PO-CH/NL/0140

PART A

Part. A.

SECRET

(Circulate under cover and
notify REGISTRY of movement)

Begins: 10/12/86.
Ends: 6/1/87.

PO -CH /NL/0140
PART A

Chancellor's (Lawson) Papers:

ECONOMIC FORECASTING AS
POLICY BACKGROUND FOR
THE 1987 BUDGET

Disposal Directions: 25 Years

23/8/95.

PO -CH /NL/0140
PART A

B87

COPY NO. 6 . . OF 20

NOTE OF A MEETING HELD IN HM TREASURY ON WEDNESDAY, 10 DECEMBER 1986

Those present

Chancellor
Chief Secretary
Financial Secretary
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Scholar
Mr Cropper
Mr Ross Goobey

Mr Battishill)
Mr Isaac)
Mr Houghton) IR
Mr Calder)

CAPITAL GAINS AND INCOME TAX

PAPERS

Mr Cayley of 4 December, Mr Mace of 5 December, Mr Cropper of 5 December, Miss Rutter of 8 December and Mr Scholar of 9 December.

1. The Chancellor said he was grateful for the Revenue and other papers. He accepted there were some difficulties and disadvantages with his proposal. But he also saw some important advantages. He asked for one additional option for the CGT threshold to be considered: a £10,000 threshold. This would have the advantage of being roughly revenue neutral (looking at the CGT side alone), and would lead to a sizeable reduction in the number of CGT payers. Mr Houghton gave the figures for this option, on the same basis as the table in Mr Cayley's paragraph 12:

Threshold: £10,000.

Yield (£M):

(i) 1988-89: -5

(ii) Full year: nil.

Tax payer numbers: -25,000.

Volume of disposals:

(i) Shares: -8 per cent.

(ii) Land: -6 per cent.

(iii) Overall: -7 per cent.

Staff savings:

(i) 1988-89: 170.

(ii) Full year: 455.

2. It was not necessary to implement both the CGT and income tax parts of this proposal in 1987: it would be possible to implement the income tax part alone. And even if we did go ahead in 1987, that would not be the end of the story: in the next Parliament, the Chancellor would be interested in following the US tax reform route, to vanishing exemptions, and just two income tax rates (basic rate and 45 per cent, with a rate of 50 per cent to withdraw the value of the exemptions). But that was for the next Parliament; what the Chancellor wanted to establish now was an automatic linkage between income tax and CGT rates, so that as income tax rates were reduced, CGT rates would follow. The question was, could we do this much as an interim step?

3. The advantages which the Chancellor saw in the proposal were:

(i) simplification (through the end of indexation);

(ii) a small shift in the burden from shares to land; and

(iii) a low profile shift in the burden from individuals to companies.

The disadvantage was that the proposal gave rise to significant losers. It was necessary to look carefully at the worked out examples of how particular individuals might fare. We needed to identify who the losers were, and how big their losses would be (action: Mr Cayley).

4. The Chief Secretary was concerned that those who would lose from this package would not know that a cut in top rates was in prospect in the next Parliament. This was an argument for only proceeding with the CGT part of the proposal when it was possible simultaneously to cut the top rate of income tax. He asked that the work on particular examples should include the case of the working farmer.

5. The Financial Secretary was rather sceptical about the principle of treating capital gains as income. And indeed the proposal did not go the whole way: it retained a separate threshold, and charged only half of gains. Problems would arise with very large single disposals (eg of land) which would be hard hit by the removal of indexation. Since they would be charged at 30 per cent (half x 60 per cent), the same rate as now, there would be no compensation for the loss of indexation.

6. Mr Cassell noted that the rise in the RPI between 1982 and 1987 was around 30 per cent. So abolition of indexation involved withdrawing a substantial relief. Government supporters might see it as a very risky strategy (for them) to establish the principle of integration of income tax and CGT ahead of the General Election. Sir P Middleton argued for integration of CGT to come in only as a package with a reduction in top rates, because of the problem of "lumpy" assets. He would also support the £10,000 threshold. Subject to those points, he saw distinct advantage in the proposals. One important question was the effect on the financial

markets. Mr Cassell agreed that this would need looking at carefully, but pointed out that gilts would not be affected.

7. Mr Isaac said that the overall effect of the package would be a large number of modest gainers, and a few large losers. The biggest losses would be associated with assets acquired round about 1982. The Chancellor stressed that the worst that could happen to anyone was a return to the pre-1982 position: tax of 30 per cent on unindexed gains.

8. There was some discussion as to whether a cut in the top rate of income tax in 1987 had to be ruled out. It would help to cushion the impact on very large gains. Mr Cassell suggested that a token cut might be possible, eg 2p off all rates. The Chancellor and Economic Secretary, however, thought that a cut in the top rate of income tax in 1987 would be politically virtually impossible. It would be presented as a tax handout for the rich, and that would obscure the rest of the contents of the Budget. There was, however, a half-way house, whereby the Chancellor in his Budget Statement could set out his intention of reducing the top rates of tax in the next Parliament, much as he and his predecessor had set out the target of a 25 per cent basic rate.

9. Sir T Burns said that, given all that had been said about indexation relief, he thought it would be very difficult to abolish indexation this Parliament, outside the context of a more fundamental reform. It would be better to act in the next Parliament, simultaneously with cutting the top rate of income tax and perhaps moving to a system of vanishing exemptions. But abolishing indexation relief in 1987 was too close to the introduction of the relief in 1982, and would look as if the Government was chopping and changing on this issue.

10. Mr Battishill welcomed the proposals. He thought that some bold initiative of this sort was necessary. The present CGT system was fiendishly complicated. Accountants were beginning to see the

merits of simplification, even where that meant adopting a more rough and ready approach. He hoped that it would be possible to keep the package as radical as it now was, and not to chip away at it. But it was inevitable that there would be criticisms: for example, academics would focus on those taxpayers whose marginal rate went up from 40 per cent to 45 per cent. The Chancellor noted that the 40 per cent band in the present higher rate structure was relatively narrow: so it was reasonable to assume that, even though a significant number of people were in it at any one time, they would be a changing population.

11. Mr Cropper thought that abolishing indexation relief would cause a great deal of anxiety. People would be concerned in case inflation were ever to take off again. (The Chancellor pointed out that this was no different from the position on stock relief. And the Government intended that inflation should not take off again.) Mr Cropper also pointed out that when categorising the reform as being good for shares and bad for land, it was important to remember that "land" included property in the private rented sector, which the Government wanted to encourage.

12. Finally, the Chancellor noted that the proposal would affect insurance companies particularly adversely. So he would either proceed with this or an insurance premium tax, but not both.

Further work

13. In conclusion, further work needed to be done on:

(i) "lumpy assets" of all kinds (not just land);

(ii) market consequences (and Mr Cassell was authorised to speak to the Bank);

(iii) the effect on the corporate sector, and in particular insurance companies.

However, it was as yet too early to instruct Parliamentary Counsel, even on a contingent basis.

A W KUCZYS

SECRET AND PERSONAL

CHANCELLOR OF THE EXCHEQUER

Copies to

1. CHANCELLOR
2. CHIEF SECRETARY
3. FINANCIAL SECRETARY
4. ECONOMIC SECRETARY
5. MINISTER OF STATE
6. SIR P MIDDLETON
7. SIR T BURNS
8. MR CASSELL
9. MR SCHOLAR
10. MISS SINCLAIR
11. MR CROPPER
12. MR ROSS GOOBEY
13. MR BATTISHILL)
14. MR ISAAC)
15. MR HOUGHTON)
16. MR CALDER) Inland Revenue
17. MR MACE)
18. MR CAYLEY)

JB

COVERING CONFIDENTIAL

PSM

FROM: PETER ALLUM

DATE: 11 December 1986

MR SEDGWICK

cc: Sir Terence Burns
Sir Peter Middleton
Mr Bottrill
Mr Davies
Ms Ryding Mr Pike
File DEF A26

FIGURES FOR INTEREST RATES AND INFLATION

I attach, for the record, a copy of the material on nominal and real interest rates and inflation which you asked me to supply to Cathy Ryding this morning.

