PART II

MEDIUM-TERM FINANCIAL STRATEGY

Objectives and Instruments

The Government's objectives for the medium-term are to bring down the rate of inflation and to create conditions for a sustainable growth of output and employment.

2. To reduce inflation it will progressively reduce the growth of the money stock and will pursue the policies necessary to achieve this aim. After 1980–81, for which a target range of 7–11 per cent has been announced for £M3, the Government intend to set a target range consistent with the annual growth of money supply being reduced to about 6 per cent in 1983–84. The Government intend that there should be a progressive deceleration over the period, broadly along the lines shown in Table 5, though the precise target rate of growth in the intervening years will be decided at the time.

TABLE 5

RANGES FOR GROWTH OF THE MONEY STOCK (£M3)*

	1980–81	*1981–82*	*1982–83*	*1983–84*
Percentage change during year	7–11	6–10	5–9	4–8

* As the Green Paper on Monetary Control (Cmnd. 7858) explains, the way in which the money supply is defined for target purposes may need to be adjusted from time to time as circumstances change.

3. Control of the money supply will over a period of years reduce the rate of inflation. The speed with which inflation falls will depend crucially on expectations both within the United Kingdom and overseas. It is to provide a firm basis for those expectations that the Government has announced its firm commitment to a progressive reduction in money supply growth. Public expenditure plans and tax policies and interest rates will be adjusted as necessary in order to achieve the objective. At the same time the Government will continue to pursue policies to strengthen the supply side of the economy, by tax and other incentives and by improving the working of the market mechanism.

4. It is not the intention to achieve this reduction in monetary growth by excessive reliance on interest rates. The Government is therefore planning for a substantial reduction over the medium-term in the Public Sector Borrowing Requirement (PSBR) as a percentage of Gross Domestic Product (GDP). The relationship between the PSBR and the growth of money supply is important but is not a simple one; it is affected by the economic cycle, the rate of inflation and the structure of the tax and public expenditure flows generating the borrowing requirement. But although the relationship between the PSBR and £M3 is erratic from year to year, there is no doubt that public sector borrowing has made a major contribution to the excessive growth of the money supply in recent years. The consequence of the high level of public sector borrowing has been high nominal interest rates and greater financing problems for the private sector. Even in the context of rapid inflation, high nominal interest rates are a deterrent to investment. If interest rates are to be brought down to acceptable levels the PSBR must be substantially reduced as a proportion of GDP over the next few years. The projections summarised in Table 9 below show how, given the Government's plans for public expenditure, the PSBR could be reduced progressively to 1–2 per cent of GDP, which would be a little below the average ratio recorded in the 1960s. On the cautious assumption made about GDP growth, fiscal and monetary objectives are fully consistent with such a path for the PSBR.

Public Expenditure

5. A key element in this strategy is a reduction in public expenditure. The plans announced in the public expenditure White Paper (Cmnd. 7841) show a reduction of 4 per cent in the volume of public expenditure between 1979–80 and 1983–84 and the assumptions about GDP growth described below imply a fall in expenditure as a proportion to GDP from 42 per cent to under 40 per cent over the period. Table 6 below shows the expenditure plans in cost

TABLE 6

GENERAL GOVERNMENT EXPENDITURE

(£ billion)

	1978-79	1979-80	1980-81	1981-82	1982-83	1983-84
General government expenditure at 1979 survey prices(1) ...	68·1	71	70	68½	67½	67½
At 1978-79 prices						
General government expenditure in cost terms(2)	64·6	66½	66	64½	63	63
Special sales of assets(3) ...	—	−1	−½	—	—	—
Shortfall(4) ...	—	−¾	−½	−¾	−¾	−¾
Interest payments(5) ...	7·6	8	8	7½	7½	7
National accounts adjustment(6) ...	1·8	1½	1½	1½	1½	1½
Total expenditure in national accounts terms(7)	74·0	74½	74½	73	71	70½

(1) Expenditure on programmes by central government and local authorities and the contingency reserve. See Cmnd. 7841, Table 1.1, lines 1, 2 and 5. Debt interest payments are shown separately below. Since most plans are not decided in detail yet for the years after 1980–81 broad assumptions have been made about the share of general government in the total of expenditure on programmes shown in Cmnd. 7841, Table 1.1 for 1981–82 to 1983–84. For convenience, the whole of the contingency reserve is allocated to general government in all years in this table. It is not allocated by sector in the columns for 1980–81 in Part IV of this Report.

