellious once again. Now Sir James Cleminson and Sir Terence Beckett may make good hors d'oeuvres for breakfast at No.11. But the CBI has learnt a thing or two in recent years. It does not just complain on television as it used to do. It does the rounds of the Government backbenchers. And it is one thing to stare down the great industrialists: but something else again to stare down the Tory backbench 1922 Committee.

So there is a missing ingredient. The missing ingredient is participation in the European exchange rate mechanism. And I would hazard a guess that it is missing in a literal sense. It was intended to be there. But the Prime Minister is yet to be converted.

A great deal of rubbish is talked about the e.m.s. Collective wisdom in the City, at the Bank of England, in the CBI, and across much of the spectrum of the House of Commons, would have us believe that by linking up the pound to the deutschmark system (which is what it is) we should enjoy lower interest rates, more stable currency, and probably faster growth and more employment thrown in for good measure. It is almost uncannily similar to the magic qualities attributed to precisely the opposite nostrum - floating exchange rates - fifteen years ago (and by many of the same people). In reality there is no earthly reason, from its past performance, to expect greater exchange rate stability vis-a-vis the dollar through linkage with the deutschmark. Rather the contrary, in fact. Equally participation in the e.m.s. could logically be expected at the present time to lead to our interest rates being higher, not lower, than they would otherwise be. As for growth and employment, Joanna Southcott's box would be about as useful.

But the e.m.s. does have one unique ingredient. It involves a set of rules. The participants are committed to keeping their currencies in station (unless they take a conscious - and very high profile - decision to do otherwise). So whereas the CBI is at liberty at present to demand four points off base rates, and sterling down to DM3.50 or whatever figure takes its fancy, while the Treasury, having jettisoned its monetary target, has no logical refutation apart from barrack-room abuse, if we signed on with the e.m.s. it could cheerfully advise the CBI to read the rule-book. All the more so since the CBI leads the chorus of demands for us to join the club.

For the moment (but for how long?) all this is academic. The Prime Minister will not tolerate such continental entanglements and so, as Dr Johnson used to say, 'there's an end on't'.

Even without this magic ingredient, however, the strategy on which the Chancellor is now embarked could work better than the critics are willing to concede for the next eighteen months if he can stick to it that long. It is likely to involve some real increase in the PSBR for 1985/86, however disguised by asset sales, whether that increase results from a slump in oil revenues, a cut in tax rates, or some additional increase in public spending programmes, or - most likely - a combination of the three. That, coupled with lower inflation rates resulting from strong sterling and weak commodities, should mean that the purchasing power of those in work will be rising steeply. Prospects for those without a job may not be so rosy: with margins squeezed, rising labour costs and unaccmomodating sterling, it is hard to envisage many employers embarking on recruitment drives. But we still have one of the highest 'activity rates' in the world: more than five out of every six of us are poised to share in the take-home pay bonanza, and that is an awful lot of voters.

Looking more than eighteen months ahead the prospects do become more murky. Experience must lead one to expect that by then some of the impressive volume of domestic credit building up will come through in prices; and also that the pressures of relatively high interest rates and a relatively strong currency will be feeding through into unacceptable strains on the corporate sector, and also - very possibly - the banking sector. Meanwhile the debt service element in the total public spending bill will, as Tim Congdon regularly reminds us, be assuming formidable proportions, while on the other side of the ledger the Chancellor's revenues from oil will presumably be shrinking substantially; and the balance of payments on current account is likely to be well into the red.

If all this sounds strangely familiar, it is. For what we are really embarked upon may not be monetarism updated; nor is it 'supply side' economics; but it has all the hallmarks of Reaganomics. Now we all know where Reaganomics have landed the United States: a huge and unsustainable budget deficit; a huge and unsustainable payments deficit; an uncomfortably expensive currency; and an almost irresistible surge of protectionism. But we should not overlook where they have taken President Reagan to: a landslide re-election, and the highest popularity rating of any second-term President in living memory.

One's instinct is that, for Britain, Reaganomics are likely to prove a shorter tether than they have been for Reagan. Which is why I ventured to suggest in the House of Lords the other day that Nigel Lawson should be having words with the Prime Minister about a date with the electorate not later than the spring of 1987. And let's hope there will be time enough to switch tracks again back to fiscal discipline when the votes are safely garnered in.

START OF A SOMERSAULT?

Tim Congdon

Mr Lawson started as a radical Chancellor of the Exchequer. In his Mansion House speech in November 1983 he said that the Government's key financial objective was price stability. Although he qualified this by describing it as an 'eventual' goal, the speech undoubtedly came as a surprise both for its boldness and its ambition.

