12 July

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Pl. put this in the folder for Forecast meeting – and a copy of it in the folder

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Economic Secretary
Financial Secretary
Minister of State (R)
Minister of State (C)
PCC
Mr Cassell
Mr Evans
Mr Britton
Mr Shields
Mr Riley
Mrs Lomax
Mr Sedgwick
Mr Barber
Mr Ridley
Mr French
Mr Harris

SAM BRITTAN - 'A FRAMEWORK FOR A STIMULUS'

You asked for my reaction to Sam Brittan's article "A framework for a stimulus" in the F.T. of 8 July. The article takes the following line,

(i) money GDP is growing at a lower rate than is consistent with the MTFS; whereas the MTFS was based upon a growth of money GDP of $9\frac{1}{2}$-10 per cent the most recent movement of inflation and output points to a growth of only 8 per cent per annum

(ii) the authorities should fix as an objective a growth of money GDP of 10 per cent on average for the next two years

(iii) this leaves room for a stimulus - providing it is within the framework of the MTFS

(iv) a fiscal stimulus is preferable to a reduction of interest rates

(v) This fiscal stimulus should involve a reduction of NIS or VAT

2. I would summarise my reaction as follows,

(i) the framework of looking at money GDP is useful in assessing whether policy is operating with the appropriate degree of tightness. However the article puts too much stress on fine tuning this magnitude and

exaggerates the extent to which the government can offer the community a trade-off of x per cent growth for y per cent inflation

(ii) our assessment is that nominal GDP is growing a bit below the rate expected at the time of the budget but the difference is possibly only 1 per cent compared with Mr Brittan's estimate of 2 per cent. This forecast revision owes more to a lower than expected growth of exports and more rapid growth of imports than to a lower than expected growth of 'domestic' demand

(iii) Given the magnitude of the revision to the forecast and the reason for it I am not convinced that a fiscal stimulus at this point is appropriate. Instead I would prefer to continue the policy of reducing interest rates where possible and appropriate. Over the longer term, the conclusion that a reduction of labour costs is required to encourage the necessary amount of labour using (better described as 'capacity expanding') investment is consistent with the approach taken in the last Budget and could remain the priority next March. There may also be a case for announcing in the Autumn that from next April NIS will continue to operate at an effective rate of 2 per cent rather than revert to 2½% as is indicated by the present arrangements.

Money GDP and the MTFS

3. The Brittan article argues that instead of growing within the range of 8-12% money GDP is probably growing in the range of 6-10%. He obtains this estimate by combining official hints that this year's inflation rate will be lower than the official forecast of 9 per cent (he puts it at 8 per cent) with the outlook from CBI surveys of output growth of between 0 and 1 per cent.

4. The revision to the official forecast is rather less than this. The June forecast did revise downwards the growth of money GDP for 1982, but only by 1 per cent - from the MTFS figure of 10½% to 9½%. One source of confusion may be the revision to the inflation outlook. This has mainly been in the 'administered' components of the RPI, such as mortgage interest rates, and council house rents which do not affect the GDP deflator in the same way.

5. When examining the case for a stimulus a further relevant factor is the reasons for the revision to the forecast. This has primarily been because of a deterioration

in net trade. The weakening of exports can be partly explained by the worse world outlook but the import picture also suggests that a smaller than expected proportion of the increase in domestic demand is being met from domestic sources.

6. To highlight this problem it is interesting to compare the forecast expenditure figures for the first half of this year with those for the same period in 1981. Domestic demand is almost 4 per cent higher - mainly because of a recovery of private sector fixed investment and a virtual end to de-stocking. But exports are only a little over 1 per cent higher whilst imports are up by 11 per cent. The result is that output is only 0.7 per cent higher than a year ago. To an extent the rise in imports is a reflection of the nature of the increased demand; in particular stockbuilding has a high import content. But it also appears that a large proportion of the increased investment in plant and machinery is being imported. This all suggests that the problem of slow recovery is not easily characterised as a problem of inadequate domestic demand.

