(4)

PRIME MINISTER (2) 30/5

30 May 1985

MONEY POLICY AND THE ECONOMY

MS

Moving Targets

It is an increasingly common view in the City that we are witnessing the death of monetarism (Phillips & Drew, De Zoete & Bevan, Hoare Govett, etc). In March 1980, when the MTFS was launched, we were told strategy relied on one targeted monetary aggregate, Sterling M_3. Its growth would fall to 4-8% in 1983-84. It was not new: Denis Healey's Chancellorship had used Sterling M_3 targets to an increasing extent in his latter years.

In 1981, Sterling M_3 was downgraded a little, as we were told Sterling M_3 had not been a good indicator of monetary conditions. Some slight attention should also be paid to the exchange rate. In 1982, M_1 entered the list of targeted monetary aggregates, and we were told that narrow money was important, as well as wider money. The exchange rate gained a little more prominence. In 1984, M_0 was introduced, M_1 was dropped, and PSL2 had a short life as a monitored variable. In 1985, the exchange rate was seen to have greater priority.

Nigel's announcement that Sterling M_3 no longer has the same importance as it used to, is being taken in the City as evidence that he wishes to relax policy, as he is concerned about jobs and is doing a gentle pirouette. Alan Walters would see it as the final, sensible transition to Monetary Base.

1982-5 - Is it at all like 1970-73?

De Zoete's point out in their analysis that, between 1970 and 1973, monetary growth rose sharply by 93.4% for Sterling M_3, and 77% for PSL2. M_1 stayed under reasonable control. This led to a subsequent major inflationary surge. Between 1982 and 1985, if we annualise the last 4 months' data to give a figure for 1985 as a whole (a slightly unfavourable way of doing the calculation, but not too important in the total) Sterling M_3 growth is 52.6%, and PSL2 66%; whilst M_0 is under control. They sound some warning notes.

However, there are still encouraging signs on the inflation front:

- there is no inflationary surge in commodity prices, unlike 1974-75;
- there is little sign yet of a major upward movement in pay settlements in the private sector, although drift in the public sector, coupled with considerable earnings growth in the private, is nudging pay upwards again;
- the feed through to inflation so far from the sharp decline in sterling last year has been relatively modest by past experience, and we now have had several

months of rising sterling which should begin to correct the worst of this effect.

Should we worry about the rate of monetary growth?

Against a more deflationary world background, and with an economy which is working much more efficiently than it did in the early 1970s, more of the monetary stimulus may go into output, and less into price inflation. With real interest rates of this level, and with sterling behaving much better, money policy is now tight, as the Chancellor will argue. Round-tripping must be prevalent, and helping to distort the wider money figures.

However, money policy has to be very tight to hit a 3% inflation target. There are things that can be done to strengthen the chances of monetary growth going into output and less into prices. This underlines the need for:

a. A strong competition policy in product and service markets.

b. Continued attempts to free the labour market, and to bring more of the unemployed into the labour market to lower the average cost of labour.

c. The need to run a money policy which hits the middle-of-target ranges, thus keeping sterling's value up.

d. The need to avoid self-inflicted political wounds which also raise the RPI by more than they should - eg water rates, gas prices, rents, etc.

e. The need to free more land to lower land prices, facilitating more house building, and to keep the costs of new housing down - we are already witnessing too rapid an increase in house prices for comfort.

Anyone for a U-Turn?

As commentators begin to argue that the policy - both monetary and fiscal - is somewhat laxer than they thought, there are more dangers of an allegation of a U-turn. I attach a copy of the cover of the latest Phillips & Drew Review, and a copy of De Zoete's recent accusation of a U-turn on some elements of public spending policy. Their view has fed on Nigel Lawson's statement in the Budget that there was no pre-ordained magic in any particular level of PSBR, and that in a future year he might consider a higher one.

