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THE ECONOMY

Money policy remains loose

	Money Growth	
Variable (Rough Scope)	3 Months % pa	1 Year
M_0 (mainly cash)	-1.5%	+3.4%
M_1 (M_0+ current a/cs)	+24.6%	+18.0%
£M_3(M_1+ deposit a/cs)	+19.5%	+14.5%
PSL2	+16.6%	+14.2%

(Source: Greenwells)

The tight control of M_0 mainly reflects high interest rates, which encourages holding cash on deposit, and the growing volume of transactions using credit cards rather than bank notes.

The easiness of money is shown by the rapid rise in share prices; by the weakness of sterling againist the yen, DM and other leading non-dollar currencies since July; and by the money figures themselves. The rise in £M_3 partly reflects the decision to stop overfunding against a background of strong private sector credit demand.

City commentators are, in the main, apprehensive

They point to the higher level of asset sales, falling oil revenues, likely PSBR and public spending overruns, and continuing difficulty in curbing spending. Simon & Coates see it as a case of "reflation, inflation". Capels call it "monetary muddle, fiscal fudge". Messels (Tim Congdon) foresee "a general deterioration in financial control . . . the MTFS is crumbling". Panmure's are relaxed, seeing it as a sensible extension of the story so far. And Hoare Govett think a limited dose of "Reaganomics" will work for a while. Several quote the NIESR article by Odling Smee and Riley "Approaches to the PSBR", as these two Treasury economists can be portrayed as critical of current Government policy.

Options

There are three possible options:

1. Enter the EMS and tighten policy to German standards. This would mean higher interest rates, further cuts in public spending, or no tax cuts to try and halt the creeping devaluation of the pound against the DM. The strain could not all fall on monetary policy: fiscal policy too would need adjusting.

2. Carry on as we are. The world is still very deflationary, commodity prices are falling (or should be if cartels are allowed to break up), expansion elsewhere (especially the easier money in the US) will help us, and a pound strong against the dollar and weak against the yen and DM has some charms.

3. Tighten domestic policy a little without the extreme jolt of 1 above. Attack the less sensitive areas of public spending more vigorously (eg force some tightening of working capital in nationalised industries to cut PE by, say, £500 million; let grants to Industry and Agriculture undershoot budgets; avoid bailing out the tin cartel with any additional money to that already lost, etc); and be cautious in the 1986 Budget about the extent of tax cuts that have immediate effect.

Assessment

You need more growth for more jobs; you do need to continue to persuade people that the Government is not in the business of cutting popular areas of public spending; but you need to keep the achievement on inflation.

Option 1 is the most foolish. It means a tight reining back now - even if you devalue on entry to the EMS. It will undermine the Government's credibility if you then have to leave the EMS before the Election, having stressed its importance to economic discipline in the meantime. It will impede growth, force you into more borrowing overseas, and in the end squander the reserves.

Option 2 is tempting - try and prove the commentators wrong again. Certainly Treasury forecasts of inflation have been better than private ones in recent years; and the strength of the pound against the dollar, coupled with lower commodity prices, means it's different from 1973-74 (when the monetary position was similar to today's). It is encouraging to see that the very rapid rate of growth in bank lending has slowed down in recent months.

If this was 1986, Option 2 would clearly be right. The danger with it in 1985 is that it may force you to an earlier Election than is ideal, as it warms up the economy too soon.

I conclude in favour of Option 3. It is reasonable to replace falling oil revenues with higher asset sales. 1986-87 needs to see public spending undershooting targets through good control over extraordinaries and through some strong pressures on the easier areas to keep it down. There can be little chance of lower interest rates for the time being until the pound and the money aggregates look better. This may not happen for several months.

About Budget time you may wish to reaffirm to colleagues that overruns in 1986-87 will usually have to be absorbed within the departments' budgets, and you could consider a small package of expenditure reductions in less sensitive areas.

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