48) **ECONOMIC INDICATORS AND THE BUDGET - 1981: PART C**
18TH FEB 1981 - 20TH FEB 1981

COPY NO 11 OF 35 COPIES

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CHANCELLOR OF THE EXCHEQUER 33/016 17.3.81.

c Chief Secretary
Financial Secretary
Minister of State (C)
Minister of State (L)
Sir D Wass
Mr Burns
Sir K Couzens
Sir A Rawlinson
Mr Ryrie
Mr Middleton
Mr Bridgeman
Mr Britton
Miss M P Brown
Mr Cassell
Mr Kemp
Mr Monck
Mr Unwin
Mrs Lomax
Mr Neuburger
Mr Riley
Mr Sedgwick
Mrs Stamler
Mr Turnbull
Mr R G Ward
Mr Mowl
Mr S Davies
Mr Ridley
Mr Cropper
Mr Cardona
Mr J C R Dow) Bank of England
Mr C A E Goodhart)
Prof. Walters (No. 10)

POST-BUDGET FORECAST

On 12 February I reported to you the economic forecast on a pre-budget basis. This minute sets out our view of the economic prospect on the basis of the main items in the provisional package decided on 13 February and endorsed on 17 February; reports our assessment of the effects of the budget package on the economy; compares Treasury and outside forecasts; and asks you to decide on the main points of the forecast to be published.

The budget package

2. We have assumed the following package of tax measures:

(i) double revalorisation of specific duties;

(ii) half revalorisation of direct tax allowances and thresholds;

(iii) 3% Bank Levy;

(iv) PSBR smoothing;

in addition to expenditure and tax decisions (including stock relief) already in the pre-budget forecast. We have not tried at this stage to allow for any other budget possibilities, which are generally small in macro-economic terms.

The effects of the package on the economic outlook

3. We have worked out the effects of this package, as they would alter the economic outlook presented to you last week. Please

[redacted]

/note

[redacted]

note that this is not the same as the "definition of the budget package" proposed in Mr Folger's minute to the Financial Secretary of 10 February, the main differences being that this concept starts from a non-indexed base and includes the effect of North Sea tax changes and stock relief, which, like revalorisation of taxes, are already included in our pre-budget forecast.

4. The main direct effect of the package is to reduce the disposable income of the personal sector by about $1\frac{3}{4}$% in real terms by the fourth quarter of this year. As a result, both savings and consumers' expenditure are likely to be lower. Some of the fall in demand is met by lower imports, as well as by lower domestic output. By mid 1982 GDP could be $\frac{1}{2}$ % lower. In consequence, unemployment is likely to be slightly higher, possibly by 25,000 by mid 1982.

5. The reduction in the PSBR makes possible lower interest rates while keeping to the usual forecasting assumption of a fixed money supply (growth of £M3 at the centre of the 6-10% range during 1981-82). The scale of this reduction is very hard to judge, but could be up to one point off the long rate by early next year. The fall in interest rates offsets some of the fall in output brought about by the lower PSBR.

6. Reductions in interest rates will tend to reduce the exchange rate, but the tighter fiscal policy, reflected in a larger surplus on the balance of payments, may well offset this. The price level is higher as a result of the extra increase in specific duties. The inflation rate by the end of 1981 is raised by about one percentage point.

7. The improvement in the public sector's financial position is at the expense initially of the personal sector and the banks. Industrial and commercial companies, although their profits may be down a little, appear to be relatively little affected, with their disposable income (in real terms) not much different.

8. Very tentatively we would assess the effects of the package on the forecast as follows (a more detailed assessment will follow next week):-

[redacted]

GDP 1981 Q4		$-\frac{1}{4}$
% 1982 Q4		$-\frac{1}{2}$
Unemployment, mid 1982 thousands		+ 25
Interest rates		
%	long term 1981-82	$-\frac{3}{4}$
	short term 1981-82	$-1\frac{1}{4}$
Retail price level		
%	1981 Q4	+ 1
	1982 Q4	$+\frac{1}{2}$
Inflation rate		
%	1981 Q4	+ 1
	1982 Q4	$-\frac{1}{2}$
PSBR		
£bn	1981-82	- 2.6
	1982-83	$(-2\frac{1}{2})$