Peter Allum

P F L ALLUM

Pursuant to
the long run

13

Figures consistent with the 1986 Autumn Statement printout.

Financial year:	Short term interest rates 1	RPI inflation (% change) year on year 2	RPI inflation (% change) through the year 3	Real Short term interest rates 4
1970-71	7.7	7.3	8.6	1.1
71-72	5.5	9.3	8.0	-2.8
72-73	7.8	7.1	7.9	1.2
73-74	12.8	10.5	12.8	3.0
74-75	12.3	17.9	20.3	-7.0
75-76	10.2	24.6	22.5	-12.9
76-77	12.1	15.3	16.5	-2.5
77-78	6.8	14.0	9.5	-6.6
78-79	10.8	8.3	9.6	1.5
79-80	14.9	15.8	19.1	-0.6
80-81	15.5	16.3	12.7	0.7
81-82	14.2	11.5	11.1	3.1
82-83	11.5	7.1	4.9	4.0
83-84	9.7	4.7	5.2	5.0
84-85	10.9	5.1	5.5	6.0
85-86	12.1	5.9	4.9	7.0
86-87	10.5	3.1	3.6	7.0
87-88	10.3 *	4.0	3.1	7.3
88-89	10.0 *	3.9	4.7	5.9
89-90	10.0 *	5.4	5.6	4.8

1 3 month Sterling LIBOR rate.

2 current financial year over year earlier

3 end quarter (Q1) of current financial year over previous end quarter (Q1)

4 3 month LIBOR rate less year on year percentage change in consumers' expenditure deflator. (Different measures of real interest rates could be obtained using other price deflators, for example the wholesale price index, or by using an alternative measure of inflation, for example 'through the year' rather than 'year on year.')

* Autumn statement shows interest rates ~~below~~ for 1987-88 and later years below those in the internal October forecast. This reflects the decision to make the AS printout consistent with PEWP assumptions on interest rates issued to Departments.

RB 15 DEC 1986 -25

PARLIAMENTARY UNDER SECRETARY OF STATE

DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB
01-212 3434

My ref:

Your ref:

B87

PGM (None of these look at all relevant to BA)

The Hon Peter Brooke
Minister of State
HM Treasury
Parliament Street
LONDON SW1P 3AG

15 December 1986

MINISTER OF STATE	
REC	15 DEC 1986
ACTION	Mr G Mackenzie
	PS/Chlex, PS/CST
	PS/FST, PS/EST
	Sir P Middleton
	Mr Scholar
	Miss Sinclair
	Mr Romanski

Mr Walters
Mr Cropper
Mr Tyne
Mr Ross Goodey
PS/C&E
PS/IR
MST

Dear Peter

1987 FINANCE BILL STARTERS

I am writing once again to let you know of the measures that I would hope to see included in next year's Finance Bill. There are six candidates altogether, of which four are definite and two remain uncertain. Of the definite candidates, one (a) is intended to solve a specific problem within the trade licensing system, two (b&c) would tighten up the enforcement penalties system, and one (d) deals with dishonoured cheques procedures. Of the contingent candidates, one (e) deals with dishonoured cheques procedures and the other (f) is concerned with the trade licensing system. In detail, the proposals are:

a. New taxation class for Recovery Vehicles

This proposal was foreshadowed in my letter of 28 November 1985. Recovery vehicles are permanently in the possession of motor traders, and there is thus no reason why they should continue to be allowed to be used under trade licences. I propose to designate a new, separate, tax class for recovery vehicles and this proposal has the support of the trade. The question of the appropriate duty rate will be covered in a later letter from John Moore to Nigel Lawson, but broadly, we envisage a phased approach eventually leading to the 'PLG' rate. There should be a small revenue gain and the proposal would take up a quarter of a page in the Finance Bill.

b. Clarification of and increase in penalties for vehicle licensing and registration offences

One problem with enforcement of the vehicle licensing system is that fines for abuse of the system can be very low. Several regulatory offences (including, for example, failure to notify the vehicle keeper's change of address, or failure to notify a vehicle's change of ownership) have suffered from this because the law is not clear about the maximum penalty involved.

I propose to make the penalty levels clear to the Courts, and my officials are currently discussing those levels with Home Office officials. These levels are expected to be in the range of £100 to £400, depending on the seriousness of the offences involved. Little revenue gain is expected, and the proposal would take up only a few lines in the Finance Bill.

c. Increases in back duty payable on conviction for VED evasion

This is under discussion with the Home Office, and there are three possible approaches to the general proposal to increase the penalty for VED evasion, only one of which would be for final inclusion in the Finance Bill. These are:

i) making arrangements for backduty to be payable on conviction for VED evasion at twice the normal rate; or

ii) requiring at least six months' back duty to be payable on conviction for VED evasion; or

iii) requiring back duty to be paid for the whole period of evasion, regardless of any period when the vehicle was not used or kept on the public road.

Each of these proposals would increase the punishment for VED evasion, make more offenders accept out-of-court settlement, and encourage voluntary relicensing. They would have the effect of relieving pressure on the enforcement agencies, including the Police, the Crown Prosecution Service, the Courts, and my own Department. The proposals would produce a revenue gain of between six and eight million pounds, depending on the option selected, and would take up perhaps six lines in the Finance Bill.

d. Dishonoured cheques: increase maximum penalty for failure to surrender vehicle excise licence.

Under this proposal, failure to surrender a vehicle licence obtained with a cheque that is dishonoured would involve a penalty of £400 or five times the annual rate of duty. This would thus increase the penalty to a level where it would always exceed the licence value, which is not the case with the current maximum fine. There would probably not be a revenue gain from the increase, which is intended as a deterrent. The proposal would take up some two lines in the Finance Bill.

To turn to the more uncertain candidates;

e. Dishonoured cheques: provision for the Department to claim duty lost while the licence was held by the offender

This proposal would allow duty to be claimed for the period a vehicle licence obtained with a dishonoured cheque was held by the offender, without the need to prove use or keeping on the public roads. The current system is weak, and can have the effect of a VED evader escaping several months' VED until he finally returns the vehicle licence. The new proposal would have a negligible revenue gain, but would have a valuable deterrent effect. It would take up some two lines in the Finance Bill.

f. Trade licensing - technical adjustment to the 1986 Finance Act

My officials are currently seeking urgent legal advice on the means to correct a minor technical defect in the 1986 Finance Act provision. I will write to you separately on this matter.

I should also let you know that an additional measure about which my officials wrote to yours in September will not be pursued this year; this is the introduction of exemption certificates for non-plateable vehicles. Two further proposals are also not being pursued; a power to seize licence discs and a power to seize trade plates.

Finally, I hope you will agree that last year's experience showed that such items have a smoother passage through Finance Bill Committee if there is no Transport Minister there to provoke discussion.