7. The growth of money demand over the past six months may have slowed to between 8 and 9 per cent per annum. But this can be largely attributed to the weak world level of output and the high interest rates operating last Winter. Now that nominal interest rates are significantly lower some pick-up is expected. Even so it is important not to make too much of relatively small movements of money GDP. The Brittan article implies a degree of fine tuning that is difficult to reconcile with a magnitude that is not easy to forecast; that is subject to considerable data revisions and can only be imprecisely influenced by policy instruments.

8. We discussed the role of a money GDP objective last year. As you know I see some merits for its use as a way of describing the objectives of policy and assessing the strength of policy at a time when financial indicators are giving conflicting signals. This is particularly the case when there are major institutional changes and innovations in banking technology. But there are problems as we found last year. Money GDP is the addition of inflation and output; this is not always useful for policy purposes when the objective is a reduction in inflation and an increase in output.

9. As Sam Brittan suggests it is presentationally useful to be able to argue that government policy is directed towards controlling the growth of nominal magnitudes but that the outcome for inflation and output is in the hands of private sector agents. But if you take this seriously, Government cannot logically go on to say, as he suggests: "we will do our best to ensure that if inflation does drop to 7 or 8 per cent then output will rise by 2 or 3 per cent. If inflation were to fall to 5 or 6 per cent output growth would rise towards 4 or 5 per cent".

Government can no more 'seek to ensure' 4% growth at 6 per cent inflation than at any other rate of inflation. Indeed it is part of the case for focussing on money GDP, as he himself has made it, that government cannot determine inflation and output separately in this convenient way. Government can attempt to maintain a growth of money GDP of (say) 10 per cent but, for example, if there was some tendency to undershoot this figure because of lower than expected inflation any policy response would affect inflation as well as output. On this view the most that can be said is that Government will attempt to maintain a growth of money demand of (say) 10 per cent. The division of that is up to the private sector and the higher the inflation rate the less room is available for real growth.

10. More generally it is important to recognise that the conditions for growth of output involve more than a reduction of inflation; it also requires the incentive to produce in the form of profitability and an adequate growth of world demand. A money GDP framework presented in the form proposed could go too far to lead people to think that all that is required for better output is a lower rate of inflation. In addition to lower inflation increased returns from investment are necessary if the output levels necessary to support higher levels of employment are to be achieved. And if world output is depressed this must limit the extent to which UK output can grow.

Size and Nature of Stimulus

11. Even though I have questioned the scale of the revision to the outlook this does not remove entirely the case for some easing of policy and it is important to avoid any further tightening. This is the approach that has justified the attempt to continue to reduce interest rates and the discussions you have held on the implications of trying to avoid being caught up in a higher level of US interest rates. The various financial indicators do suggest that financial policy last Winter was tighter than expected and the latest monetary figures are consistent with some easing of interest rates.

12. However there are two important qualifications. Inflation has fallen faster than expected in recent months and this has the effect of easing financial conditions for any given annual PSBR or money supply growth. The second qualification is that the outcome for public expenditure may be worse than assumed in either the MTFS or the latest forecast. This must be taken into account in any assessment of fiscal policy.

13. Sam Brittan argues for fiscal measures rather than for lower interest rates.

That choice may be affected by the scale of any action; and our (smaller) estimate of the room for manoeuvre may point more in the direction of interest rate changes in any case. But it is worth looking at the options again and the logic for the present approach.

14. There is widespread agreement that any policy action should be directed towards 'supply encouragement'. This means reducing UK costs and increasing profitability. Both interest rate reductions and the fiscal changes proposed in the Brittan article fall into this category. There would also be agreement on the need for 'capacity increasing' investment as well as 'productivity increasing' investment. This is where the choice of approach becomes more difficult.

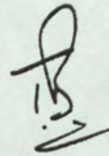
15. VAT gets onto his list because it reduces labour costs indirectly as a result of lower prices. But the objections in terms of the tax structure are well known. It can also be argued that this is not the time for measures which reduce the inflation rate in the period immediately ahead but which are likely to raise inflation in the following period. This is because weak commodity prices are already having important temporary disinflationary effects. To combine this with other measures that would only have temporary effects would only help to reinforce the chances of a reversal on inflation.