<u>Post-budget forecast</u>

9. On the basis of the provisional package our assessment of the post budget outlook is summarised in the table below:-

PSBR, 1981-82, £bn	11.2
Retail price inflation, per cent change:	
year to 1981 Q4	11.1
year to 1982 Q2	8.1
Interest rates, average 1981-82:	
- long term	$13\frac{1}{4}$
- short term	$12\frac{1}{2}$
Output, per cent changes:	
between 1980 and 1981	- 2.3
between first half 1981 and first half 1982	+ 0.3

/10. This

[redacted]

10. This forecast assumes that £M3 will grow at the centre of the 6-10 per cent range; interest rates are then forecast to be whatever are necessary to persuade the private sector to buy sufficient gilts to keep money growth to 8%. More details of the monetary forecast are given in the attached note, the figures in which supersede those given by Mr Monck in his minute of 17 February.

Outside forecasts

11. You will wish to be aware of the forecasts of the main outside groups. Mr Burns has been holding a series of meetings recently, and a separate note has been sent to you on the outcome. Table 1 attached sets out a summary of the outside forecasts, for the variables and time periods of most relevance to the Industry Act Forecast.

12. On the PSBR, outside forecasters are generally looking for a lower figure in 1981-82, on a pre-budget basis, than we are. We know that all outside forecasts take a more optimistic view on North Sea oil revenues, and we suspect that the level of public expenditure in 1981-82 to be shown in the White Paper will be higher than most people are expecting.

13. On retail prices, the forecasts for the fourth quarter of 1981 are generally around 10-11% on a pre-budget basis (which generally means revalorisation of indirect taxes). Very few outside forecasts are as low as 9% on a pre-budget basis (equivalent to 10% on a post-budget basis, assuming full passing on of tax increases).

14. On output, the outside forecasters are generally expecting a fall between 1980 and 1981, mostly in the range -1 to -3%. Most expect, pre-budget, some recovery between the first halves of 1981 and 1982.

Industry Act Forecast

15. The main focus of attention is the summary table. I attach two versions of it: A and B. A follows the format used last year, in which percentage changes for output and demand are shown year on year i.e. between 1980 and 1981. B shows the format used in 1979, in which the percentage changes for output and demand are shown between the first halves of 1981 and 1982. From a

/forecasting

[redacted]

forecasting point of view, A has the advantage of starting from a partly known base (1980) rather than, as in B, from an almost wholly unknown base (1981 first half). But of course B emphasizes the modest recovery forecast for output over the next year. In addition to the summary table, we propose to retain the other table which shows forecasts by half year of demand and output.

16. You will wish to consider, first, the format of this table and second, the proposed forecasts, in particular, of the PSBR, prices and output.

17. On the PSBR, outside forecasters last year understated the outcome about as much as we did. In our forecast for 1981-82, there are as ever major risks in both directions. Factors that could make the outturn worse than forecast include:-

(i) lower output and/or higher unemployment;

(ii) less tight policy on cash limits, contingency reserve and EFLs, including any relaxation of the 6% pay factors;

(iii) the effects of strike action in the public services.

18. On retail prices, our post-budget forecast for the fourth quarter of 1981 is around 11% (this is, in effect, 1% lower than the November Industry Act Forecast of 11% because of the extra rise in indirect taxes). We have used this forecast as the basis for a social security uprating in November 1981 of 10%. A breakdown of the rise may show how it is compatible with low figures for private sector inflation:-

	% changes between the fourth quarters of 1980 and 1981
Food	6.6
Nationalised industries	16.8
Housing (rates, rents, mortgage rate etc.)	17.8
Items subject to specific duties (mainly petrol, tobacco, alcohol)	17
Other	7
Total	11.1

19. The record of past forecasts, over most of the seventies, shows a 2% average margin of error looking ahead 7-8 months. For

/forecasts

forecasts made at budget time in 1977, 1978, 1979, the error averaged less than ½%; the error on the 1980 budget forecast was just over 1%; the error on the internal Treasury assessment made at the time was over 3%.

20. A figure higher than 11% could result from:-

(i) A fall in the exchange rate (we think the rate may settle at a level a bit above its current (17 February) level of 102.5).

(ii) A stronger trend in world prices.

(iii) An end to the wave of price cutting, as the need for destocking disappears.

(iv) Higher growth in wages, for example as a reaction to the expected fall in real incomes.

21. Or, of course, some or all of these factors could go the other way. A figure of 10%, clearly within the margins of error, might be achieved. It would, however, be lower than almost all outside forecasts; and the record of Treasury forecasts does not point to consistent downward bias. If you were to decide on a lower price forecast, for example, 10%, this could perhaps best be achieved by assuming lower wage increases and/or further inroads in to profit margins.