Michael

MICHAEL SPICER

PESM

Secretary of State for Trade and Industry

DEPARTMENT OF TRADE AND INDUSTRY
1-19 VICTORIA STREET
LONDON SW1H 0ET
Telephone (Direct dialling) 01-215) 5422
GTN 215) ....
(Switchboard) 01-215 7877

B87

CONFIDENTIAL

18 December 1986
ADVICE BY 9.1.87 PLEASE!

CH/EXCHEQUER
REC. 19 DEC 1986
MR SCHOLAR
CST FST EST MST
SIR P MIDDLETON
SIR T BURNS
MR F E R BUTLER
MR CASSELL
MR MONCK
MR BURGNER
MRS LOMAX
MR CROPPER
MR TYRIE
MR ROSS GOOBEY
PS/IR PS/C+E

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
LONDON
SW1

Dear Nigel,

1987 BUDGET

This seems an appropriate moment for me to give my suggestions for the inclusion of measures in your coming Budget which I feel would help commerce and industry to contribute effectively to the increase of national wealth.

You have made clear your intention to continue the process of reducing the burden of personal taxation. I share your priorities on this, and would be happy to see the bulk of any room for manoeuvre used for this purpose. Last year, you decided to offset in small part a reduction in the basic rate of income tax by increasing some of the higher rate thresholds by less than the rate of inflation. I recognise the reasons for this; but the later moves substantially to reduce the higher rates of personal tax in the United States leave us somewhat exposed in what is increasingly an international market for senior managers in industrial and commercial companies. I would therefore hope that the thresholds for higher tax rates could at least receive the benefit of full indexation this year.

I have chosen my proposals for changes in taxes which directly affect business so that they do not to a significant extent reduce the scope for action on personal taxation. Some of my specific suggestions are set out more fully in the enclosed memorandum. If there are points in them which your officials wish to follow up with mine, I hope they will do so, as in previous years.

1786
1986
BOARD OF TRADE
BICENTENARY

DW4BUQ

81/18/12

999-1

In the field of corporate taxation, you announced in your 1984 Budget the rates of corporation tax to apply for the four year period from April 1983 to April 1987. It would be most helpful to industry in planning for the short to medium term if in your coming Budget you are able to announce the rate of corporation tax for 1987/88, and give a clear indication of your intentions for subsequent years. I naturally hope that you will find scope for some reduction in the present rate of 35 per cent; but in any event I regard it as most important that there should be no increase.

The particular aspect of corporate taxation on which I and my colleagues in DTI have received the greatest volume of representations from industry in recent months has been the tax treatment of R and D. It is commonly alleged that a number of our competitors have a more favourable fiscal regime for R&D, to the point where it pays some UK-based companies to carry out R&D abroad. We have agreed that there should be a review in the next few months of R&D taxation in other countries, and I do not propose to make any new proposals pending the outcome of the review. But I would urge you to look again at the two specific proposals made in Leon Brittan's Budget submission last year, for the extension of tax relief to expenditure incurred by a consortium on R and D before trading begins, and for the clarification of the definition of research used for the Scientific Research Allowance.

I set out the case for the first in some detail in my letter of 17 March to John Moore, and will not repeat the arguments at length. In part the proposal is a response to representations we have received from industrial companies and financial institutions; but I believe that it would have at least as much value in stimulating a new and flexible approach by industry, financial institutions and higher education to commercially oriented R & D. We are both concerned about the relatively poor R & D performance of British industry. I believe that this proposal offers one of the most cost-effective means available of stimulating an improvement. I am pleased that our officials have made good progress, on a "without prejudice" basis, in elaborating a possible scheme. I am content with the outline that has been prepared and I very much hope that you will be able to include it in the Budget.

We also receive a good many complaints that the Scientific Research Allowance, which you decided in last year's Budget to retain, is of little value because the definition of scientific research has proved in practice both narrow and uncertain. I understand that this concern is not at present matched by a significant increase in the Inland Revenue case load on the point. Nonetheless, I believe it would help industry at very little cost if the definition could be clarified by making it more specific and relating it more closely to how R&D is actually carried out in industry. Section 1.174-2 of the US Internal Revenue Code, while doubtless unsuitable for incorporation in UK law as it stands, illustrates an approach which I think industry would find more helpful.

I should also like to propose some further changes in the tax treatment of financial services. I very much welcomed the reduction in the rate of Stamp Duty on securities transactions to ½ per cent from the date of the Big Bang. But this still means that transaction costs in London are higher than in other financial centres apart from Tokyo, and leaves the City at a competitive disadvantage at a critical moment in the evolution of a world securities market. There remains a strong case for the complete abolition of Stamp Duty on securities transactions, but I realise that the revenue loss would be significant. A further reduction of 1/4 per cent be a great help to the City's competitive position, and on past form much of the apparent revenue loss would be offset by an increased volume of turnover. (I note that the yield of the 1 per cent Stamp Duty on securities transactions in 1985/6 was 15 per cent greater than the yield of the 2 per cent duty two years earlier.) The reduction of the main Stamp Duty on securities to 1/4 per cent would also make possible a pro rata reduction, to 3/4%, in the new tax on the transfer of shares for the purpose of creating depositary receipts. as well as the halving of Stamp Duty Reserve Tax.

The changes to be introduced under the Financial Services Act in the range of investments permitted to authorised unit trusts will require parallel changes in the provisions defining the tax status of the trusts. Our officials are well advanced in the preparation of proposals to achieve this. I am sure that you agree that the scope of the tax changes needs to be wide enough to enable us to achieve our purpose of allowing unit trusts greater flexibility in their choice of investments within a firm regulatory framework. I also hope that you will look again at the 1/4 per cent unit trust instrument duty. The amount of tax collected is quite small, and the duty is an increasing handicap to the trusts, and particularly to money market funds, in competing with other investment media.

I have two suggestions to make on the tax arrangements for life insurance. The Stamp Duty of 50p per £1000 insured distorts competition between savings media and is widely seen as discriminating against life insurance companies. More specifically, the application of this duty to the reassurance in the UK of life policies written abroad is a major burden for UK reinsurers and seriously handicaps them in international competition for this business. This latter change would only cost about £1m and I do hope you can agree to meet it.

Like my predecessors, I have been concerned that the exemption from double capital gains charges enjoyed by unit trusts and investment trusts has not extended to unquoted venture capital companies, with the result that they have been compelled to establish residence off-shore. I am delighted therefore to hear that a solution to the problem seems to have been found that does not require legislation. I hope that continuing discussion on the tax treatment of venture capital fund managers' profit on their personal stake in the funds will have a similarly successful outcome. If solutions on both points enable the funds to come back on shore, the revenue effect will be positive.

I have also been following the progress of discussions at official level on disincorporation relief. It seems clearly right that the relief available when unincorporated traders incorporate should be matched for businesses which decide to disincorporate; and I understand that this is now accepted in principle. I recognise that to translate this into legislative terms is not straightforward, but I hope that you will be able in the Budget at least to indicate your intention to introduce disincorporation relief.

You are, I understand, looking again at the tax advantages enjoyed by dual resident companies, the cost of which has now reached substantial proportion. I have already written to Norman Lamont to say that I am content with your proposal to curtail this relief.

On VAT, I fully support your efforts to secure agreement at Community level to a new directive which would permit a substantial increase - even beyond the 35,000 ecu proposed by the Commission - in the turnover threshold above which firms must register; and I hope that you will as a minimum increase the present threshold of £20,500 in line with inflation. The proposals in the consultative document on VAT and small businesses will also in the main be welcomed by industry, and I would particularly urge the early introduction of an option for smaller traders to account for VAT on a cash basis. But I hope you will reconsider the suggestion that firms with a turnover below the registration threshold should no longer have the option of registering. This could have a serious effect on a substantial number of repayment traders.

DW4BUQ

CONFIDENTIAL

My final point is small in the context of the Budget as a whole but could have serious implications for jobs on Merseyside. I understand that Customs and Excise are considering a proposal to abolish the long-standing excise charge on matches and lighters. I appreciate that those duties may have to go eventually in part of wider moves to harmonise excise duties in the Community. But their early removal would gravely threaten 300 jobs at Bryant and May in Liverpool, and my own view is that abolition of the duties in the coming Budget would not be a good idea.

