Europe Enters the Eighties*

I. Introduction

After a decade of instability, Europe looks to the eighties with the hope of achieving the goals of stable growth and lower inflation. M. Barre's plan in France, the election of Mrs. Thatcher in Britain, the Pandolfi plan in Italy, the Moncloa pact in Spain and the establishment of the European Monetary System (EMS) are the principal steps recently taken to elaborate and achieve these goals. Unfortunately, instability cannot be eliminated simply by rhetoric or by relying on bureaucratic solutions. To achieve greater stability in the eighties, the countries of Europe must develop medium-term policies for external and internal balance which avoid the mistakes of the seventies.

We are optimistic that greater stability can be achieved. Voters appear to recognize, despite repeated promises, that governments have not achieved stability by fine tuning economic activity. In France, Britain and elsewhere voters have shown a preference for medium- or long-term policies to reduce inflation and increase growth of real income. Voters in some countries have recognized that the growth of aggregate output has fallen as the relative size of the public sector has increased. At the same time, Europe has adopted a system of internally fixed, but adjustable exchange rates, with the intention of reducing instability arising from the international monetary system.

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II. The European Monetary System

The EMS aims to create a zone of exchange rate stability in Europe by fixing exchange rates and keeping them fixed by exchange market intervention. This aim is to be applauded. However, if exchange rates which are fixed administratively are to be stable, they need to be equilibrium exchange rates. This can only be achieved if member countries pursue mutually consistent monetary policies.

During the 1970's, the monetary policies have been seriously inconsistent with exchange rate stability. In the accompanying table, the *actual* rates of inflation and monetary growth per unit of output experienced on average during 1970/78 by the major European countries are compared to the rates of inflation and monetary growth which would have been *consistent* with exchange rate stability and a German rate of inflation of 5%. As is apparent from the table, exchange rate stability in Europe in the 1970's would have required degrees of monetary discipline far greater than national monetary authorities were prepared to implement. For example, whereas in Italy actual money growth per unit of output was 16.1 per cent, it would need to have been only 0.6 per cent to have been consistent with exchange rate stability.

TABLE

NATIONAL MONETARY POLICIES REQUIRED FOR THE SUCCESS OF EMS 1970/78

Country	Actual Inflation	Actual Money Growth per Unit of Output	Inflation Money Growth Ratio	Inflation Consistent with Exchange Rate Stability*	Money Growth per Unit of Output Consistent with Exchange Rate Stability
	(1)	(2)	(3)=(1):(2)	(4)	(5)=(4):(3)
Belgium	7.4%	4.8%	1.5	5.1%	3.4%
Denmark	9.4	7.0	1.3	5.3	4.1
France	8.7	6.5	1.3	2.5	1.9
Germany	5.0	7.0	0.7	5.0	7.1
Italy	12.0	16.1	0.7	0.4	0.6
The Netherlands	7.8	8.1	1.0	6.1	6.1
U.K.	12.5	10.8	1.2	2.1	1.7

* Consistent inflation rates are calculated by subtracting from the German rate of inflation the rates of change of each country's real exchange rate against the *D-mark*. Real exchange rates are defined as market exchange rates corrected for differences in price levels of the countries concerned.

The past evidence suggests, therefore, that those monetary policies necessary to ensure that fixed exchange rates are also stable equilibrium rates imply a degree of monetary discipline far greater than the national monetary authorities have shown. Such discipline is simply not feasable for the foreseeable future because of the temporary but substantial losses of output growth involved

The only remaining alternative is periodic revaluations and devaluations. But the prospects of such parity changes, which typically come too late, will revive massive speculation. Large-scale interventions, capital controls and, eventually, large and abrupt parity changes will be tried but found wanting since they fail to solve the basic problem, namely the pursuit of inconsistent monetary policies by the countries concerned. If such policies remain, and nothing yet points to their disappearance, the EMS will end up in a series of exchange rate crises and collapse. The chances that this will happen are substantial because:

— member countries have refused to choose that country that will act as the trend-setter of monetary policy to which all others have to adjust in return for exchange rate stability,

— no agreement has been reached on the kind of policy to be followed by such a country,

— no steps have been agreed which would ensure domestic monetary policies consistent with exchange rate stability,

— the criteria which should guide parity changes have not been specified.

Therefore, under the EMS national monetary authorities find themselves, like before, with no limitations on their freedom of action. Given their past policies, the absence of such limitations is the single most serious threat to a lasting success of the EMS in creating a zone of exchange rate stability in Europe.