The Political Cycle

I also attach a copy of a chart which demonstrates that there is nothing unusual in the current profile of support for the Government. De Zoete plot the trend of public confidence in the Government compared with the average of the last 4 electoral cycles (in one of which the Government went on to win the subsequent Election; in the others, the Government of the day lost, but by a narrow margin). This shows that support is declining as usual, but it would be comforting to see the decline in support bottoming out some time in the autumn or early winter.

Conclusion

You could discuss with Nigel how he sees the MTFS and the general economic strategy evolving. Is he confident that the rapid growth of broad money in the last 2½ years does not matter? Does he feel we have to retain monetary tightness for longer? When he comes to relax in order to stimulate output and jobs in time for the next Election, is his preferred mechanism to do it by monetary relaxation and lower interest rates, and therefore probably lower sterling; or through a continuation of tight money policy, and a raised budget deficit? Is he also aware of the presentational difficulties if the policy is seen to be a U-turn?

Our recommendation is still to concentrate on micro measures, to run a tight money policy for a bit longer, and not to give way on the PSBR next year.

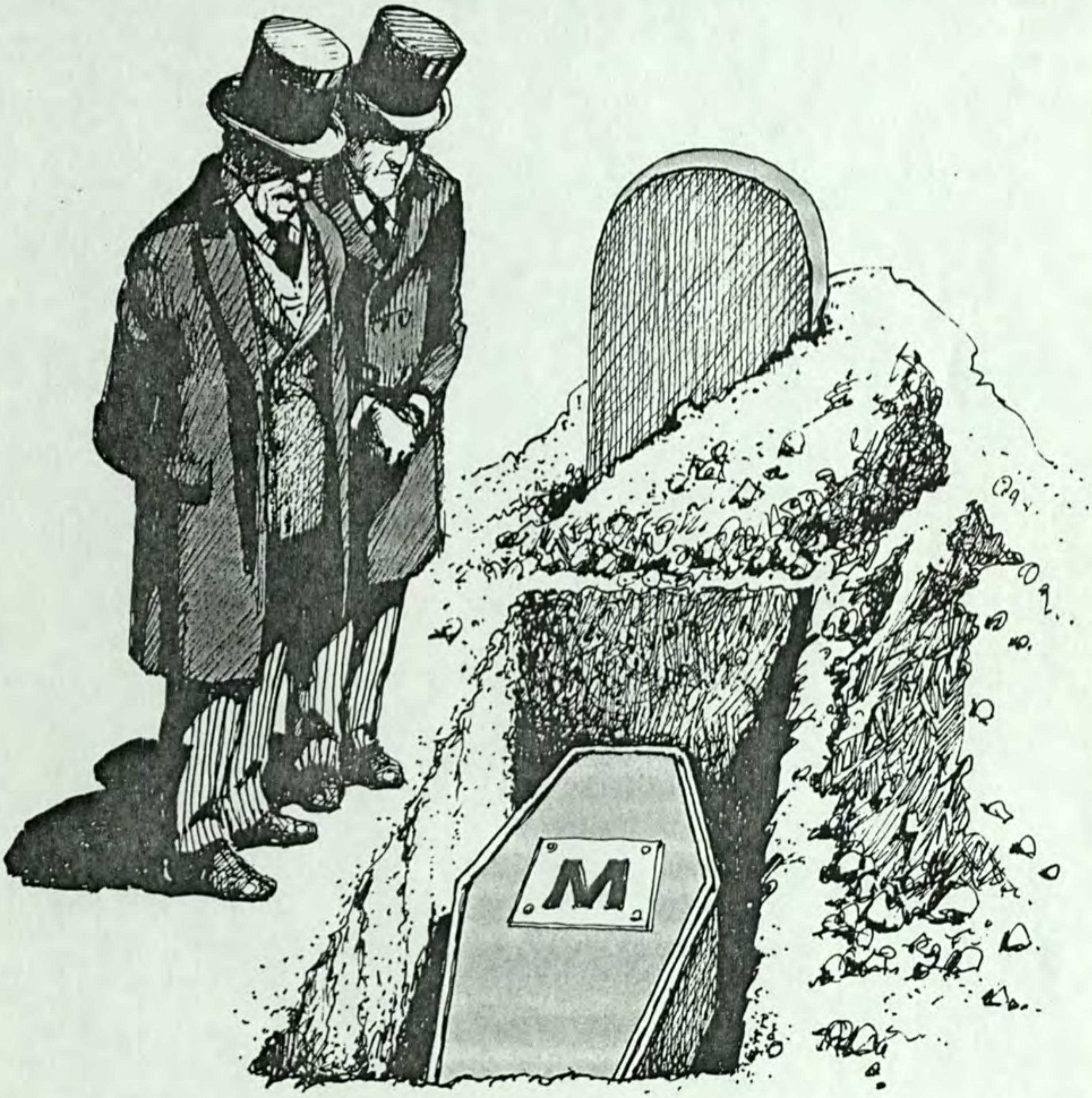
J. Redwood

JOHN REDWOOD

Phillips & Drew

MARKET REVIEW

MAY 1985



The death of monetarism

NO REFLATION WITHOUT REPRESENTATION

* A buoyant domestic economy with inflation rising is not the background to stimulate reflationary policies.

* But, as our analysis over previous pages has shown, growth could ease and inflation could remain high.

* Two policy actions therefore seem likely:

  - money policy will remain tight for longer than is still the commonly held view;

  - stimulatory fiscal measures will begin to form as a response to the many representations now being made, but they are unlikely to take effect until fiscal 1986/87.

Thatcher U-turn on export loans

The Prime Minister has privately ordered a tactical U-turn on the Government's policy on "soft" — low interest — loans to win export orders after Britain's failure to secure the Bosporus bridge contract in Turkey.

The Government's policy change is unlikely to be publicly announced but it will be hailed as an important shift in economic strategy by Tory MPs, including many wets seeking to reduce unemployment.