(2) Line 1 revalued to 1978–79 prices in cost terms, *i.e.* including the relative price effect. For each category of public expenditure its relative price is the ratio of its deflator to the deflator for GDP at market prices. The figure for 1978–79 is equal to the sum of the lines for central government and local authorities in Cmnd. 7841, Table 5.3.

(3) Cmnd. 7841, Table 1.1, line 10, revalued to 1978–79 prices. For 1979–80 includes revenue offsets to planned expenditure and a small element attributable to public corporations.

(4) Cmnd. 7841, Table 1.1, line 12 revalued to 1978–79 prices with certain adjustments in respect of public corporations. Includes the net effect of different economic assumptions from those used in Cmnd. 7841.

(5) For 1978–79 as in Financial Statistics, March 1980. For 1979–80 and 1980–81, revalued figures for general government in line 12 of Table 14 of this report.

(6) Adjustment to convert line 2 to the definitions used in national accounts statistics. For 1978–79 includes residual measurement differences.

(7) For 1978–79 equal to line 4 of Financial Statistics, March 1980, Table 2.4. This base year is chosen because it is the latest complete year for which outturn figures, and full details of relative prices, are available.

terms (*i.e.* including the relative price effect) at 1978–79 prices and allowing for shortfall. General Government expenditure in cost terms is gradually reduced over the next four years—from £74½ billion in 1979–80 to £70½ billion in 1983–84. The financial framework described below sets these expenditure projections against an illustrative projection of government revenue.

Revenue in the Medium-Term

6. The growth of government revenue over the medium-term will be dependent upon the growth of output. This is heavily conditioned by the underlying growth of productivity, the growth of the world economy, and the speed of reduction of the recent high rate of inflation.

7. Since 1973 growth in output has fallen both in the United Kingdom and in the rest of OECD (see Table 7). Over this period growth in OECD output and in world trade in manufactures has roughly halved. It is very possible that, given the recent rise in oil prices, world output and trade will not grow faster over the next few years than in the past five years. In most industrial countries there is strong evidence of a slowdown in productivity growth in recent years. In Britain, recorded productivity growth (for the whole

TABLE 7

WORLD AND UNITED KINGDOM GROWTH RATES

(Annual average per cent)

	1964-73	1973-78	1978-80
Growth of Output			
OECD* ...	5·2	2·6	2
United Kingdom† ...	3·0	1·0	−1

* Weighted average of Gross National Product (GNP) of OECD countries, excluding United Kingdom.
† GDP.

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economy excluding the North Sea sector) over the period 1973–79 averaged only ½ per cent a year—compared with an average of 2½ per cent in the preceding decade. The consequence of the slower growth in productivity in the 1970's is that there has been less excess capacity in the economy than might have been expected, on earlier experience, given the slow growth of output.

8. The process of reducing inflation almost inevitably entails some losses of output initially, though it promises a better growth of output in the longer-term. The United Kingdom is unlikely to be an exception to this rule. The size and duration of these initial effects, however, will depend in large measure on how quickly behaviour, particularly in pay bargaining, takes account of the new monetary environment. As inflation subsides, the basis will be laid for sound, sustainable growth. The sooner inflation comes down the faster the rate of economic growth that can be accommodated within the monetary guidelines set out in Table 5.

9. Since the growth of the economy strongly affects the growth of government revenue at unchanged tax rates the illustrative projections in Tables 8 and 9 make the deliberately cautious assumption of an average growth rate of 1 per cent a year for the years after 1980, that is at about the same rate as recorded between 1973 and 1979. The economy should be capable of growing faster than this, but for the purposes of these projections it is prudent to assume a low growth rate.

