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PRIME MINISTER

THE BUDGET OF MARCH 1985

The public sector financial deficit of the UK when measured as a percentage of GDP was roughly the same as that of the United States.

Even taking account of our higher savings rate than the United States, this is too high and is not sustainable. Such a high fiscal deficit throws a big burden on interest rates and crowds out private sector development.

A first budget priority should be to reduce the financial deficit of the public sector. In present conditions, this probably means a fiscal adjustment of less than $1bn. In terms of PSBR, it amounts to some £5½bn.

As we saw in 1981 such a 'tight' budget will not depress demand and reduce growth; on the contrary, it will generate market confidence, lower interest rates and promote expansion. You will regain control.

Whatever room there is for tax reductions should be concentrated on raising thresholds. They are still far too high and inhibit both employment and enterprise.

The MTFS

This is the appropriate time to drop M3, PSL2, or any other broad aggregate from the targets. They have been eliminated de facto long ago - we should formalise their demise. Our targets, as in Germany and Switzerland, should be the monetary base. As the Treasury papers have shown, this has always served us well and can be used with confidence to guard against persistent inflation. A steady declining growth rate for Mo to approximately zero will eliminate inflation.

The only argument against Mo is said to be City incredulity. However the City has been tutored in the past by the Bank to the view that Mo, as mainly notes and coin, could not be a suitable indicator, compared with some measure of credit, such as M3, PSL2, etc. This view has been discredited (and not merely in the UK). With the Banks cooperation, City credibility in Mo could be quickly established.

As far as the budgetary targets are concerned, may I suggest they be recast in the form of financial deficits of the public sector. These exclude, inter alia, the negative effects of asset sales and so they are much more appropriate as a means of fiscal effects than the PSBRs. In practise, this would not involve any substantial change in the movements of the PSBR or financial deficits since the asset sales are predicted to be about constant for the next three years.

The Exchange Rate

I can only reiterate what I have said so often: our domestic monetary policy should be adjusted to achieve stability and inflation-free growth in our domestic economy. To hold our domestic monetary policy hostage to all the rumours, reports, politics and external events that assail us is a recipe for violent instability in the whole economy. Of course we cannot ignore external events etc, but we should not magnify them and inflict them on Britain in the form of violent oscilations in interest rates.

In particular, the appropriate policy for a falling oil price is to let the exchange rate depreciate (but of course not to encourage a depreciation). I do not accept the "losing control" argument unless it can be shown clearly that monetary/fiscal policy is loose (as in December 1984 and January 1985). This is clearly not the case in January 1986; I think our present monetary policy is too restrictive.

In short, I think that the case which you made in this morning's meeting was analytically correct, and, although I venture far from my last here, politically adept.

ALAN WALTERS
<u>24 January 1986</u>