Unhappily, a large gap has emerged between rhetoric and performance, and the gap is widening with every speech which Mr Lawson makes. The Mansion House speech in 1985 was much plainer and more circumspect than its predecessor two years earlier, but even then most City analysts did not believe its forecasts for government borrowing 1985/86 or 1986/87. The loss of trust is symptomatic of a more general problem. The Thatcher Government is widely admired for reducing inflation from the 15 per cent level it averaged in the late 1970s to the 5 per cent figure now regarded as a norm. But this is regarded as an achievement of the first term. There is a widespread perception that not much progress has been made on the financial front in the second term.

Are the doubts and the criticisms justified? If they are, Mr Lawson must feel doubly disappointed. Financial policy would have failed to meet the expectations of many government supporters; it would also have failed to fulfil his own stated aspirations. Mr Lawson has a reputation for tough and whole-hearted commitment to the Government's medium-term financial strategy. In June 1980,while Financial Secretary to the Treasury, Mr Lawson put the strategy into perspective for the benefit of regional City editors. In his briefing to them he remarked that 'in order to reduce the inflation rate on anything more than an ephemeral basis it is necessary to reduce the rate of monetary growth'. It followed that 'the centrepiece of the strategy is a medium-term monetary target, to which we are committed'. In a sharp rebuttal of a report from the Treasury and Civil Service Committee which has just appeared, Mr Lawson observed that nowhere in the report was 'it suggested that that target cannot or will not be met; indeed, our record since taking office is evidence that we do meet our monetary targets, however unpopular the short term measures needed to do so are'.

Moreover, the monetary target was not to be seen in isolation. It could only work in harmony with 'a consistent fiscal policy' which therefore implied 'a reduction in the public sector borrowing requirement as a proportion of national output'. Mr Lawson continued, 'it is in this sense that our policy is fiscalist as well as monetarist. And it is for this reason that we have included in the strategy an illustrative fiscal framework.' (In fairness, it should be added that he denied that the Government had a PSBR target because 'inevitably there is much that is uncertain'.)

The June 1980 briefing gives us criteria for assessing the Government's financial behaviour in its second term, criteria with which Mr Lawson cannot disagree. Has inflation been reduced? Has fiscal policy supported the aim of monetary control?

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The first disappointment is that inflation has not fallen. On the contrary, it has risen from the low point of 3.7 per cent touched in May 1983. Uncertainty about the Government's determination to stick to its financial targets contributed to a run on sterling in December 1984 and January 1985. To check this slide the Bank of England endorsed a big jump in interest rates which increased the cost of mortgages. This, combined with the usual effect of sterling depreciation on import prices and on pay settlements in export-orientated manufacturing, led to an acceleration in inflation. The twelve-month increase in the retail price index reached 7.0 per cent in May 1985, virtually double the figure on which the Conservatives fought the 1983 election.

Much better news on inflation is in prospect in early 1986. But very favourable world commodity prices, not government policies, are largely responsible for the improvement. The setback on inflation in 1985 can legitimately be interpreted as the consequence of slippage on financial control. This slippage has several dimensions, with an apparent inability to hold public expenditure to target as perhaps the most fundamental.

In the 1984 Budget the Government had a planning total for public expenditure in 1984/5 of £126.5b after asset sales of £2b; the effective planning total was therefore £128.5b; the outturn was £131.9b, an overrun of £3.4b. At the same time its planning totals for 1985/6 and 1986/7, again after adding asset sales, were £134b and £138.5b; the outturns are now expected to be £136.7b and £143.9b respectively. In practice there is almost certain to be some above-estimate spending in a pre-election year. So 1986/7 could see a planning total of £145b, £6.5b - or 4 per cent - more than the first official projection of Mr Lawson's Chancellorship.

That may not sound too bad. Most Chancellors are unable to resist the innumerable pressures on the public purse and have to accept some defeats in their battles with the spending departments. But the difficulties with expenditure have not prevented Mr Lawson from cutting taxes, with the result that the PSBR has also exceeded the figures envisaged in the 1984 Budget.

The crude PSBR totals do not bring out the underlying deterioration and are open to misinterpretation. On their basis, Mr Lawson was able to claim in this year's Autumn Statement that in 1985/86 'the PSBR would be the smallest it has been as a percentage of GDP since 1971/72'. He said that this would be the case even without £2.5b proceeds from special asset sales.