I am copying this letter to the Prime Minister and David Young, and to Sir Robert Armstrong.

Yours –

PAUL CHANNON

Paul

DW4BUQ

SECRET

Board Room
H M Customs and Excise
King's Beam House
Mark Lane London EC3R 7HE

From: B H KNOX

Date: 18 December 1986

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Scholar
Miss Sinclair
Mr Cropper
Mr Tyrie
Mr Ross Goobey
PS/Inland Revenue

BUDGET 1987: EXCISE DUTIES

INTRODUCTION

1. We have adopted a different and earlier timetable this year. Papers have already been submitted on various minor excise duties, matches and mechanical lighters, betting and gaming duties, marine diesel fuel and also on the wine duty structure review. To complete the picture, and to enable you to consider your initial approach to excises as a whole, this paper examines the taxable capacity of the main duties, taking into account revenue-raising capacity, price elasticities and consumption patterns.

Internal distribution: CPS, Mr Jefferson Smith, Mr McGuigan, Mr Whitmore, Mr Wilmott, Mr Bone, Mrs Hamill [illegible]. We have also adopted a different format. Unlike its predecessors this paper does not suggest specific options or packages: partly because it is too early in the decision-making process, but also because we need a steer. In effect we take revalorisation as a starting point and we discuss what room for manoeuvre exists around it. Once you can say what directions you prefer (perhaps after Chevening) we shall be glad to provide more specific advice or packages.

3. We have therefore reduced the volume of detailed analysis, usually found in the annexes. This year there are only 2 : Annex A shows for reference the price, revenue and RPI effects of both across-the-board revalorisation and - in ready reckoner form - a one per cent duty change, while Annex B shows in graph form how the main duties have varied since 1978-79. We are using the same revalorisation assumption as in the Autumn Statement: 3.25 per cent. Revenue effects are quoted generally in nominal terms (ie changes from an un-indexed base); the effects in scorecard terms of changes other than revalorisation can be derived by subtracting the values for revalorisation shown in Annex A.

4. So far as VED is concerned, this paper (which incorporates the view of the official Treasury, who have the policy responsibility in this area) deals principally with the rates on cars and light vans. For other vehicles you are considering the possibility of a shift of £100 million in the balance of taxation from lorry VED to derv duty. The arguments are considered in Mr Romanski's note to you of 5 November and 12 December.

5. In previous years we have discussed here the presentational effect of rounded unit price increases. The matter has assumed less significance in recent Budgets, with duty increases in most fields having been expressed in unrounded terms. We therefore make no further reference to it in this paper, although we shall if necessary return to it in later packages.

TAXABLE CAPACITY

6. In our view there is no major excise duty which could not bear revalorisation. The main considerations and points to be decided for each main group of duties are set out below.

TOBACCO

7. There are strong health arguments in favour of at least maintaining the value of the duty on cigarettes in real terms. Since the 1979 Budget the specific duty on cigarettes has been increased overall by nearly 70 per cent more than revalorisation. These increases have attracted no more than predictable criticism from the industry and have been welcomed by health interests. However, the 1986 Budget increase of over twice revalorisation (especially in contrast to the standstill on drinks) came as something of a shock to the industry, and they have started an extensive campaign for "a year off for tobacco" in 1987. In addition to the secular trend against smoking, duty increases have clearly affected consumption, which fell by about 20 per cent between 1980 and 1985. Consumption for the first 8 months of 1986 is down 6.1 per cent, compared to the same period in 1985. There has been increased penetration of the market by cheap imports, while home production in this period fell by 7.1 per cent. Employment has suffered in recent years, but not wholly as a result of duty changes.

8. Imported cigarettes accounted for less than 2 per cent of the market before 1983. Their market share rose to 10.6 per cent for 1985 and for the first 8 months of 1986 this figure increased to 11.4 per cent. The industry argues that UK firms cannot compete with the cheaper subsidised imported brands which are mainly sold in the "own label" market. Competition with imports has to be seen however in the context of the unwillingness of the major UK tobacco companies to compete in this market. The industry also claims that heavy taxation helps imports, but in fact the structure of our duty and the way it is increased (ie with concentration on the specific element) combine to give a higher proportionate increase on cheaper cigarettes. The following table shows excise duty as a percentage of the weighted average December price of both UK produced and imported cigarettes:

	Imported	UK produced
December 1981	59.1	60.8
" 1982	59.8	60.6
1983	61.3	60.0
" 1984	63.6	61.0
" 1985	67.4	61.4

The industry argues, however, that smokers are no longer loyal to particular brands and that when there are major increases in taxation they turn to cheaper imported brands, even if the duty increases bear harder on them.

9. The tobacco industry as a whole directly employs some 20 thousand people in the UK - or 0.1 per cent of all employees. Although the industry makes much of the employment it provides in areas of high unemployment, only about half of these jobs are located in such areas. However the industry is an important employer in Northern Ireland. Prior to the 1986 Budget the tobacco industry accounted for some 4,000 jobs there - nearly 1 per cent of the total - but in May of this year Rothmans (UK) announced the closure of its factory at Carrickfergus with the loss of 800 jobs, and in August Gallaher announced the closure, phased over 2 years, of its factory in Belfast, shedding 700 jobs. In the industry overall employment has fallen by 28 per cent since 1980 although it has fallen more rapidly than production, which reflects streamlining by manufacturers and investment in more efficient equipment. On the other hand, employment can be represented as just a small part of the equation. The ASH (Northern Ireland) report, published in November, considers both the benefits ("savings" on pensions, sales profits, employment, tax revenue) and the costs (lost productivity, individual expenditure, Government expenditure on health care, capital grants etc) of smoking, and concludes that the net cost to the community in Northern Ireland is £103 million per year. ASH extrapolates these findings to suggest that the tobacco industry in the UK as a whole "costs" the country over £4 billion.

10. Revalorisation of cigarette duty would produce the following result:

Price effect pence per packet (20ks)	Specific duty increase %	Yield 1987/88 £m	RPI impact effect %
3.0	3.25	80	0.09

(Hand-rolling tobacco is conventionally treated the same way as cigarettes, and the above figures include the effect of an equivalent duty increase for it.)

Despite the industry's problems, for both health and revenue reasons there are good arguments for going beyond revalorisation. However, in the light of the campaign mentioned in paragraph 7 we doubt whether it would be politically attractive for an increase in cigarette duty to be wholly disproportionate to that for other duties. Therefore, unless you plan a large degree of over-indexation all round, we suggest that double revalorisation (+£80 million in scorecard terms) is probably the limit for cigarettes. At present retail prices, this would take us over the maximum level (55 per cent of the total tax burden) at which specific duty can be levied under EC rules; but on past form the tobacco companies will raise their prices in the New Year, which should mean we can leave the ad valorem component untouched (this is better for home producers). However, Imperial have indicated that they may be forced to forego a price increase this year to compete for market share, so this cannot be relied upon. We shall keep an eye on this and advise further if necessary - we take as our objective the need, other things being equal, to keep as close as possible to 55 per cent, if necessary by increasing the ad valorem rate.

11. The duty on <u>pipe tobacco</u> has remained unchanged in the last 4 Budgets because of the lack of buoyancy in its consumption, because it is smoked proportionately more by the elderly, and because it is produced in areas of high unemployment (half of UK pipe tobacco manufacture is in Northern Ireland). The market remains depressed: clearances were down 10 per cent for the first 8 months of 1986 compared to the same period of 1985. In isolation the case for special treatment

is the same as in previous years. The revenue significance is not large (we expect to receive only £70 million under this head in the current year) and pipe tobacco remains heavily taxed compared with other countries. This would not normally be crucial, but you specifically drew attention to the point in your 1986 Budget speech.