16. The case for an NIS reduction is that it reduces employment costs directly. As we know the problems lie in judging the size of any offsets because of leakages into lower prices and higher pay settlements. A further complication is that NIS is relatively inflexible as it needs a long lead time. I remain attracted by the longer term arguments for NIS reductions. Poor cost competitiveness and the need to reduce employment costs make this a particularly inappropriate tax. But the time for assessing changes is in the context of the budget judgement when the competing uses for any scope for tax reductions can be examined. It is not a measure to be taken because of small deviations from the expected growth of output. The exception to this is that there may be a case for examining the possibility of an announcement in the Autumn that from next April NIS will continue to operate at an effective rate of 2 per cent rather than revert to 2½ per cent as is indicated by the present arrangements. By then we should know a little more about the prospect for 1983-84, especially the public expenditure plans. If action is not taken there will be an increase in the effective rate in April - or at least there appear to be one.

17. Interest rate reductions also reduce business costs although they do not directly reduce the effective cost of employment. But in my view Sam Brittan,

makes too much of this distinction in his article. It is true that labour substituting investment is more likely the higher are employment costs. But lower interest rates will also encourage capacity expanding investment. He mentions the fact that lower interest rates might bring a lower exchange rate. The effect of this may be considered to be ambiguous in the present context as it will simultaneously increase profitability and inflation. However real interest rates remain very high by the standards of historical comparison and there is a good case for a return to more normal levels. And we are not operating an exchange rate target as he assumes. Finally interest rates are particularly suitable for change within a financial year because of their flexibility.

18. The budget strategy in March was to do what was thought possible to reduce business costs by fiscal means. At the same time an overall PSBR was chosen to give the possibility of reducing the high level of real interest rates. Some progress has been made to reduce interest rates and there is further scope available if it is judged appropriate and still leave real interest rates at or above normal levels. There seems to be little case for changing that budget judgement at this stage particularly as the actual reduction in NIS has not yet taken place.