We believe that the EMS will not survive the inconsistencies in monetary policies currently pursued by member countries. There will be neither price nor exchange rate stability. We believe, however, that there is a better alternative. Countries should conduct their monetary policies in order to *stabilize* and *equalize* inflation rates within the European Community at their lowest possible level, being at least what Germany regards as its maximum tolerable level of two percent, but preferably zero percent. By preventing inflation differences in this way, a major source of exchange rate instability

would be avoided. Real exchange rate changes would then be the only major source of exchange rate instability. Real exchange rate changes are those changes in market exchange rates which cannot be accounted for by inflation differences. Rather, they result from changes in technology and trading patterns, and from unexpected changes in real money balances. Since real exchange rate movements can neither be foreseen nor fully prevented by monetary policy, nominal exchange rates need to be flexible in order to allow real exchange rate changes to take place. Floating exchange rates, therefore, are a necessary condition for stable price levels.

In our alternative proposal, flexible exchange rates are paired with stable and equalized inflation rates across Europe. Monetary policy would be aimed solely at the reduction, stabilization and equalization of inflation rates. The realization of this objective would remove the critical cause of current exchange rate instability, thereby reducing exchange rate risks. Moreover, since inflation rates would then be, on average, more predictable, purchasing power risks will also be reduced substantially.

The aim of reducing, stabilizing and equalizing inflation rates at their lowest possible level would be greatly furthered if full convertibility between European currencies were to be established. This would mean that domestic and foreign money holders would be free to move out of those currencies that lose their purchasing power rapidly and into those currencies that lose their purchasing power less quickly.

For full convertibility to be achieved it is necessary that capital and exchange controls be dismantled immediately.

III. France

After the March 1978 elections the new government, led again by M. Barre, made clear its intention to liberalize the economy. This was a welcome change in an economy plagued by bureaucratic controls and excessive restrictions. Controls on industrial prices were removed; the deficits of the public enterprises were reduced; the anti-trust policy was strengthened; the French economy was open to more competition. Furthermore, M. Barre tried repeatedly to convince the French people, and rightly so, of the importance of responsible fiscal policy and monetary control. Despite these promises, budget and monetary policies have remained expansive in 1978, budget deficit having more than doubled to 44 billion francs. To finance the deficit the *Banque de France* increased the rate of monetary growth contrary to its announced intention of reducing it.

Inflation will increase in 1979. The main cause of the expected increase is the government's fiscal and monetary policies. The price increase announced by the oil cartel will add to the rate of inflation. Although the latter is receiving a great deal of public attention, the main cause of inflation should not be obscured. For the year 1979, the inflation rate will be closer to 10%, or may be even above, than the 8-9% generally expected.

The acceleration of money in 1978 will have a favourable effect on the real rate of growth of the economy, especially during the first half of 1979. The same can also be said about the increasing size of the budget deficit. However, the rise in oil prices will tend to contract output, in particular over the second part of the year. Exports should be broadly neutral in their effect. All these factors suggest that the rate of growth of the economy may be a little higher than last year but not by much, in the region of 3.5%.

The expectation of a continued high rate of inflation will lead to a depreciation of the franc vis-à-vis other currencies. The acceleration of inflation in Germany and in the United States in 1979, however, should somewhat reduce this tendency over the foreseeable future. In the longer run the inflation differential between Germany and France means that the franc must depreciate significantly vis-à-vis the *Deutsche-mark*.

In view of the expected level of economic activity and rising import prices the trade account is likely to deteriorate somewhat in 1979, but not by much.

With an expected inflation rate of around 10% in 1979, it can be anticipated that the relatively small but noticeable increase in the rate of growth of wages observed in 1978 should continue in 1979. By the end of the year wages are likely to rise about 13%. If the inflation rate worsens however, which is not an implausible assumption, the 13% growth figure could well be a minimum.

During the year, unemployment is likely to deteriorate. Even if the rate of growth of the economy accelerated somewhat, this acceleration would be too small to have a noticeable effect on the unemployment rate.

If the authorities are serious about their repeatedly promised fight against inflation and about their stabilization policy, they must return to the original principles of the "Plan Barre". Control of the government budget is a necessary precondition to achieve a non-inflationary rate of growth of money. In addition, the authorities should realize that if the EMS is to succeed it will require a continuing depreciation of the franc vis-à-vis the *Deutsche-mark*. In the long-run the stability of the EMS requires that the rate of growth of the French money stock approach that of the German money stock.