12. Strict revalorisation would produce the following result:

Price effect pence per 25 gram pack	Specific duty increase %	Yield 1987/88 £m	RPI impact effect %
2.3	3.25	Neg	Neg

13. The duty on <u>cigars</u> has not been increased in the last 2 Budgets. The considerations were the state of the industry and the fact that (contrary to conventional impression) cigar smoking is widely spread across social groups. Consumption, which has been in decline for some years, has rallied somewhat this year, 0.6 per cent up for the first eight months compared to the same period in 1985, but 1985/86 consumption is still 27.5 per cent below what it was in 1979/80. Overall since 1979 the duty has been increased by 12 per cent more than required for revalorisation. The case for special treatment is the same as in previous years. But cigars compete much more closely and are more easily substitutable than pipe tobacco for cigarettes. In the health risk league they occupy a position somewhat above pipe tobacco. Revalorisation since the last Budget would give the following:

Price effect pence per pkt of 5 whiffs	Specific duty increase %	Yield 1987/88 £m	RPI impact effect %
1.6	3.25	5	Nil

14. If Ministers felt inclined to give favourable treatment to any tobacco products, pipe tobacco is the front runner. Indeed, the presumption has probably already been established that the duty will not be increased unless there are stronger reasons than simply revalorising, and we do not see such reasons as existing at present. The revenue cost would be negligible in scorecard terms. Cigars are another matter; the danger here is that a third year in which there was no increase would tend to create the presumption that they were viewed very much the same as pipe tobacco and would get the same special treatment. To avoid creating this presumption, and to avoid a revenue cost of £5 million in scorecard terms, we suggest that the duty on cigars should at least be revalorised.

MOTORING TAXES

15. There is no doubt about the ability of the road fuel duties (petrol and derv) to cope with increases equal to or in excess of revalorisation. Consumption of both is buoyant: petrol up 5.3 per cent and derv up 11.5 per cent for the first 9 months of 1986 compared to the same period of 1985. They are large potential revenue-raisers and, despite the restructuring of the RPI which means that from January 1987 both derv and unleaded petrol will be included, still more RPI-efficient than most. However, because one third of petrol and nearly all derv is bought by businesses, any large increases in the duties would have a significant effect on business costs.

16. The arguments put forward for leniency by the rural motoring lobby do not carry as much weight nowadays: the difference between urban and rural petrol prices is much smaller than it used to be and depends on competitive conditions rather than consistent urban/rural differentials. Leaving aside the Highlands and Islands, and the remotest rural areas, at the beginning of December the highest

recorded price was 169.6p per gallon (for example in Glasgow and Nottingham) compared to an average pump price of about 168p per gallon, some 6p below its pre-Budget price this year. The oil market is of course liable to further fluctuation but at this stage it seems idle to speculate about prices next March.

17. On unleaded petrol, the MST has agreed the main recommendations in Mr Jefferson Smith's submission of 28 October including granting a rebate to unleaded petrol of 5p per gallon with effect from Budget day 1987; the figures that follow assume this to be the case.

18. Strict revalorisation of the duties would produce the following result:

	Typical price change (including VAT*) pence	Duty increase %	Yield 1987/88 £m	RPI impact effect %
Petrol	3.3 per gallon (leaded petrol)	3.25	165	0.08
Derv	2.8 per gallon	3.25	35	see note (i)

* Most derv consumers can reclaim VAT.

(i) Derv is to be included in the RPI from January: its weight is not yet known, but the impact effect is likely to be negligible.

NB The revenue estimate assumes 10 per cent offset for bus fuel grants.

19. This would leave the average pump price of leaded petrol (on the basis of present prices) at 171.3p per gallon, nearly 3p per gallon lower than before the 1986 Budget. Double revalorisation - an increase of 6.6p per gallon - would give a price about 0.6p per gallon higher than pre-Budget 1986. The pump price of unleaded petrol would then be about the same as leaded. Assuming that lorry VED is reduced by £100 million and derv duty is increased on a lorry-neutral basis, <u>after</u> revalorisation the pump price of derv would increase by about 12.2p to become 162.2p per gallon, still nearly 13p a gallon lower than pre-Budget 1986. If you also wished to recoup from derv duty the revenue which would have been obtained from lorry VED revalorisation (£15 million) a further 1p per gallon would be added to the price

however, only around 18 per cent of derv is bought at the pump, most being purchased at lower prices in bulk by industrial and commercial consumers. It is worth noting that the UK already has the highest effective rate of derv duty in the European Community (except for Ireland), and this may be quoted in any criticism of increases of the order of 12p or 13p a gallon.

20. VED on cars and light vans was not revalorised in 1986, the loss being offset by over-indexation of petrol duty. You have indicated that you would be prepared to consider a similar course in 1987, and it would be welcomed by the Secretary of State for Transport - who would actually like a bigger switch than that implies. The main arguments in favour of repeating last year's pattern are that it relates the duty burden more closely to the actual mileage driven, to the advantage of private motorists and pensioners who drive fewer miles than average. The corollary of that argument, though, is that it would hit essential business users of cars proportionately more. VED is generally perceived as a less unpopular tax than petrol duty - there was surprisingly little criticism of the increase of more than double revalorisation in the 1985 Budget - but the state of petrol prices may again give scope for loading the duty increase on to petrol duty. A revenue-neutral package combining a standstill on car VED together with over-indexation of petrol duty would require a total increase in the price of (leaded) petrol of 4.7p per gallon.

ALCOHOLIC DRINKS

21. Despite this year's standstill on duties, a substantial sector of the drinks market remains sluggish. Consumption of beer, which amounts for nearly half of the revenue from alcoholic drinks, fell by 0.1 per cent in the first 8 months of 1986, though generally brewers have maintained profits by raising prices. Nor is the spirits market buoyant; clearances of whisky were down 3% in the same period. (It is too early to assess the whisky industry's sales performance this year as figures for the all-important pre-Christmas period are not yet available. Although whisky sales were up in 1985, and trade journals suggest 1986 will be a record year, the industry itself is pessimistic about its current prospects.) In the first seven months of 1986 gin clearances were down 11% and vodka clearances were up 1.4%. We think that overall trends, both short and medium term, are

against spirits. Cider had a poor first half-year in 1986: down 2.8 per cent. On the other hand table wine sales remain buoyant: up 6.2 per cent to August. Sparkling wine sales continue to grow: up 8 per cent to August. Year-on-year figures for fortified wine clearances are badly obscured by the fall-out from blocking the 'blending' loophole and by vermouth producers' decision to drop the strength of their product.

22. Looking at the sector as a whole, we see no overriding reason in principle for not at least revalorising all the drinks duties. However, there are complicating factors. Revenue arguments point towards at least revalorisation, and the health lobby will certainly look for a real increase in duty levels. But, given the duty standstill in this year's Budget, it would be awkward to present any general increase on drinks much above revalorisation as consistent with that decision. This would only be possible if the treatment of drinks was seen to be consistent with the treatment of excise duties as a whole.

23. Other considerations affect decisions on individual duties. For example, the brewers are up in arms about the proposed changes to the VAT partial exemption rules. On their reckoning they could lose concessions of up to £70 million a year. This is greatly exaggerated and we would expect after further detailed discussions with the industry to reduce the burden to no more than £25 million in 1987-88 but this would still be substantial as a proportion of the additional £60 million we could get from revalorisation of beer duty. The brewers could be expected to complain of being doubly taxed if both went ahead, and you have suggested going easy on the excise duty as possible mitigation.