22. On <u>output</u>, tables A and B show our proposed forecasts. You may wish to consider including in the text of the FSBR the following table:-

1975 = 100

	1980		1981		1982
	I	II	I	II	I
GDP	109	105½	104½	105	105
Manufacturing output	98½	90½	87½	88½	88½

The first line is anyway to be found in the second of the standard Industry Act Forecast tables; the second line we gave to the Treasury Committee after pressure from them for a quarterly or half yearly path.

/23. You

[redacted]

23. You will want to make the most of the half yearly path and of the slight recovery shown. Yet the forecast is consistent, given the known margins of error, with a continuing fall in both GDP and manufacturing output over the next year - as well as with a more pronounced rise. The downward risks to the forecast of GDP are emphasized by the very low January import figure.

24. There is a potential conflict between the short-term forecast, as we see it, and the growth assumption proposed for the MTFS of ½% a year between 1980 and 1983. The latter, which is higher than our central estimate, would point to a level of GDP (1975 = 100) in 1983 of 109. This is four points above the level of GDP in the first half of 1982 shown in the table in paragraph 22, and would imply output growth at an annual rate of a good 3 per cent between the first half of 1982 and mid 1983. This could prove difficult to defend (the Treasury Committee are bound to take this up) and suggests that either the ½% a year growth assumption is too high or the level of output in the short-term forecast by the first half of 1982 is too low.

Conclusions

25. You are invited to:-

(a) Note our post-budget assessment, and the comparisons with outside forecasters;

(b) decide on the main elements in the published forecasts, in particular of:-

the PSBR
prices
output

26. We shall submit early next week a complete text and tables of the Economic Prospect section of the FSBR. We shall incorporate any further changes to the forecast, as a result of either policy decisions or changes in forecasting judgement - though we aim to keep the latter to the minimum consistent with taking account of the latest information.

HPE

H P EVANS

18 February 1981

[redacted]

[redacted]

TABLE 1

SUMMARY OF OUTSIDE FORECASTS

	Output (i)	Output (ii)	PSBR	Retail price inflation (i)	Retail price inflation (ii)	Current accou of balance o payments
	1980 to 1981	1981 I to 1982 I	1981-82	Q4 1981	Q2 1982	1981
	% change	% change	£bn	% change over year earlier	% change over year earlier	£bn
1. London Business School	-1¼	+2½	12	(9.7) CED	(9.3)	3
2. National Institute*						
3. Phillips & Drew	-3	+2	11½	9.8	9.4	1
4. Bank of England	-2½	-1½	11.2	(10.9)CED	(9.9)	3
Treasury (pre-budget)	-2	+ ½	13.8	10.0	7.3	1½
Treasury (post-budget)	-2¼	+ ½	11.2	11.1	8.1	2½

All forecasts completed in early 1981. Phillips & Drew assume budget measures worth £1¼ billion to reduce PSBR in 1981-82; otherwise, with exception of Treasury post-budget assessment, these forecasts are on a pre-budget basis, which generally means full revalorisation of direct and indirect taxes.

*February 1981 forecast not yet available.

[redacted]

[redacted]

A TABLE 10 SHORT-TERM ECONOMIC PROSPECTS

	1980 to 1981	Margins of error
A. Output and expenditure at constant 1975 prices		
Per cent changes:		
Gross domestic product (at factor cost)	− 2½	1
Consumers' expenditure	− ½	1
General Government expenditure on goods and services	− 1½	1½ †
Other fixed investment	− 1½	3
Exports of goods and services	− 5½	2½
Change in stockbuilding (as per cent of GDP)	+ ½	¾
Imports of goods and services	− 1	2
B. Balance of payments on current account £ billion:		
1981 First half	2	¾
1981 Second half	0	¾
1982 First half	− ½	1¼
C. Public Sector Borrowing Requirement £ billion: in brackets per cent of GDP at market prices:		
Financial Year 1980-81	13½(6)	
Financial Year 1981-82	11 (4½)	3½(1½)
D. Retail Price Index		
Per cent change:		
Fourth quarter 1980 to fourth quarter 1981	10 ✓	2
Second quarter 1981 to second quarter 1982	8 ✓	4
E. Money Supply (Sterling M3)		
Per cent change at annual rate:		
Mid-January 1981 to mid-April 1982	8 ✓	