In 1979, the trend in monetary growth must be reduced. For this, two things are absolutely necessary: a smaller budget deficit and temporarily higher money market interest rates. The objective should be to reduce the *average* yearly rate of growth of money by about 1.5%, i.e. to 12%. This value is higher than the announced 11% *end of year to end of year* target. But two things must be noticed: (1) our target is in terms of the *average* money growth over the year and not from end to end of year; this type of average target should be adopted as it would be more meaningful than the actual one; (2) a more rapid reduction of the money stock would put undue pressure on real growth and unemployment.

The rate of growth of money should be reduced gradually over the coming years, to a level of around 7% per annum as that is the rate which is necessary to eradicate inflation *in the long-run*. To attain this objective the authorities should announce, and realize, *average* annual money growth targets declining by about 1.5% every year over the next several years. This policy would not only lead to gradual decline of the inflation rate but would also reduce the uncertainty associated with economic decisions and the "rules of the monetary game" to which economic agents would have to adapt in the coming years would be clearly understood.

To achieve these targets more efficiently, the authorities should adopt an institutional framework under which they can control the money stock by controlling the monetary base. Such a method of control would make it possible to dismantle the system of credit ceilings which impedes the efficiency of the financial system, increases costs, reduces competition between banks and misallocates resources.

Even though the proposed 1979 budget deficit was only 15 billion francs (against a voted one of 9 billions in 1978), the gap between government expenditures and revenues should be smaller

this year than last because taxes should increase more than forecast in the National Accounts (it was the reverse in 1978). Government deficits can be financed either through money creation or bond issues. If inflation is to be avoided, it is necessary that deficits be financed by bond issues rather than money creation. But if the deficit itself is not reduced, financing it in a non-inflationary way will channel more and more savings towards the public sector at the expense of the private sector. There will be a "crowding out" of private investments, and consequently a reduced rate of real output growth. Persistent deficits, however, also place governments under pressure to finance them through money creation and inflation. For these reasons the deficit must be eliminated over the next few years.

To summarize, if the authorities wish to stabilize the economy they must implement a credible program to control the growth of government expenditures (including social security expenses). Without a reduction of this growth, either taxes would have to be raised continuously, with all the consequences that one could expect for the economy, or the growth of the money stock would soon become uncontrolable. In either event, the future of the French economy would be seriously endangered.

IV. Germany

The main problem facing the German authorities now is to combat inflation and rising anticipations of future inflation without damaging the recovery in the real rate of growth of the economy. Since late 1977 the real growth rate has increased from 2.4% to about 4%, and the growth of real capital formation has risen from 3.5% to about 8%, while the unemployment rate has fallen from 4.6% to 3.9%. However, the rate of inflation has also risen, from a low point of 2.1% last fall to 3.5% now, and is expected to increase to well above 4 percent by the end of this year, reflecting the excessive monetary growth since late 1977.

The early resurgence of inflation and inflationary expectations are predictable results of the policies followed by the German authorities. Specifically, they reflect the attempt by the *Bundesbank* last year to hold down the appreciation of the *Deutsche Mark*. The *Bundesbank* should recognize that the attempt to fight a transitory real appreciation of the currency by monetary means has no lasting

effects on the real exchange rate. Instead, they heighten monetary instability and inflationary pressures.

What is needed is a strategy that corrects the errors of the past and orients policy toward the requirements of long-term stability. This strategy should embrace both monetary and fiscal policy, and should place shorter-term policies into an explicit longer-run perspective.

With respect to monetary policy, we recommend that the *Bundesbank* adopts the following short and longer-term strategy:

1) in the near term, policy should avoid too sharp a deceleration in monetary growth, so as to maintain the recovery in real growth into 1980. The *Bundesbank* should therefore announce that it will not seek to reduce monetary growth to the lower limit of the official target range set for 1979, i.e. 6% by end-year, but should instead steadily lower the year-on-year growth rate of the central bank money stock to 7-7.5 percent in the fourth quarter of 1970. The average rate of monetary growth would then decline from 11.4% in 1978 to about 8.5% to 9% in 1979.

2) For the longer term, the *Bundesbank* should announce target rates of monetary expansion for a number of years into the future, so as to permit the public to form reliable anticipations about the future course of monetary policy. Vague statements of intent are not a substitute for explicit longer-run targets. The public has learned to discount such statements as official rhetoric. The *Bundesbank* should therefore announce that it will maintain into the 1980's a policy of gradually reducing monetary growth. We recommend that the targets should be announced for a reduction in the average growth of the central bank money stock to below 7% in 1980, 5.5% in 1981 and 4.5% in 1982.