24. The relative levels of the different duties are also a factor. Beer duty has risen some 20 per cent more than revalorisation since 1979 while spirits duty has fallen by nearly 25 per cent, the duty ratio between the two (for equal amounts of alcohol) having changed from 1:2.5 to 1:1.6. Although this has been welcomed by the spirits industry as a clear signal both that the Government is moving towards equality of treatment for all drinks (a shift that they want to see continue) and, latterly, that it sympathises with the whisky producers' problems over stock relief, the brewers are naturally less happy. Table wine duty cannot be increased by more proportionally than beer duty because of the European Court's judgement;

and to do less would be perverse for an imported product with a buoyant market. Our review of the wine duty structure (which the MST is considering) may indicate that some changes in relative duty levels are appropriate, and a rise in the table wine duty could help here. The duty on sparkling wine is not constrained by the beer/wine judgement but is already some 65 per cent above that on still wine, and we suggest that the same percentage increase should be applied to both. Cider ceased in 1984 to be the star performer of the drinks trade and there is no current threat of EC infraction proceedings as an incentive to increase the real rate of duty (now about half that on beer). Indeed a substantial increase could be harmful to this essentially domestic industry.

25. These factors point in various directions, and there is no simple route through the maze. We suggest that the following approach may help. First, looking at drinks as a whole, should the duty increase be strict revalorisation, an increase in line with that decided upon for excise duties as a whole or something less? Second, within that overall "envelope", what grounds are there for special treatment for particular duties? Here it may be easiest to start with beer and table wine, which between them account for around 60 per cent of total drinks receipts, and where the brewers' VAT problems may point to an increase a little below the level for the excise duties as a whole. Having set a level for the beer and wine duties, decisions can follow on spirits. There is a case for lenient treatment related to relativities and in the case of whisky, stock relief; this points to giving spirits similar treatment to beer. Finally the less important duties (fortified wines and cider) can slot into place in the light of the levels of the main duties and the other considerations outlined above.

26. Strict revalorisation of all the drinks duties would produce the following result:

	Typical price change (incl VAT) pence	Duty increase %		Yield 1987/88 £m	RPI impact effect %
Beer (pint)	0.7	3.25		55	0.04
Cider (pint)	0.3	3.25		Neg	-
Table wine (bottle)	2.6	3.25		15	0.02
Sparkling wine (bottle)	4.2	3.25	)		-
Sherry (bottle)	4.4	3.25	)	5	-
Port (bottle)	5.1	3.25	)		-
Spirits (bottle)	17.7	3.25		25	0.02
TOTAL				95	0.08

MATCHES AND MECHANICAL LIGHTERS

27. At your request these duties have been reviewed again this year. Mr Knox's note to the Minister of State of 19 November sets out the arguments for retention of both duties and recommends unchanged duty rates this year. A standstill would have a nil scorecard effect. At his meeting on 3 December to discuss our starters, the Minister of State expressed an inclination not to proceed with abolition. (This would certainly accord with the recent French decision to increase domestic excise duties on matches and lighters, although we cannot plead their excuse - that of raising funds to finance the extinction of forest fires on the Cote d'Azur!)

BETTING AND GAMING

28. These duties are considered in Mr Knox's note to the Minister of State of 14 November. The main scope for change is in your suggestion for abolishing on-course betting duty and recouping the revenue from gaming machine licence duty. That can be achieved by revalorising from the date of the last increase (a rise of some 25 per cent). Although we do not know what demand effects such an increase in gaming machine licence duty would have, the changes together should be

revenue-neutral against both indexed and non-indexed bases. In addition to this switch we understand that Ministerial approval has been given to restructuring the pool betting duty on a graduated scale, thus shifting the burden from the smaller pools to Littlewoods - roughly revenue-neutral.

MINOR OILS

29. Consumption of gas oil is static or even falling, while there is some growth in fuel oil use following the fall in oil prices. Product prices are currently well below their pre-Budget 1986 levels. A revalorisation of the minor oils as a whole would yield about £5 million. We assume, as in previous years, that the rate of fuel oil duty is to stay unchanged, and the increase in gas oil duty needed to yield £5 million overall would amount to around 0.27p per gallon on the existing duty of 5p per gallon. We think that after the extensive changes in Budget 1986, the minor oils could reasonably be left alone this year, with the prospect of a more significant increase in gas oil (say £10 million and 1/2p a gallon) in a subsequent year. You are considering whether to require pleasure craft to use fully dutied derv rather than gas oil: our advice (in Mr Jefferson Smith's paper of 12 December) is that given the modest yield (about £15 million) the disadvantages outweigh the benefits.

RETAIL PRICE INDEX

30. From January 1987 both derv and unleaded petrol are to be added to the RPI. The details are not yet available but we can be fairly certain that the RPI impact effect of changes will be small.

31. The RPI impact effect of revalorisation across-the-board would be about 0.3 per cent. But by the time the effect of any excise duty increases was added to the RPI the 0.6 per cent increase resulting from both the excise duty and income tax changes in this year's Budget will be dropping out of the year-on-year rate of change. This means that there could be headroom for excise duty changes amounting to up to twice revalorisation without adversely affecting the index, although this headroom would need to be considered in the light of any changes on the direct tax side with RPI implications.

SECRET

BUSINESS COSTS

32. Businesses account for about one third of petrol consumption and virtually all of derv. Revalorisation of all the duties (nil in scorecard terms) would add about £125 million to business costs in 1987-88. A further £30m would arise from revalorisation of VED.

DEADLINES FOR DECISIONS

33. Decisions on the rates of excise duties should ideally be taken 2 clear weeks before the Budget and on VED 4 weeks. Final decisions could be left until after those dates, but with an increasing risk of error if more than one or two items were still undecided. It is possible as a contingency to print and distribute documentation on specific alternatives, the degree of risk depending on how complicated the changes are and the amount of time given to mount the exercise. If a last minute change were necessary there would be scope for reviewing decisions as late as 3 or even 2 days before the Budget. This particularly applies to tobacco, for which duty changes do not take effect until the Friday after the Budget, affecting relatively few traders. For the other excise duties very late changes could be managed if the decision was between specified alternatives eg 5p or 6p on petrol. In general, and this is true for all our taxes and duties, the earlier the decisions are taken the smoother the printing operation. It is helpful to have any decisions in advance of the deadline.

Bryce Knox

B H KNOX

ANNEX A (i)

REVALORISATION AT 3.25% (1)

	Price change including VAT on typical item(2)	Yield(3) 1987-88 £m (4)	Yield(3) 1988-89 £m	RPI impact effect(5) %
Beer	0.7p per pint	55	60	0.04
Cider	0.3p per pint	neg	neg	neg
Wine - table wine	2.6p per 70cl	10	15	0.02
- sherry	4.4p per 70cl)	5	5	Neg
- port	5.1p per 70cl)			
Spirits	17.7p per 75cl bottle	25	25	0.02
Tobacco - cigarettes(6)	3.0p per 20 KS	80	85	0.09
- pipe	2.3p per 25 gram	neg	neg	neg
- cigars	1.6p per 5 whiffs	5	5	nil
Petrol	3.3p per gallon	165	180	0.08
Derv(7)	2.8p per gallon	35	40	(see note 8)
VED - cars	£3.25 per year	65	65	0.03
- other		15	15	nil
Minor duties(9)		5	5	neg
TOTAL		465	500	0.28

(1) Autumn statement forecast of revalorisation factor.
(2) VAT is payable in addition to the duty except in the case of VED.
(3) Rounded to nearest £5 m.
(4) Assuming mid-March Budget.
(5) Rounded to 2 decimal places. Total ignores "neg" entries.
(6) Includes hand-rolling tobacco.
(7) Most derv consumers can reclaim VAT.
Revenue estimates assume 10% offset for bus fuel grants.
(8) Derv to be included in the RPI from January: weight not yet known, but impact effect likely to be negligible.
(9) Minor oils, matches & mechanical lighters, gaming machine licences.