The fault here is to take no account of North Sea oil taxes. It is obviously incorrect for any government to take credit for the fiscal advantages given by these taxes. They are an accidental gift of nature. As they are also finite, they should not be regarded in the same way as permanent sources of revenue such as income tax. A reasonable procedure is to calculate what the PSBR would be in the absence of asset sales and North Sea taxes. Sooner or later they will both come to an end. The results of the exercise are presented in the table on the next page.

The Impact of North Sea Oil Revenue and Asset Sales of the PSBR (all figures in £m)

	(1) Actual PSBR	(2) North Sea revenues	(3) Receipts from asset sales
1978/79	9,222	500	-300
1979/80	10,020	2,200	1,467
1980/81	12,680	3,840	944
1981/82	8,629	5,880	959
1982/83	8,865	7,810	2,103
1983/84	9,735	8,900	2,592
1984/85	10,255	12,000	3,200+
1985/86	8,000	11,500	3,700+
1986/87	7,500	8,500	6,000+

	(4) PSBR, without North Sea oil and asset receipts	(5) Actual PSBR as % of GDP	(6) Adjusted PSBR as % of GDP
1978/79	9,422	5.4	5.5
1979/80	13,687	4.9	6.7
1980/81	17,464	5.4	7.5
1981/82	15,468	3.3	6.1
1982/83	18,778	3.2	6.7
1983/84	21,227	3.2	7.0
1984/85	25,455	3.1	7.8
1985/86	23,200	2.2	6.5
1986/87	22,000	2.0	5.8

+The figure for asset sales in this column does not correspond to that for 'Special asset sales' in official documents, but also includes council house sales, land sales, etc. These are assume to have been £1.2 b in 1984/85, 1985/86 and 1986/87.

Figures are actual until 1984/85; thereafter they are projections based on official documents.

Sources: several issues of 'Financial Statement and Budget Report' and 'Autumn Statement'.

The disturbing message is that the PSBR as a proportion of gross domestic product, adjusted for the special influences, was 7.8 per cent in 1984/85, the highest figure under the present Conservative Government. True enough, the estimates for 1985/86 and 1986/87 are more reassuring, with the adjusted PSBR falling in both years. But the Chancellor has told us that this would happen before and, time after time, his forecasts have not been reached.

The conclusion must be that so far in its second term the Conservative Government has done nothing to reduce inflation beneath the level established in its first term and that there has been some weakening in the Treasury's resolve to restrict the budget deficit. Fiscal policy may not have been self-evidently incompatible with monetary restraint, but neither has it been convincingly supportive.

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What, then, of the money numbers? How firm has Mr Lawson been in defending the so-called 'centrepiece of the strategy'?

When Mr Lawson spoke about monetary control at the beginning of his period of Chancellor it would have been inconceivable that the growth of sterling M3 could ever again run at 20 per cent on an annual basis. If the Barber boom taught the Conservative Party anything, it taught the dangers of irresponsibly rapid credit and money growth. But there are many signs that a 20 per cent rise in sterling M3 will be recorded in early 1986. At present sterling M3 is about 14 per cent higher than twelve months ago and in the last four months the rate of increase has accelerated further. Between now and April next year companies will be borrowing heavily from their banks to finance capital expenditure ahead of the change in capital allowances. In addition, both building societies and banks are enjoying strong demand for mortgages, and intend to meet this demand as fully as possible.

The outcome will be even higher rates of bank lending growth and, hence, of monetary expansion. It is not quite certain that sterling M3 will register a 20 per cent increase, but it is very likely. Mr Lawson recognises the possibility and wants to anticipate the potential embarrassment. In the 1985 Mansion House speech he therefore suspended sterling M3 from target status.

There may be reasons for this drastic step, but the Government - for long so dogmatic about monetary control - should spell them out. The usual mutterings about 'distortions' and 'behavioural changes' have been heard, but why were these distortions and behavioural changes not present before the middle of 1985 (when the monetary overshoot began) and why were they present afterwards? Was there an obvious change in the institutional framework of monetary control three or four months ago? Perhaps Mr Lawson could enlighten us on the details.

Monetary mismanagement has been accompanied by government criticism of both sides of industry for excessive pay increases. The exhortations to keep wage settlements down are curiously reminiscent of the 1960s and hint at a return to incomes policy of some kind. If that were to happen, the Government would have accomplished a remarkable somersault in economic policy. A key theme of the 1979 election was that inflation could and should be curbed by monetary means, not direct government interference in pay. But now that the Government has breached its own fiscal and monetary guidelines, it feels emboldened to berate private employers for paying workers 'too much'. Like so many Chancellors before him, Mr Lawson cannot treat the British people as adults, as the best judges of their own incomes and rewards.