An effective phasing out of inflationary expectations requires credible policies for both the short and longer term. We urge the Central Bank Council of the *Bundesbank* now to make the necessary longer-run committment. Adoption of such an approach would allow Germany again to take the lead in the battle against inflation in the EEC. To be successful, however, the German authorities have to allow the *Deutsche Mark* to float. Efforts to stabilize exchange rates have always led to more inflation in Germany as the economy has been opened to the inflationary influences of other countries policies. The mistakes of the past should not be repeated. Other European countries would then be free if they so wished to stabilize their exchange rates against the *Deutsche Mark*.

With respect to fiscal policy we note that Germany has stabilized the share of national income devoted to government expenditure. But government deficits of an order of close to 3% of nominal GNP cannot be justified during periods of strong economic growth. To continue such deficits promotes anticipations of the crowding out of private investment in the future. What is required is a reduction in the nominal growth of government expenditure so that the government's share in nominal GNP does not increase above its current 47%. This year's total expenditure is already planned to increase by about 9%. Next year will be a Federal-election year with political pressures to raise the growth of expenditure. We think that responsible political leadership should avoid this, in order to contribute to fighting the new round of inflation. Governments of all levels should agree, therefore, on lowering nominal expenditure growth, down to 6.5% in 1980, 5.5% in 1981, and 4.5% in 1982. The aim should be to eliminate the deficit early in the 1980's. Thereafter tax rates will have to be reduced to avoid an unnecessary growth of government revenue.

The policies proposed above promise less inflation and continued real growth. The alternative is to repeat the stop-go policies of the past which would again result in higher inflation and more unemployment. The choice before the German authorities is clear.

V. Italy

The deterioration in Italy's economic performance, which set in the 1960's and progressed in the 1970's, results above all from the rapid growth of the public sector, inflationary financing of the government deficit and the erosion of private property rights. The uncontrolled surge in public expenditures is the single most important problem facing Italy today. All political parties acknowledge openly the seriousness of the situation but do little in concrete to rectify it.

Total government expenditures, including transfer payments, now represent 50 percent of nominal GDP, up from 40 percent in 1973. Taxes have risen from 33 percent of GDP in 1973 to about 39

percent of GDP in 1978. The considerable rise in the tax burden has not been sufficient to prevent rising budget deficits. These reached 32,000 billion lire in 1978 and absorbed 70 percent of total domestic credit, up from 60 percent in 1977. The increasing share of total domestic credit taken by the public sector forces the banking system to function as the link through which the private sector's saving finances the Treasury's borrowing. Moreover, the Treasury lends funds to high-risk firms which otherwise could not borrow in the market. Society as a whole suffers from the lower efficiency of resource utilization.

The policy of maintaining employment has reduced the probability of bankruptcy in medium and large-size firms which can count, if need arises, on either loans at subsidized interest rates or on outright grants. This policy may appear to benefit capital at the expense of labour; on the contrary it promotes aggressive behaviour of labour unions which act on the belief that excessive wage demands will not cause business failures. The industrial sector remains in deep distress. Caught between rising unit labour costs, unavailable credit and an uncertain economic policy, firms respond by postponing investment projects. Real wages in the industrial sector have risen faster than productivity. Unemployment has increased, notably among young people and unskilled workers. Employment is discouraged also by the existence of minimum wages and job security. Recent increases in taxation have sharply reduced incentives to work.

Unions have no interest in lobbying for lower government expenditures and hence lower taxes because (a) there is room for redistributing income from capital to labour; and (b) government expenditures are perceived to benefit labour more than capital.

The large difference existing between the cost per worker borne by the firm and the worker's take-home pay has promoted a sizeable underground economy. Small firms in the industrial and tertiary sectors hire individuals with the understanding that no taxes and social security contributions will be paid. The extent of "black" market activity is not known but is reputed to involve up to 4,000,000 workers.

The Italian economy improved in 1978 in several ways: inflation was down to 13 percent from the 18 percent mark in 1977; the growth rate of labour cost per unit of output in industry was down 11 percent from 19 percent of 1977; the increase in import prices declined dramatically to 4.5 from 17 percent in 1977; profit margins

improved; the growth rate of industrial production reached 2 percent (zero in 1977); the growth rate of real GDP increased to 2.2 percent (1.7 in 1977); and international reserves more than doubled.