SECRET

ANNEX A (ii)

READY RECKONER: SPECIFIC DUTIES INCREASED BY 1%

The larger the increases, the less accurate is this ready reckoner, but the figures can be multiplied by up to 10 with reasonable accuracy.

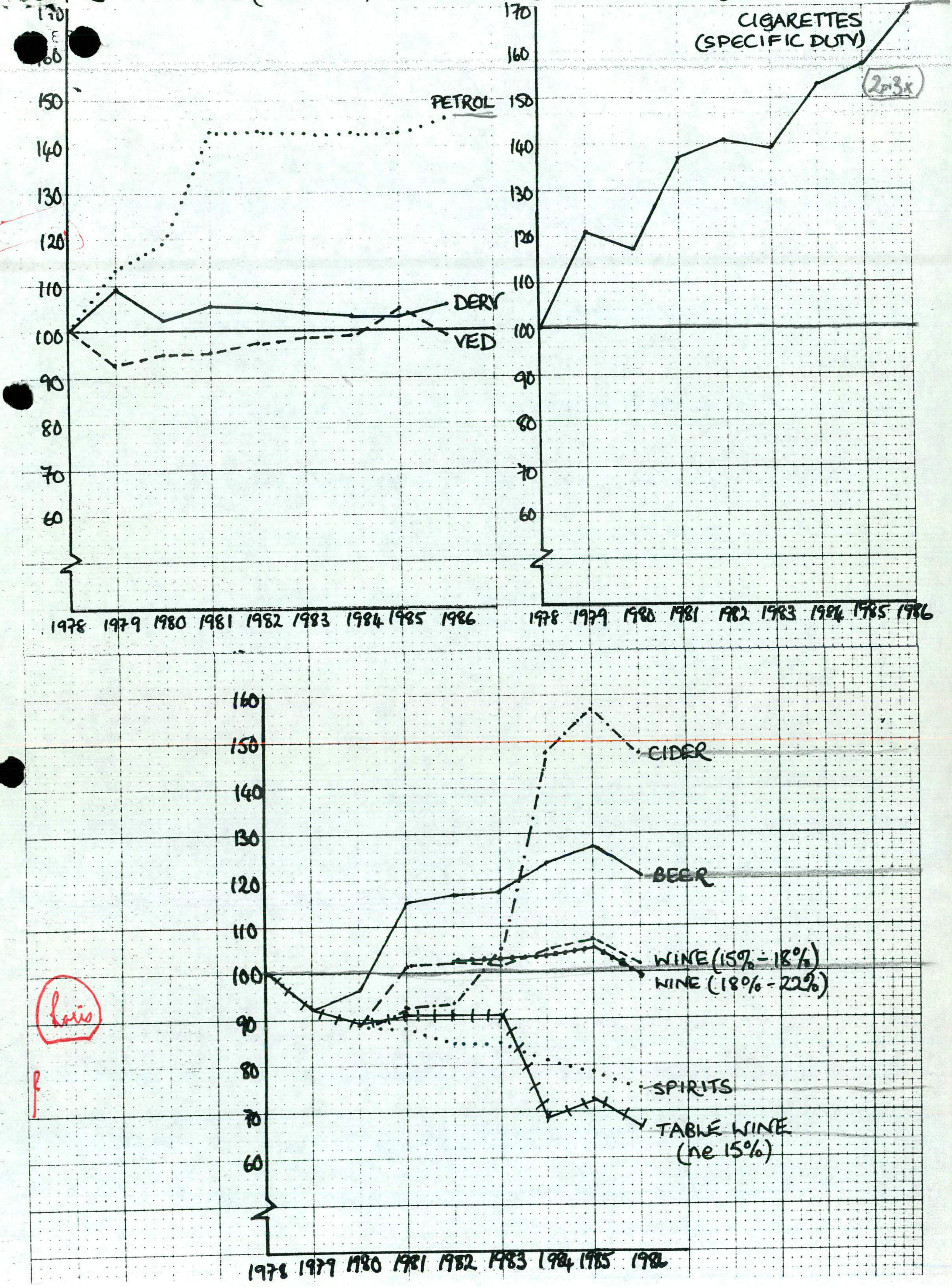
	Price change including VAT on typical item(1)	Yield(2)		RPI impact effect(4)
		1987-88 £m (3)	1988-89 £m	%
Beer	0.2p per pint	17	19	0.01
Cider	0.1p per pint	neg	neg	neg
Wine - table wine	0.8p per 70cl			
- sherry	1.4p per 70cl)	5	5	0.01
- port	1.6p per 70cl)			
Spirits	5.4p per 75cl bottle	7	8	0.01
Tobacco	0.9p per 20 KS	27	29	0.03
Petrol	1.0p per gallon	50	55	0.02
Derv(5)	0.9p per gallon	12	13	(see note 6)
VED - cars	£1.00 per year	21	21	0.01
- other		5	5	nil
Minor duties (7)		1	1	neg
TOTAL		145	156	0.09

neg = negligible

(1) VAT is payable in addition to the duty except in the case of VED.
(2) Rounded to nearest £5 m.
(3) Assuming mid-March Budget.
(4) Based on latest RPI.
Rounded to 2 decimal places.
Total ignores "neg" entries.
(5) Most derv consumers can reclaim VAT.
Revenue estimates assume 10% offset for bus fuel grants.
(6) Derv to be included in the RPI from January: weight not yet known, but impact effect likely to be negligible.
(7) Minor oils, matches & mechanical lighters, gaming machine licences.

ANNEX B

DUTY RATES INDEXED (1978 = 100) RELATIVE TO REVALORISATION (REVALORISATION = 100)



RA3.3 CONFIDENTIAL

Ch
For Terry & Peter
meeting @ 5PM

FROM: A C S ALLAN
DATE: 18 December 1986

SIR T BURNS

cc Sir P Middleton

PSBR AND INTEREST RATES

As I have explained to you, the Chancellor would be grateful for an analysis of the evidence on the relationship between the PSBR and interest rates in the 1980s. He made the point to the Prime Minister that, while there had been an evident correlation in the 1970s, this appeared to have broken down in the 1980s.

2. He feels there are a number of reasons why this might be so:

(i) The increasing integration of worldwide capital markets means that the UK interest rates is much more effected by world conditions than UK conditions alone.

(ii) The declining size of public sector borrowing - particularly relative to private sector borrowing - means that marginal changes in the PSBR have little effect on interest rates.

(iii) Interest rates are crucially effected by exchange rate expectations, and the increasing volatility in exchange markets (and the variety of factors which influence them) means that the PSBR played a much less important role.

3. Your paper for Chevening discusses both why we might expect a link between the PSBR and interest rates, and also why that link might be difficult to observe ex post. We agreed that you would discuss at your meeting with the Chancellor this afternoon what further work might be helpful.