† This margin applies to General Government consumption

[redacted]

[redacted]

B TABLE 10 SHORT-TERM ECONOMIC PROSPECTS

	Forecast	Margins of error
A. Output and expenditure at constant 1975 prices		
Per cent changes: first half 1981 to first half 1982		
Gross domestic product (at factor cost)	½	1½
Consumers' expenditure	1	2
General Government expenditure on goods and services	− ½	1½ /
Other fixed investment	− ½	4½
Exports of goods and services	− 2	4½
Change in stockbuilding (as per cent of GDP)	+ 3½	1¼
Imports of goods and services	+ 9½	3½
B. Balance of payments on current account £ billion:		
1981 First half	2	¾
1981 Second half	0	¾
1982 First half	− ½	1¼
C. Public Sector Borrowing Requirement £ billion: in brackets per cent of GDP at market prices:		
Financial Year 1980-81	13½(6)	
Financial Year 1981-82	11(4½)	3½(1½)
D. Retail Price Index		
Per cent change:		
Fourth quarter 1980 to fourth quarter 1981	11	2
Second quarter 1981 to second quarter 1982	8	4
E. Money Supply (Sterling M3)		
Per cent change at annual rate:		
Mid-January 1981 to mid-April 1982	8	

/ This margin applies to General Government consumption

[redacted]

[redacted]

THE POST-BUDGET MONETARY OUTLOOK

This note describes in more detail our assessment of the post-Budget monetary outlook on the basis of the provisional package of tax measures described in the covering minute. The same assumption has been made about the growth of £M3 in 1981-82 (i.e. 8%) as in the provisional pre-Budget forecast reported on 12 February, to which some minor changes have been made, and the assessment has been agreed in broad outline with the Bank financial forecasters (though senior Bank officials have not seen it).

2. The pre-Budget forecast suggested that, if the monetary target was to be met, there was little, if any, scope for falls in interest rates over the next eighteen months given the fiscal stance assumed. On a post-Budget basis, the prospect is for a somewhat brighter interest rate prospect, but the scope for falls in interest rates is not likely to be particularly large.

3. Table 1 below shows the post-Budget forecasts of the PSBR, nominal GDP and financial wealth and the changes in these which are the result of the Budget package.

Table 1: Determinants of the Demand for Money
(changes due to the Budget package in brackets)

	PSBR (£ billion)	Net Financial Wealth*	Gross Financial Wealth*	Nominal GDP**
		% changes during the year		
1980-81	13.7	23	17½	10
1981-82	11.2(-2.6)	11½(-2¼)	11 (-1)	12(+½)

4. One counterpart of the reduction in the PSBR due to the Budget is a reduction in the growth of net financial wealth of the private sector. Growth of Nominal GDP in 1981-82 is actually increased, however, because the rise in prices as a result of the indirect tax increases is larger than the downward effect on real GDP. This,

*Excluding the effects of revaluations of existing assets due, for example, to changes in interest rates.

**At market prices.

[redacted]

together with the lower interest rates in the forecast, implies some rise in bank lending to the private sector and so the proportionate reduction in gross financial wealth is less than in net financial wealth. The Bank levy has relatively little effect on the non-bank private sector and this also reduces the effect on measured gross financial wealth for a given reduction in the PSBR.

5. The fact that, even before allowing for the reduction in interest rates, the effect on gross financial wealth is relatively small would normally mean that the downward impact on interest rates would itself also be relatively small: this is a familiar feature of using indirect taxes to reduce the PSBR. But there is another factor tending to raise the effect slightly. It is assumed that the target for inflows into National Savings remains unchanged at £3 billion, and assuming the target is met this means that any given change in gross financial wealth feeds more strongly on to money.*

① NIS
② 1%-400

6. Table 2 shows the forecast post-Budget levels of interest rates and the inflation rate. 6-10

Table 2: Interest Rates and Inflation
(changes due to the Budget package in brackets)

	3-month interbank rate	20 year gilt rate	mortgage rate	RPI (% change on a year earlier)
1980-81	15½	13½	14¾	16¼
1981-82	12½(-1¼)	13¼(-¾)	13¼(-¾)	11½(+1)

This forecast, which is for short rates to fall to 12 % and for long rates to fall to 13 % by the end of 1981-82, assumes fairly favourable assumptions about expectations in the gilt market, as did the pre-Budget forecast reported earlier. (We have, however, made a small upward adjustment to interest rates on a pre-Budget basis, which is worth about half a point on short rates in 1981-82).