A leading member of Labour's shadow Treasury team said last night that such a U-turn would enable the Government to steal the opposition's clothes — soft loans will be a central plank in its policy for economic revival.

The policy switch has been made with the sanction of a few Cabinet ministers to allow more generous credit to be offered by British Leyland to the Thai government, which is seeking tenders for a contract for 4,000 buses for the Bangkok mass transit authority.

Ministers privately admitted last night that the policy switch was a direct reaction by Mrs Thatcher to the loss of the Bosporus bridge contract, won by the Japanese government by the alleged unfair use of heavy subsidies through soft

Brittan heckled by jail officers

At the end of the speech, during which he announced a crash programme to head off potential trouble in the prison system, there was muted applause and some slow hand clapping.

THE TIMES WEDNESDAY MAY 22 1985

Joseph puts surprise new offer to teachers

ECONOMIC RESEARCH

de Zoete & Bevan
25 Finsbury Circus London EC2M 7EE
Telephone: 01-588 4141
Telex: 888221 and 883179

de Zoete & Bevan (Far East)
81a New Henry House
10 Ice House Street Hong Kong

deZB

Weekly Economic Survey

Michael Hughes
David Bowers
Mark Brett
Beatrice Parrish

TOPIC 1060-1084 Daily Economic Bulletin
TOPIC 1085-1094 Exchange Rate Monitor

Issue 85/19 16th May 1985

Tories third in opinion poll

* The further deterioration in the Government's support shown by the latest Gallup Poll is not unusual for this stage of the election cycle. It will only become a real market concern if this deterioration continues into the Autumn. This is the stage when these polls traditionally improve in favour of the government ofthe day.

* It is therefore too early to contemplate a response by the Government to its critics. The time is right however to expect them to be rigorous in their control of inflation. Control over the monetary aggregates now is required if a falling consumer goods inflation trend is to be assured in a 1987 election year.

* UK monetary policy is not exceptionally tight at the moment. A continuation of recent monetary growth trends and it will have to be. Our own expectations for RPI growth beyond the next six months are rising. An inflation rate above 6% in 1986 seems to us to be an increasing probability.