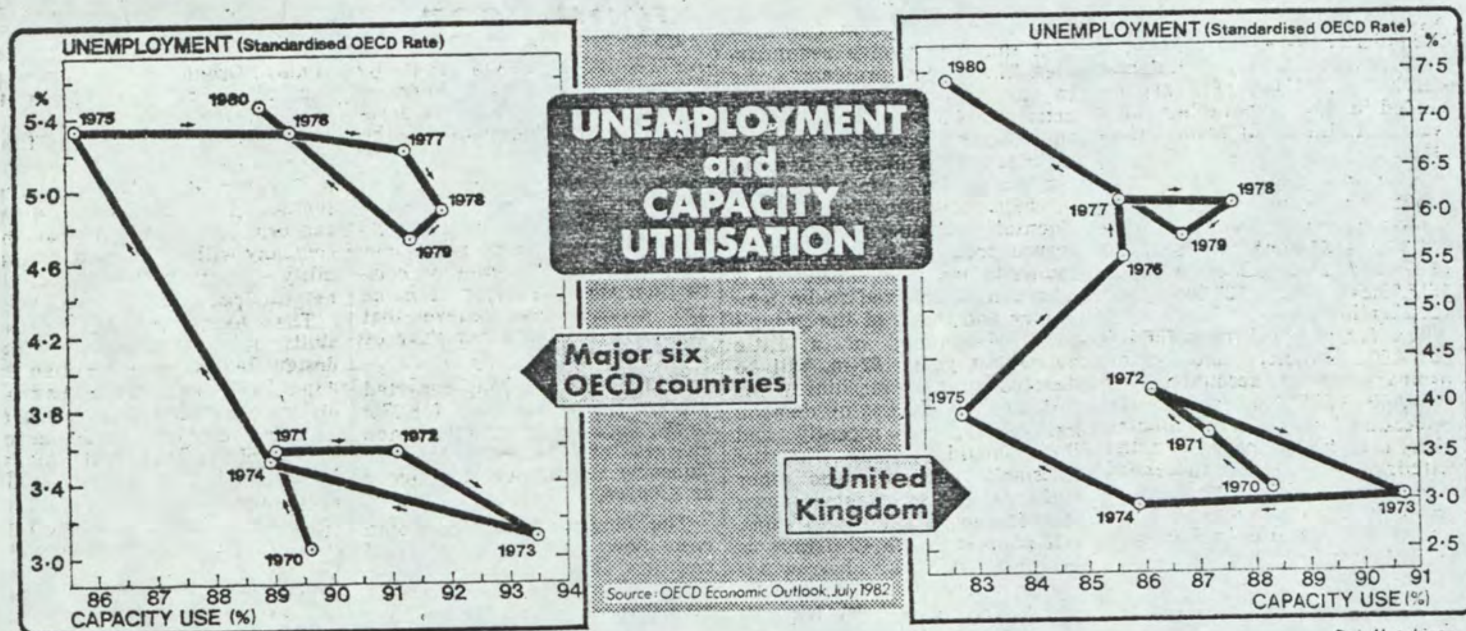
TERRY BURNS

12 July 1982

ECONOMIC VIEWPOINT

A framework for a stimulus

By Samuel Brittan



Bob Hutchison

The high level of real interest rates is one among several pieces of evidence suggesting a shortage of potential capacity. The two "oil shocks," other changes in input prices, technical progress, and shifts in the composition of demand have all made a good deal of existing plant and equipment obsolete. The rise in the labour force in many countries has increased the capital shortfall compared with what is required for full employment.

The chart shows how, both in Britain and in the six main countries of the OECD combined (the U.S., Japan, Germany, France, Italy and the UK), a given degree of capacity utilisation has been associated with successively higher unemployment rates. For instance, an 82½ per cent degree of capacity utilisation was associated in the UK with an unemployment rate of 4 per cent in 1975, but one of 7½ per cent in 1980.

Thus the main bottleneck in the way of expansion may no longer be skilled labour, as in the past, but lack of adequate physical capital. The OECD concludes that an economic recovery which brought a return to past levels of capacity utilisation would not be sufficient to absorb the labour market slack.

The capacity index is based on a direct calculation by the OECD, based on factors such as past investment and relative price changes. It is not derived from business surveys.

THERE IS said to be an argument in the Treasury and the Bank of England between those advisers who want to take a risk with the exchange rate in order to reduce British interest rates and those who believe that a strong pound is an essential prop in the battle against inflation.

Those who want to reduce interest rates are thinking not only of the direct stimulus that lower interest rates would provide for activities such as stock-building and construction. Some among them also think that a lower pound would in itself be directly useful for the boost it would give to competitiveness.

Readers will have no difficulty in imagining for themselves the slogans used on either side of this argument. My own view is that it will never be resolved at the level of policy instruments and a shift is needed to the level of policy objectives.

Interest rates, exchange rates and fiscal policy are all instruments for influencing *demand*. It is not a bit of good becoming bogged down in an argument about means until we have made up our minds in which direction to exercise this influence. Some City and Conservative enthusiasts try to say (a) that we do not need a demand stimulus and (b) that interest rates must be lowered—as if the second were not above all a means to the first. This is a mirror image of the error of the U.S. Reaganites who argue on the fiscal side.

What is the main insight that should have been gained from the so-called "monetarist" counter-revolution? Not some dubious and ephemeral technical monetary proposition, but the much more important warning that it is impossible for governments to spend their way into target levels of output and employment irrespective of what is happening to wages and prices.

What is the main insight which we can retain from the Keynesian revolution at a policy-making level? It is that governments and central banks have a responsibility for stabilising the growth of *monetary* demand—that is total cash spending or Money GDP.

Jeremy Bentham once said that the opponents of the "Principle of Utility" ("the greatest good for the greatest number") were themselves unwittingly using that very principle in their arguments designed to refute it. Similarly nearly every rejoinder I have read to the proposal for a Money GDP objective contains statements which take this measure for granted as a criterion for stabilisation policy.

The matter is of immediate and practical relevance. Between 1979 and 1980 Money GDP was rising at average rates of 16 to 18 per cent per annum. Talk of inadequate demand or stringent financial policy rang very hollow during this period. Now, however, the Central Statistical Office has announced and highlighted the fact that Money GDP rose by only 10 per cent in the year to the first quarter of 1982. We now therefore have a genuine policy choice.