Fiscal overruns, 20 per cent monetary growth, warnings about excessive pay increases... It all sounds so depressingly familiar, so depressingly like the muddle of the 1970s. One has to wonder whether the Mr Lawson who spoke so intelligently to the regional City editors in June 1980 is the same Mr Lawson who is now our Chancellor of the Exchequer. What has happened to monetarism, fiscalism and price stability? What is left of the medium-term financial strategy? Does Mr Lawson, who was supposed to have been its ' intellectual architect' still really believe in it?

CONSULTING THE ORACLE

Patrick Minford

The Chancellor's Mansion House Speech and November Statement have much to recommend them. There is a new and welcome flexibility in fiscal policy, something which we have been long advocating; the use of asset sales for tax cuts against a background of long-term reform of public expenditure is a good way to proceed. It brings forward supply-side improvements and sugars the bitter pills of reform and restructuring which this Government is everywhere handing out. Furthermore, 1985/86 will be the first year under this Government in which real public spending has actually fallen; all the major ministries, even including Defence, Health and Social Security, are now finally taking measures on the control and reform of public expenditure. All this make it very hard to understand the economists in the Square Mile who cry 'insufficient stringency'; can it be they have not understood the elementary algebra of the Government's planning of debt, taxes, and spending over a long period in a consistent way,or is it that they are extrapolating past failures in expenditure control? If the latter, of course they may have a case: but it is my judgement that there has been a turning point. The Government's critics have been handed some modest extra infrastructure spending where a good new case could be made; and existing capital spending, which has always been substantial and has risen steadily in the past few years, has been put into a clearer focus. However, privatisation, the better performance (partly under the threat of privatisation) of the remaining industries in the public sector, the fall in the number of civil servants, the levelling-off of unemployment, and the relentless search for efficiency (to the Rayner and Heseltine managerial tune), all these, with new attitudes among spending Ministers, are now at last taking visible effect. When turning-points appear, it is important to recognise them and not to go on fighting the last war.

The Delphic riddles of monetary policy

More's the pity that the Chancellor has retreated into muddle and discretion in monetary policy. He announced that £M3 would be downgraded as an indicator; this was right because, as I have long argued, it has become highly unreliable in the new competitive savings environment. He also announced that MO, the unfamiliar Monetary Base (consisting of currency in circulation plus bankers' balances of currency and reserves with the Bank of England) which is as its name implies the base of the whole money and credit pyramid, would be upgraded to the role of a principle indicator. Again, good. MO has been an extremely reliable monetary indicator since the inauguration of a new financial environment in 1979; its sharp tightening in 1979-81 preceeded the sharp fall in the growth of Nominal GDP by an average of 2-3 quarters.

During this critical episode, interest rates and the exchange rate were forced up; and through these channels nominal GDP was reined back.

M0 turns out to have just the right degree of interest elasticity to be a good and reliable indicator; its response to a 1% p.a. rise in short-term interest rates is about half percent in the short run, rising to about 2% in the long run. Not <u>too</u> high (with a lot of close substitutes) so that its reduction does not much affect interest rates and spending. But not so very low that when it is reduced, spending has to fall immediately to reduce the demand for it; in other words, interest rates <u>do</u> act as something of a shock absorber for changes in its supply.

But the Chancellor spoilt all this by wrapping it up in ambiguity and references to the exchange rate as another (principal) target. His remarks - liberally interpreted through the mouths of friendly commentators - have been taken to mean that interest rates are now aimed at stabilising the trade-weighted exchange rate at around 80.

Rumour also has it that parts of the Treasury, in combination with great and good policy-makers throughout Whitehall and in the Bank of England, are pushing hard, in the same spirit, for the UK to join the European monetary system. The current target of 80, it is suggested, is a sort of trial run for joining the EMS at around current exchange rates.

This is a dangerous game, in two ways. First, discretion, ambiguities, half truths, deception - these things are the stock-in-trade of old-fashioned Keynesian central banking and the direct antithesis of what the Medium Term Financial Strategy was designed to put in place, namely a clear set of targets around which expectations could be reliably formed about the monetary environment.

