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Prime Minister ②

I asked Alan if he had any comments on the Chancellor's note.

MCS 29/6

PRIME MINISTER

ECONOMIC PROSPECTS: CHANCELLOR'S MEMORANDUM OF 25 JUNE

1. We believe that the general description of the prospects for the next two years is broadly correct. Furthermore the Chancellor's "positive actions" provide a consistent and welcome thrust to policy over the next two years.

The Prospects

2. i. GDP and Unemployment. I suspect that if our monetary policy is not too tight we shall see an expansion rather bigger than the Chancellor expects, comparable perhaps to the expansion in 1933. The Chancellor is, of course, reflecting the history of the last 20 years, and I suspect that he has not adequately allowed for the fact that the environment has changed substantially. Nevertheless, I think it is wise to plan for broadly what he has in mind, growing output and unemployment stabilised at perhaps a little less than three million, with no dramatic falls in prospect.

ii. Prices. The Chancellor has been shown to be pessimistic about inflation so far, and I think he continues in this vein. The Chancellor says, "on past experience some rise in inflation rates must be on the cards as the recovery proceeds".

But we have changed the relevance of "past experience", as we have shown in the productivity changes. It is quite usual for countries that have gone through a monetary reform such as the UK to experience rapidly rising output associated with sharply falling inflation rates. I think also the Chancellor is in error in believing that inflation may be generated by a sharply falling effective exchange rate or undue increases in pay. The former may be perfectly consistent with very low inflation, (as in Britain from 1931-33). And surely we know by now that increases in pay were

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primarily responsible for generating unemployment, not inflation. Our inflation rate is determined by the progress we make in controlling our monetary aggregate, which so far has been good.

iii. Interest Rates. The Chancellor says in 3(iii) that interest rates "depend crucially upon what happens in the US".

This line of argument is, at least to some extent, inconsistent with the fact that we have "decoupled" our interest rates from the United States, to the extent that there is currently three-and-a-half percentage points difference between three month dollar and sterling rates. Furthermore, the idea that US interest rates do, or should, determine our interest rates can lead to erroneous arguments - namely that the PSBR has no effect on interest rates. (This has encouraged the view that we need not be concerned about the PSBR - a very dangerous line of argument indeed.)

It is important to be clear that our interest rates should be determined by the monetary aggregates. In particular we should not be influenced by high United States interest rates causing an appreciation of the spot dollar, and a depreciation of sterling. In fact the exchange rate should be used only to check the consistency of the evidence on monetary conditions that we obtain from our monetary aggregates.

It is noteworthy, however, that the Chancellor's recommendations in para 14 substantially amount to an effort to decouple our interest rates from those in the United States. (In that sense it is

/somewhat inconsistent

somewhat inconsistent with the report in para 3(iii)). There he lays stress on the appropriate degree of tightness in monetary conditions in determining interest rates. This we believe is right.

iv. The Tax Prospect. Given the projected rate of growth, the Chancellor is entirely correct. There is no room for manoeuvre now.

v. World Trade. The outlook is very uncertain, but I cannot second-guess the Chancellor.

vi. Oil Prices. I believe there is more likelihood of a collapse in oil prices over the next two years than does the Chancellor. OPEC's ability to control marginal supply is becoming less and less, but the Chancellor is entirely right to stress that the only risk of oil price explosions would come from a major political upheaval.

AW

28 June 1982 ALAN WALTERS