10. The implications for government revenues of this illustrative growth rate are shown in Table 8. Revenue is projected on the conventional assumption of constant indexed tax rates and allowances at current, 1980–81, levels. Between 1979–80 and 1983–84 total government receipts are projected to rise by £5 billion, with the contribution from North Sea oil revenues accounting for about half of the increase. If the average growth rate were higher than assumed here, the rise in non-North Sea receipts could be expected to be greater.

TABLE 8

GENERAL GOVERNMENT RECEIPTS

	1978–79	*1979–80*	*1980–81*	*1981–82*	*1982–83*	*1983–84*
*General Government Receipts at 1978–79 prices** (£ billion)						
Taxes on income, expenditure and capital	48·3	52	52½	52	54	55½
National Insurance, etc.	10·2	10	10	10½	10½	10½
Interest and other receipts	6·5	4	5	5	5	5
Total Receipts	65·0	66	67½	67½	69½	71

* Converted to 1978–79 prices by using the deflator for GDP at market prices, so that these projections are directly comparable with the expenditure projections in Table 6.

Money Supply and Public Sector Borrowing

11. The revenue profile in Table 8, in conjunction with the declining profile of public expenditure, would permit a progressive reduction in the PSBR after 1980-81. This is shown in Table 9.

12. This particular course for the PSBR is not to be interpreted as a target path. It is a projection of the course of the PSBR based on the assumed growth of GDP and present public expenditure plans that should be broadly compatible with the monetary objectives. Fiscal policy will be operated so that the PSBR for any particular year will be consistent with declining monetary growth in the particular circumstances of the time. The PSBR path shown requires, on the assumptions made, a "fiscal adjustment". If such adjustment turns out to be appropriate for a particular year the Government would assess nearer the time whether it should adjust public expenditure, tax, or some combination of the two, and also the precise items within these that would be changed.

13. As is now generally recognised, projections of this sort are subject to wide margins of error not just because they depend crucially on the assumptions about developments in the rest of the economy, but because even with reasonably firm knowledge of such developments it would be difficult to predict revenue and expenditure with any precision. Nevertheless if

TABLE 9

PUBLIC SECTOR BORROWING

1978–79 Prices (£ billion)

	1978–79	*1979–80*	*1980–81*	*1981–82*	*1982–83*	*1983–84*
Total expenditure	74·0	74½	74½	73	71	70½
Total receipts	−65·0	−66	−67½	−67½	−69½	−71
Implied fiscal adjustment	—	—	—	—	2½	3½
General Government Borrowing Requirement (GGBR)	9·0	8½	7	5½	4	3
PSBR(1)	9·3	8	6	5	3½	2½
(as percentage of GDP at market prices) ...	5½	4¾	3¾	3	2¼	1½

(1) The difference between the GGBR and the PSBR—public corporation borrowing from the private sector and overseas—is consistent with Table 14 of this report for 1979–80 and 1980–81, and with Cmnd. 7841, Table 1.1, line 9 for subsequent years.

their limitations are borne in mind the projections described above suggest that if GDP growth after 1980 were at about the same rate as in 1973–79 there should be scope for tax reductions in the later years.

14. The path for the PSBR set out in Table 9 is consistent with achieving the planned reduction in the growth of money supply over the medium-term with lower interest rates. It is not possible to predict the path of interest rates year by year, but the strategy set out above implies that though financial conditions must remain quite tight in the immediate future while inflation remains high relative to the monetary target, there should over the period as a whole be a significant reduction in nominal rates and a steadily improving environment for investment.

Responses to alternative outcomes

15. The projections shown in Tables 8–9 fall within a wide range of possible outcomes. Events at home or abroad could develop so as to produce a very different situation. World trade could grow faster or more slowly than assumed; the supply response of the United Kingdom economy could be very different, with consequences for productivity and trade performance; oil and other commodity prices could show different movements; and the behaviour of earnings is always difficult to predict. Any of these outcomes, and many others, could significantly change the growth rate of the economy over the next few years, and hence the finances of the public sector.

16. To maintain a progressive reduction in monetary growth in these circumstances it may be necessary to change policy in ways not reflected in the above projections. The Government would face a number of options for policy changes to achieve this aim, including changes in interest rates, taxes and public expenditure. But there would be no question of departing from the money supply policy, which is essential to the success of any anti-inflationary strategy.