Second, suppose we take all this rumour-mongering at face value and assume we were to join the EMS at 80, what would this do to monetary policy and the economy? In the short run - because of this muddled and ridiculous state of affairs - we now have the tightest monetary policy we have ever had. MO is <u>declining</u> at one and a half per cent p.a. on the past three months; over the past six, it has grown a miserable one and a half per cent p.a., and on the past twelve, three and a half per cent. These figures are flashing red on the dashboard of monetary control; a stalling in the growth rate, unless immediate action is taken to reduce interest rates, is now increasingly likely. Already, the latest production figures are showing the first decline; is this surprising when the real interest rate to <u>prime</u> borrowers is no less than eight per cent p.a.?

In the long run, joining the EMS would push us back into the 'fixed-but-adjustable' parity world of the last year of Bretton Woods; in this world, when policies diverge, as they systematically do, periodic devaluations and revaluations are necessary and their timing relatively predictable, with the result that when a parity change is in the offing, capital moves violently across the exchanges to take advantage of what is effectively a one-way option. When this happens, central banks are forced to make very sharp changes in interest rates to dam up the flow. They are also forced to adopt exchange controls, because monetary policy alone cannot cope. Both these things are highly damaging to an economy; swings in interest rate of this size cause big swings throughout the economy. And exchange controls foster inefficient - because protected -investment projects.

These rumours, and any policy reality behind them, must stop before more damage is done. What is required is a series of clear demonstrations, by actions on interest rates, of the primacy of the MO target range, currently being seriously undershot. The exchange rate should cease to be a criterion of action - and visibly so - except when it moves violently and so threatens monetary stability; in other words it should revert to being an 'override mechanism' rather than a target. As for £M3, bank credit, and any other 'indicators', they should drop out of sight.

In forecasting I would assume that before long sense will prevail in monetary policy along these lines. But if money does remain as tight as it is for much longer - e.g. up to the Budget - the growth rate will probably fall and unemployment start to rise again, even though inflation will come down more sharply. This could easily provoke panic expansion of money later in 1986, but too late to reverse the renewed rise in unemployment before the end of 1987. It is to avoid such confidence-depressing and volatile movements that monetary rules are advocated.

Tax threshold or standard rate?

I have argued repeatedly for rises in tax thresholds on the grounds that these cut the proportion of income paid in tax to the principle benefit of the low paid who are in, or close to, the unemployment trap. For the same reason I was in favour of the Chancellor's Budget changes to National Insurance which lowered their contributions.

Unfortunately, though a step forward in a number of areas, especially on SERPS and the poverty trap, Mr Norman Fowler's Green Paper on Social Security made a very small impression on the unemployment trap; essentially it changed only the position of young workers. Even with previous changes in tax thresholds and National Insurance, 25 per cent of the labour force still have ratios of income out of work to income in work of over 80 per cent, and another 17 per cent ratios between 70 and 80 per cent: i.e. are in the unemployment trap. This means that thresholds of income tax and national insurance are still the highest priority for tax reduction, on grounds of economic efficiency and less abstractly of the effect on unemployment. This point is well known to the Chancellor.

But against it a political point is made: that the voters in lower and upper-middle incomes expect, on the basis of previous Tory manifestos - and will appreciate - cuts in the standard rate which give them a greater proportionate benefit than rises in the thresholds. This point seems to me to be less weighty than the economic point above: cuts in the standard rate are only about half as effective (according to our estimates) in reducing unemployment as are rises in tax thresholds for the same fiscal costs. Politically, however, it also has the following flaw in it: at this time of high unemployment voters are sensitive to the charge that they are getting rewards instead of the money going to 'create jobs'. This charge does stick to some extent if the tax cuts are standard rate cuts; but if they are rises in tax thresholds, it can be answered that it is precisely these which are the most effective ways of creating jobs, as well as giving some tax relief to the harder-pressed voters. Remember that since the War taxes have risen not because of a rising standard rate (which has in fact fallen by 20p in the £) but because of falling real tax thresholds (down for example, no less than 54 per cent since 1949 for a couple with two children). On the effectiveness of rises in tax thresholds, the Liverpool model is clear; money spent in this way creates more jobs over three years than the same money spent on infrastructure. This is also true of cuts in the standard rate, though to a much smaller extent.

Conclusion: the prospect

Mrs Thatcher and her Chancellor are now well placed to preside over at least two more years of reasonable growth, with a prospect of slowly falling unemployment and modestly declining inflation. A key element in this is a post-Mansion House renewal of monetary policy - no more words please, but a series of actions clearly signalling that a proper M0-targeting system is truly in being - and no backsliding on privatisation and public sector reformgenerally. But there is a good chance that this will happen and that the British economy could be, for the first time in a long period, giving out good vibrations on all major fronts.