* The assumed inflows into National Savings now account for 25% of the forecast personal sector surplus in 1981-82.

[redacted]

It is worth noting that the gilt sales implied by this post-Budget forecast - about £7 billion in 1981-82 - imply a share of inflows into the long-term institutions going into gilts which is considerably less than the 50% recorded in both 1978-79 and 1979-80. It is even likely to be slightly lower than the 34% expected in 1980-81 when the diversion of funds into overseas securities following the abolition of exchange controls is likely to have been at a peak.

7. As with the pre-Budget forecast, this assessment of the interest rate prospect has given some weight to a forecast of £M3 derived directly from gross wealth, with gilt sales treated as a residual. As before, the direct forecast suggests that the interest rates in the central post-Budget forecast will not be sufficiently high to ensure monetary growth in line with the target. It again suggests that the growth of £M3 might be 10 - 11% in 1981-82.

8. Finally, Table 3 shows our forecasts of other monetary aggregates on a post-Budget basis.

Table 3: Other Monetary Aggregates
(changes due to the Budget package in brackets)

	MO	M1	£M3	PSL1	PSL2
1980-81	12.0	8.6	15.8	14.7	13.0
1981-82	12.1(+1)	14.5(+2)	8(-)	7.4(-)	8.2(-)

9. The narrower monetary aggregates are forecast to grow faster post-Budget than pre-Budget. This is because they respond more powerfully to higher prices and, particularly, to lower nominal interest rates while being little affected by the reduction in wealth. M1 is thought to be especially sensitive to interest rates.

10. Once again it is important to stress the margins of error around this forecast and its conditionality on the rest of the forecast.

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MR UNWIN

cc Mr Middleton
Mr Britton
Mr Evans
Mr Cassell
Mr Turnbull
Mr Pirie (paragraphs C3-C6)
Mr Ward (paragraphs C14-C1?)

BUDGET SPEECH SECTION C: MONETARY POLICY

I attach a redraft which follows the Chancellor's preferred sequence: why monetary control and the MTFS is important, the difficulties of monetary control, the improvement of techniques, the monetary target, funding initiatives, National Savings and the smoothing passage which I think you supplied. National Savings still precedes funding but I do not think that matters.

2. I have made a few changes of substance. They are:

a. to cut the reference to the role of the narrow aggregates in setting interest rates but to bring out that the narrow aggregates will grow faster than the broad ones;

b. to say that the future course of interest rates will depend on actual monetary growth.

3. If a cut in interest rates were announced in the Speech, its plac... would need thought. My view is that it wouldbe best justified by the tough fiscal measures which it w... help to sugar. (If it were place... in the fiscal section that would affect the announcement about the National Savings INVAC interest rates in paragraph C15 - both the leve... of the new INVAC rate and perhaps its placing.) Please make it clea... the Chancellor that this draft can only be a preliminary cockshy unt... we know more about the policy content. We can then do work on ... argument, sequence, and connections between different sections Speech.

4. I am sending this draft over to the Bank who could proba... comments before you submit the new version tomorrow. If po... your end, it would make sense to reflect these in what you ...

5. I have followed the Chancellor's instructions on sty... more full stops. In parts it reads like three blind mi... be a general stylistic problem.

N MONCK
19 February 1981

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[redacted]

SECTION C: MONETARY STANCE FOR MEDIUM TERM AND 1981/82

C1. It is vital to slow down the growth of money over the medium term. It is not the only element of our economic policy. But it is an essential one - without it we shall not drive home our success so far so that we root out the wasting discease of inflation. That must be done before output can start rising again on a sustainable basis.

C2. We have had to face several difficulties. First we had to deal with the effects of abolishing the controls we inherited - exchange control and the corset. They were bad controls, producing benefits that were largely cosmetic and distortions that were damaging. But their abolition raised the monetary statistics. Secondly we have had the extreme and unusual economic circumstances that I have described - both in the world and in the UK. Thirdly the aim of serious and sustained monetary discipline is relatively new. The techniques available are not fully developed and tested. So the authorities cannot be sure at present of achieving their quantitative aims at all accurately.

Monetary Control

C3. Last November I outlined some improvement in techniques of monetary control that we planned to make. These will come into effect during the coming financial year.