In the Budget "Red Book" a growth of Money GDP of 9½ to 10 per cent was projected for 1982-83 and a rate of only a couple of decimal points less was projected for 1983-84.

There is clearly a danger that money national income will grow by less than projected.

There are many official hints that this year's inflation rate will be lower than the official forecast of 9 per cent. Let us put it at 8 per cent (which might be 7½ per cent on the "GDP deflator"). It also looks from CBI surveys and other evidence as if output will grow by between 0 and 1 per cent instead of the 1 to 2 per cent originally forecast by the Treasury. Putting the two sets of estimates together the most likely growth of Money GDP in fiscal 1982-83 could be somewhere around 8 per cent.

These seemingly precise figures are of course shorthand. What they really mean is that instead of the originally projected range of 8-12 per cent (which, not by coincidence, was also the objective for the different measures of the money supply) a growth rate for money GDP of 6 to 10 per cent is more likely. Even then the difference would not be worth bothering about, were it not that unemployment—even in terms of seasonally adjusted figures—is already nearly 3m and still rising at a rate of at least 30,000 a month: and there is no comfort to be drawn from vacancies, which are no higher than last autumn.

In unadjusted headline terms, the "shock" figure this July, when the school leavers arrive on the register, could easily be "Unemployment nears 3¼m" bringing the Government's second post-Falklands honeymoon well and truly to an end.

This is not a time to run any risks on the side of deficient demand growth; and it would be quite consistent both with "sound money" and new style Keynesianism for the Government to make its 10 per cent Money GDP growth projections if not into a target (a word which conjures up ridiculously precise expectations) at least into an objective for, say, the average of the next two years.

In other words it would be saying: "We will do our best to ensure that if inflation does drop to 7 or 8 per cent then output will rise by 2 or 3 per cent. If inflation were to fall to 5 or 6 per cent output growth would rise towards 4 or 5 per cent. This is not something we can achieve quarter by quarter, or guarantee at all, it is a trend towards which we can work." The other side of the coin is that real growth depends on wage and price moderation; the government's u n d e r t a k i n g would be limited to money flows over which it does have an influence.

Obviously I am suggesting a stimulus (for the first time in well over a decade) but *in the context of a reaffirmation in convincing and comprehensible terms of the Medium Term Financial Strategy (MTFS).*

It would be all too easy to give a stimulus which was more than offset by pay and price increases — thus worsening instead of improving real demand and employment. A £2bn stimulus to monetary demand outside the context of the MTFS may be dangerously large, while a £5bn boost set convincingly in its context, might be well within the safety margin.

This last figure includes the demand-boosting effect of any interest rate reduction; and any citation of it without reference to the overriding importance of staying within the MTFS framework would be a cynical and politically motivated misrepresentation.

The possible stimuli fall into three classes: public expenditure or public works measures, which on some very mechanistic calculations provide the largest numbers of jobs; the interest rate-exchange rate measures canvassed in financial circles, and indirect tax cuts either of a VAT kind or of the employers National Insurance Surcharge (NIS).

Priority should of course be given to measures with a long-term employment-increasing potential. Interest rate reductions on their own may well stimulate labour-saving rather than labour-using investment. Moreover to the extent that interest rate reductions bring down the exchange rate, they will have an unfavourable impact on domestic prices and on inflationary expectations, and thus fritter away the boost to monetary demand.

Labour-using investment will be encouraged, as the OECD points out, by anything which reduces labour costs either relative to capital costs or relative to value added. This seems to argue strongly for the VAT-NIS range of measures. In contrast to exchange depreciation, they have the advantage of reducing prices and inflationary expectation and thus encouraging wage moderation.

It would be possible for a full year revenue cost of £3bn either to abolish the remaining 2½ per cent NIS completely or to reduce VAT from 15 to 12 per cent. The latter would reduce the RPI by 1 to 1½ per cent overnight and bring 6 per cent inflation within sight. The Chancellor's very sensible desire to abolish the annual wage round and make pay increases depend on individual circumstances might then no longer be a pipe-dream. Either measure should be affordable within the context of a reaffirmed MTFS providing for a 10 per cent growth of Money GDP, so long as interest rate cuts do not go much further than those already in the pipeline.