These improvements should not be interpreted as reversing the long-run economic decline which has evolved for several years. Growth of output remains a small fraction of what was in the 1950's and the 1960's. The reduction in the rate of inflation in 1978 was in part achieved by the sharp drop of the dollar in the exchange markets. The domestic sources of inflation remain still unchecked. Monetary growth was higher in 1978 than in any preceding year.

Sensing the urgency of the problem, the government has launched a three-year program which aims at an inflation rate of about 7 percent in 1981, a growth rate of output of 4 percent and stability of the lira in the exchange markets. The program calls for an implicit wage policy which would maintain real wages constant and set targets for total domestic credit. Given the projected growth of government deficits, the total domestic credit targets will be met by savagely crowding out the productive sector. The government program fails where it is most important, namely in proposing sizeable expenditure cuts.

We share the objectives of the three-year plan; we disagree on the way to achieve them. First, the *Banca d'Italia* ought to reduce the growth rate of the money stock M_2 by approximately one half from present level of 24 percent within the next five years.

Growth and stability cannot be attained by monetary policy alone. Fiscal restraint and reform are urgent. Government corporations, under the pretext of pursuing social objectives, have been allowed to accumulate staggering losses which are financed by taxation and inflation. Many kinds of transfer payments should be reduced, especially those which have promoted high levels of consumption at the expense of investment.

The current budget of the government must be balanced by 1983: (a) to facilitate the gradual slow-down of the money stock and (b) to stop the "crowding out" of private investment. Such measures will minimise the temporary increase in unemployment that inevitably accompanies the effort to bring down the rate of inflation. The restoration of a balanced budget should be brought by reducing expenditures, mainly transfer payments, and not by raising taxes.

The Treasury should gradually reduce its lending activity to marginal firms. Banks, freed from the imposition of financing a

large portion of the government deficit, could thus regain their traditional function of lending to the productive sector of the economy.

Italy cannot expect to hold current exchange parities with the other EEC currencies. This parity should be changed from time to time until the Italian rate of inflation reaches the level consistent with exchange rate stability.

VI. Spain

Although the transition to political freedom and democracy has been successful, progress towards economic freedom and stability has been slower. The economy ails with a 14% rate of inflation, an 8.2% apparent rate of unemployment, and a GDP growth of less than 3% per year. The three main problems besetting the Spanish economy are a high rate of inflation, a high level of unemployment, and plethora of controls and regulations.

Measures to liberalize the institutional framework of the Spanish economy have been conspicuously absent, with the exception of some reforms in the financial sector. Major areas for revision are: the removal of prohibitions in the labour market that prevent dismissal of employees; the freeing of foreign commerce from quotas, state monopoly, and high rates of effective protection; the abolition of controls on price and foreign exchange; the relaxation of regulations affecting agriculture and food prices.

The efforts to reduce inflation have been conducted with determination. In a year and a half the rate of price rises has been brought from 27 to 14% and the balance of payments has been turned around from deficit to spectacular surplus.

Further progress is hampered by conventional wisdom. There are still widespread beliefs that wages or incomes policies are indispensable in an anti-inflationary programme; that one can forecast with assurance the components of gross national product; that permanent reduction of unemployment can be obtained by priming the pump; that one can pursue a restrictive monetary policy without revaluation.

The Spanish government should now take decisive measures to liberalize the framework of economic activity in three areas. The reform of the financial sector should concentrate on three main points:

a) the Bank of Spain should be given a new statute, making it independent of the Government, and a mandate to defend the domestic and international value of the peseta;

b) exchange controls should be abolished and capital movements freed;

c) government bonds should be sold in a free capital market.

Current restrictions on the labour market increase unemployment and reduce efficiency. Firms are reluctant to hire additional labour because they are prevented from reducing the labour force when demand changes. Contrary to popular belief a reform of this kind will lower the average rate of unemployment and by increasing efficiency will increase productivity growth — the only known means to raise real income and employment simultaneously.

Price controls should be removed. This will have at most a temporary effect on price levels, but no permanent effect on the rate of inflation. The major benefit, however, is to increase the efficiency of the Spanish economy.

To reduce inflation with minimum social cost, monetary targets should be announced now for the next four years. In the past, the Government has failed to achieve announced targets, and at the same time given the impression of excessive severity by trying to sterilize the effects of dirty floating. The Government could regain the confidence of the public by presenting a realistic four year programme of money supply reduction.