C4. The Reserve Asset Ratio has complicated monetary control. The first step in phasing it out was made in January. It is

[redacted]

being abolished from [today]. This involves no risks to the soundness of the banking system. The Bank of England has agreed with the banks new principles for monitoring their liquidity. The Bank will be consulted if the banks want to make any major changes in the pattern of their assets before the new system comes into effect.

C5. The Bank of England has already changed its money market operations. In its dealing with the discount houses it now relies more on buying and selling bills and less on direct lending, which will now generally cost more than comparable market rates. From [ ] MLR will be abolished and the market will have a greater role in determining the structure of short-term interest rates. The authorities will, however, aim to keep very short-term rates within an undisclosed band [which will be progressively widened].

C6. Discussions with the banks about these changes and about the cash ratio have progressed rapidly. The cash ratio at present applies only to the clearing banks. It will now be extended to all banks, reduced to [ ], and will be treated as a minimum ratio, from [1 April]. This will make it possible to operate more effectively on the banks' demand for cash. The new statistical series for retail banking deposits is being prepared and will be published in [ ]. A series for the widely defined monetary base is also being published in the Bank of England Bulletin later this month. As I said last November, these developments are consistent with a gradual evolution towards a monetary base control system. I shall be considering the pace of further moves in that direction as we gain experience of the changes we are now introducing.

C7. In considering the monetary target for 1981/82 I have had to weigh up the significance of the over-run of the target for the current period and the special economic circumstances in which it occured. So far there have been no signs that the over-run has permitted or stimulated inflationary behaviour. Indeed the underlying rate of inflation is steadily coming down, and so real interest rates have risen sharply.

C8. However, we must watch for any signs of inflationary pressures returning. If we see them we must be ready to tighten policy. We will thus ensure suitably restrictive monetary conditions over the medium term and sustain downward anti-inflationary pressure.

C9. If there were any under-shoot of our monetary targets for the coming year, I would expect to accept it. But agains the background described I have on balance decided against setting an objective for clawing back last year's over-shoot in the course of 1981/82. The new target range, based on the actual figure for banking /̅February_7, will be an annual rat

[redacted]

of /̅6-10_7 per cent for the growth of £M3 over the /̅15_7 months to April 1982. I shall consider in the autumn whether to roll over the target beyond April and, if so, whether to start recovering last year's over-run then.

C10. For later years, targets will be set nearer the time. /̅ Some recovery of last year's over-run has been built into the ranges for monetary growth given for the rest of the MTFS period_7 in Part II of the Financial Statement and Budget Report. But what matters in practice is our readiness to tighten monetary policy if there are any signs of inflationary pressures associated with last year's over-run. At present, however, I do not expect such pressures to arise.

Attention to Wider Range of Aggregates

C11. I have again expressed the monetary target for next year in terms of £M3. This broad aggregate is also the target for the MTFS. But experience has confirmed that no single monetary aggregate fully or reliably conveys the tightness of monetary conditions. So, as in the past, in making decisions about the stance of monetarypolicy, I shall continue to pay attention to other monetary aggregates and also to real interest rates/. The narrow aggregates may well grow faster than £M3 in 1981/82. From now on the monetary base will be one of the narrow aggregates to be monitored.

[redacted]

C12. A belief in the need tocontrol monetary growth is sometimes caricatured as unduly mechanistic. That is certainly neither our view nor our practice. Monetary policy must be conducted by the exercise of judgement in the light of all the indicators available. I shall maintain that approach in the coming year.

Government Finance and National Savings

C13. Apart from the changes in control I have described, our methods of raising money to finance the Government's borrowing needs will be improved in several ways. We must be sure this funding is done efficiently so that interest rates are not pushed any higher than necessary.

C14. First, more imaginative use of National Savings can help us to achieve our monetary objectives with lower interest rates than would otherwise be needed. That is why I announced changes last autumn. The latest figures suggest that we shall achieve our target of £2 billion net new National Savings for 1980/81.

C15. Our 1981/82 target is £3 billion. It is an ambitious one which call for further measures. It will be necessary to keep the interest rates on National Savings instruments at fully competitive levels. But it will be compatible with this to lower the rate paid on the National Savings Investment Account. It is at present 15% and has not been changed since MLR was reduced by 2% last November. It will be reduced to [%] from 1 May. At this level it will remain a very attractive rate compared with the return on the other main liquid assets held by individuals [I envisage that this relativity will be maintained for the rest of this year.]