We believe that the rate of monetary growth should be brought to 18% by the end of 1979. If this is done, money growth will average 19% for the year. The reduction in 1979 should be followed by reductions to 15% by the end of 1980, 12% by the end of 1981, and 9% by the end of 1982. If the rate of growth of the Spanish economy has returned to normal by then, this rate of money stock creation should mean a zero rate of inflation.

The phased reduction of money supply growth cannot be achieved without an appreciation of the peseta against other currencies. The Bank of Spain should not intervene to prevent this appreciation. Appreciation of the exchange rates that fully reflects the lower inflation rate has no lasting effects on exports.

The Spanish tradition has been one of balanced budgets and this tradition should be treasured. Temporary deficits should not be

financed by money creation. Spain has only to turn to neighbouring countries to observe the high real burden of continued large budget deficits. To avoid crowding out private capital formation the amount of Government debt placed on the market, even at competitive rates of interest, should not rise faster than GDP growth. Lasting increases in employment and high productivity growth cannot be achieved permanently by programmes which expand the Government sector deficit.

The Spanish public undeniably have expressed a wish for the extension of the welfare system, when the rest of Europe are painfully trying to reduce it. Many are unaware of the capacity of a free private sector to fulfill public needs. Even if a case is made for responding to such demands, a great deal of attention should be given to the pace of increase of the public sector and to ensure the efficient application of welfare programmes. Also the Welfare State should not be confused with a policy where everyone receives transfers from every one else.

VII. The United Kingdom

At the present time the British economy is settling into steady two-digit inflation with unemployment in excess of 5% and a real output growth rate of between 2% and 3%. Government spending and the public sector borrowing requirement continue to represent high fractions of GNP.

The policies which Britain now needs are the same as have been needed for the last twenty years and the Budget to be introduced on June 12 provides the new Conservative government with a rare opportunity to lift Britain from the condition which twenty years of persistent government expansion has brought about. The objective of the Budget should be to lay the foundations for the medium term recovery of the private sector, a reduction in the size of the public sector and a gradual and complete eradication of inflation.

The Chancellor of the Exchequer will no doubt be strongly tempted to honour the election promise and immediately cut the standard rate of income tax. This temptation should be resisted. An immediate cut in the standard rate would be widely and correctly interpreted as temporary. It perhaps would stimulate a wave of profit taking and short-term activity but it would not lead to a

renewed forward looking expansion of investment which must be the basis of a sustained private sector recovery. Its effects on unemployment would therefore be slight and shortlived. In contrast, a series of modest general tax cuts over the next five years accompanied by spending cuts, would be widely interpreted as permanent and would encourage the much needed recovery of private capital accumulation and a sustainable drop in unemployment.

Also, the Chancellor will undoubtedly want to preserve a high degree of flexibility for future policy changes and avoid committing himself to a detailed programme of future spending and tax cuts. This would be a mistake. There is more to be gained by reducing uncertainty about future government policy than by preserving flexibility. By enacting a clear and detailed committment to a programme of future tax and spending cuts, the disruptive effects of the changes would be minimized and individuals would be better placed to order their affairs so as to avoid abrupt and otherwise perhaps inequitable changes in their personal financial and economic positions.

A budget containing the provisions set out below would offer medium term credibility; public spending would be cut; the public sector borrowing requirement would fall and, as a result, so would interest rates. Those taxes which have the most damaging effect on incentives would be cut immediately and other taxes would be cut later. Such cuts would be widely anticipated and thereby give further incentive for the recovery of private economic activity and the continued reduction in unemployment. Specifically, the June 12 Budget should contain five main features:

(i) an immediate cut in public spending;

(ii) the enactment of a precise and detailed timetable for phasing out the public subsidisation of inefficient private and public sector enterprises and activities leading to a progressive fall in the government's share of GNP;

(iii) an immediate cut in the highest rates of income taxation (at both ends of the income scale) so that 60% becomes the highest marginal tax rate;

(iv) the enactment of a timetable for cuts in the general levels of direct and indirect taxes consistent with further lowering the public sector borrowing requirement and achieving a balanced "general government" budget by 1984;

(v) the announcement of a five year target path (and range) for money supply growth which gradually falls from its present level to a non-inflationary 2-4% range by 1984.

An important implication of this programme is a strong pound and possibly a transitory appreciation of the real exchange rate. The temptation to use monetary policy to moderate such an appreciation must be resisted, otherwise the existing two-digit inflation will persist and full recovery of the economy jeopardized.

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