C16. I shall be making two changes to the second issue of index-linked certificates. The age of eligibility for them will therefore be reduced in one step from 60 to 50 from the beginning of April. And a minimum bonus of 4% will be provided for existing holders as well as new buyers.

C17. In October last year, my rt hon friend, the Secretary of State for Energy announced plans for a bond which would allow British investors to have a stake in North Sea oil revenues. The Government intend to issue such a bond later this year. It will be aimed at small savers and should be widely held. It will be a non-marketable certificate, administered by DNS. Its capital value will be fixed but interest on the bond will be related to value of [BNOC's revenues].

C18. Second, the Bank's consultations with the City have shown that a new short-term debt instrument could give greater flexibility to the Government's funding programme. An announcement will be made on this before the [end of April].

[redacted]

C19. Third, I have decided that the range of choice of longer term instruments shouldbe widened by the introduction of indexed gilts for pension funds. The eligibility has been restricted in order to ensure that this new step does not stimulate inflows, since such instruments are not widely available elsewhere. I am sure it is right to make this innovation. But I emphasise that it is an addition to existir instruments and not a replacement for them. They will give the eligible institutions a choice between indexed and conventional stock. The Bank of England is announcing this afternoon details of a stock worth £/   _7. In order to allow time for the details of this new instrument to be absorbed, the subscription date will be /   _7.

C20. I believe that these initiatives, combined with the changes in monetary control and the fiscal measures I shall l announcing later, will enable the new monetary target to be achieved at reasonable rates of interest. /Indeed with the recent slackening of bank lending to the private sector I would expect to see some further easing of short term intere rates in the course of 1981/82._7 But the future course of interest rates will depend on how the monetary aggregates actually move.

C21. One factor that has complicated monetary management o the last year has been the variance in the expected monthly level of the PSBR - particularly the central government

[redacted]

component. This makes monitoring and interpretation of monetary developments more difficult than it otherwise need be. The problem lies mainly in fluctuations in the level of tax receipts during the year. In the long run it would be desirable to reduce both the size of month by month variations and the bunching of some major tax receipts in the second half of the financial year. There are various possibilities for change. Rapid progress will not be easy but I have identified some areas for improvement on which I propose to make an early start.

C22. Customs will shortly open discussions with a number of the largest payers of VAT with a view to retiming their tax payments so as to smooth the monthly flow of receipts. At present, largely through an accident of history, there are distinct peaks of VAT receipts every third month. The aim of discussions with the firms concerned will be to agree a smoothing of the flow. This should have no significant permanent effect on company cash flow but would have the incidental benefit of reducing the 1981/82 PSBR by [up to £200 million].

C23. Receipts of North Sea oil taxation contribute to the bunching of revenue. My proposals for changes in that taxation - which I shall come to later - will take account of the need for a smoother flow.

C24. I hope it will be possible to make practical progress in these areas so as to ease the task of monetary management during the financial year. I am also examining the arrangements for the collection of corporation tax. At present some £/_1.5_7 billion, or /_50_7 per cent, of mainstream corporation tax receipts come in during the last quarter of the financial year and a smoother flow would be desirable. I have not taken a firm view on what might be feasible, and I should not want to put company cash flow under unreasonable pressure in present circumstances. But I believe the possibilities should be considered further and the Green Paper on corporation tax will set out some options for discussion.

[redacted]

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MR MONCK

cc Mr Middleton
Mr Unwin
Mr Evans
Mr Cassell
Mr Turnbull

BUDGET SPEECH: MONETARY POLICY

A few points on your draft of 19 February.

(i) Para C2: omit "exchange control" - its abolition reduced £M3.

(ii) Para C6: last sentence, omit "the pace of" since it implies commitment to make such moves some time.

(iii) Para C7: omit "sharply" at end of paragraph - they too have come down "steadily".

(iv) Para C11: "The narrow aggregates may well grow faster than £M3 in 1981/82 inresponseto recent falls in short term interest rates. This should not of itself be taken as indicating a need for a tightening of monetary policy ...."

(v) Para 20: Omit last sentence or change it to read "But the future course of interest rates will depend on the progress towards our aims of reducing inflation and the growth of the monetary aggregat The sentence in [ ] refers to bank lending which is about the only monetary indicator which we are not committed to monitoring!

A J C BRITTON
20 February 1981