ACSA

A C S ALLAN

RA3.5

CHANCELLOR OF THE EXCHEQUER

NOTE OF A MEETING AT NO.11 DOWNING STREET AT 5.00PM ON THURSDAY 18 DECEMBER

Present	Chancellor Sir P Middleton Sir T Burns

ECONOMIC PROSPECTS

The Chancellor said he would like to see an empirical study of the relationship between the PSBR and interest rates in the 1980s. Sir T Burns said much of the first part of his draft paper for Chevening discussed this. Even if there was no ex post correlation, that did not necessarily affect the conclusion that for a given growth of money GDP there was a trade-off between the PSBR and interest rates. The main reason why there had been a correlation in the 1970s was because the PSBR, interest rates and nominal GDP were all being affected by fluctuations in inflation. In the 1980s there was no longer that force at work, and the ex post link was no longer obvious.

2. One argument why a link might have broken down was the greater integration of world capital markets. But even if, at the extreme, the interest rate was pegged at a particular level for external reasons, it would still be true that a higher PSBR implied a higher growth of nominal GDP and of MO. The only circumstances in which there might be no trade-off, would be in a Riccardian world of super-rationality, where tax cuts led to an increase in personal savings.

3. The Chancellor said it was not in dispute that interest rates were affected by a large number of different factors. But it was important to estimate how big an effect the PSBR had, as compared,

ECON^C
PROSPECTS
MTG
18/12

for example, with world interest rates and exchange rate expectations. He thought that effects from the exchange rate would swamp any PSBR effect.

4. Sir T Burns said he fully accepted that the size of an interest rate rise needed to offset the effects of a higher PSBR depended on the leverage of interest rates on money GDP, and that that in turn depended critically on the exchange rate effect. He certainly could not guarantee that a lower PSBR next year would lead to lower interest rates than we now had in prospect. But he still believed that all other things being equal a lower PSBR would lead to lower interest rates than we would otherwise have.

5. The Chancellor asked about the size of the effects. Sir T Burns said that this depended critically on the assumptions made. The estimate from model runs was that if the PSBR was lowered by 1 per cent of GDP that would allow a 1 per cent cut in real interest rates. The Chancellor noted that that implied that a £1 billion PSBR cut would allow ¼ per cent off interest rates.

6. Sir P Middleton said he thought that the relationship between the exchange rate and interest rates had deteriorated recently, in the sense that for a given interest rate change we now got a smaller exchange rate effect than we use to. The Chancellor thought this was an important point and wondered what the explanation might be. Sir T Burns said that there was no obvious reason, except that the UK was out of fashion. Sir P Middleton noted that this could turn round very quickly, and that made analysis difficult.

7. Sir T Burns said that a critical issue for the future was whether the rate of increase in consumer spending in the UK was sustainable, and if it was not, whether it would subside of its own accord. It was now rising faster in the UK than in any other country; yet we were the country which had lost substantial oil revenues. Our unit labour costs were also rising faster than those

of our competitors. The Chancellor saw no easy answer to this. One thing that might cause a slowdown in consumption was if the stock market dipped markedly; it had been flat since the Budget. There seemed to be very little the Government could do about unit labour costs, or indeed about political worries.

8. Sir T Burns said that two propositions which needed to be discussed were first, were the problems we now faced the result of a lax fixcal policy? And second, even with a tigher fiscal policy would we be any better off? 1985-86 had seen a significant tightening of fiscal policy, and 1986-87 had been tighter than in any other previous year (and the recent evidence showed a considerable PSBR undershoot). We were also undershooting our money GDP this year. But nonetheless the prospect for the future were for money GDP growth much higher than our ambitions. The September forecast had shown growth of 2 per cent above the MTFS path, though it was possible that was too gloomy.

9. His assessment was that we should reduce growth of money GDP by about 1 per cent a year relative to its forecast path. To do this, the forecast implied that we needed either 1 per cent on real interest rates or 1 per cent off the PSBR ratio. He thought there was a strong case for not putting all the weight on interest rates: there were genuine worries about the growth of consumption, the balance of payments position, and the existing level of real interest rates. But he thought that some tax cuts were necessary to lubricate tax reform, and that in turn was very important for its supply side effects. So he would use any fiscal adjustment partly to tighten fiscal policy and partly to cut taxes, but with the bulk on fiscal policy.

10. Sir P Middleton thought the relationship between the PSBR and interest rates was crucial. He thought it was risky to assume that the path of money GDP would revert closer to the MTFS path of its own accord, either from an exchange rate change or from consumption

slackening off. It we did decide that action was needed, we had to decide between action on fiscal policy and further rises on interest rates. The argument for fiscal policy was that it had a bigger effect on consumption. He also thought we needed a lower M0 target.

11. The Chancellor said that he thought it was important (assuming there was scope) to have tax cuts in the Budget to show we had not ground to a halt on tax reform. What he had in mind was a cut of 1p or 2p. It would be helpful if further work could be done based on a range of PSBRs, subject to the overriding constraint of not exceeding $1\frac{3}{4}$ per cent of GDP. He thought that it would only be credible to go below $1\frac{3}{4}$ per cent for 1987-88 if we could show the PSBR path going down faster over the whole of the MTFS period. It was important to concentrate on the medium term path, and not to go back to fine-tuning the PSBR. He thought the Budget which would have the best effect on the markets would be one which was both tighter than expected and also popular.

ACSA

A C S ALLAN
19 December 1986

Distribution

Sir P Middleton
Sir T Burns

CONFIDENTIAL

pmo

* Pl do chart B1 for 1980s as 7.

FROM: SIR T BURNS

DATE: 19 DECEMBER 1986

CHANCELLOR

cc
Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Mr F E R Butler
Sir G Littler
Mr Cassell
Mr Odling-Smee
Mr Peretz
Mr Scholar
Mr Sedgwick
Mr Riley
Mr Allan
Mr Cropper
Mr Ross Goobey
Mr Tyrie

Mr Battishill - I/R
Sir A Fraser - C & E

POLICY BACKGROUND TO THE 1987 BUDGET

I attach my paper for Chevening.

T BURNS

ENC

POLICY BACKGROUND TO THE 1987 MTFS

I. RECENT ECONOMIC DEVELOPMENTS

The MTFS has now been in place for nearly seven years. It was introduced in 1980 and set out targets for monetary growth and an illustrative path for the PSBR, with the aim of bringing about a progressive fall in the rate of inflation and establishing the conditions for a sustained growth in output.

2. Although the monetary targets and the PSBR path have been subject to significant revisions, the overall thrust of policy as measured by money GDP has been achieved. The first two years of the MTFS saw a halving of money GDP growth from 20 per cent in 1979-80 to 10 per cent in 1981-82, and after a further slight decline the growth rate flattened out at 8-8½ per cent from 1983-84 to 1985-86. A step down from the level seems in prospect for the current financial year, although latest data which point to a growth rate of 5½ per cent probably represent a minimum estimate. The rate of inflation, as measured by the GDP deflator, fell from 17 per cent in 1979-80 to 4¼ per cent in 1984-85, and is expected to be even lower this year after jumping up in 1985-86. The recent behaviour of money GDP, output and inflation is set out in Table 1 below.

Table 1

Money GDP and the Inflation/Output Split
(per cent per annum)

	1979-80	1980-81	1981-82	1982-83	1983-84[1]	1984-85[1]	1985-86[1]	1986-87[1]
Money GDP growth	19.9	13.8	10.0	9.2	8.3	8.6	8.2	5.4[2]
Output growth	2.8	-3.8	0.1	2.0	3.6	4.0	2.1	2.3[2]
Inflation								
GDP deflator	16.9	18.5	9.9	7.3	4.6	4.3	6.1	2.9[2]
RPI	15.8	16.3	11.5	7.1	4.7	5.1	5.9	3.1

[1] Adjusted for the coal strike

[2] Autumn Statement forecast (broadly consistent with latest data, data, but will probably be subject to upward revision - see text.

3. Since 1979-80 the decline in the rate of inflation has matched the decline in money GDP growth, resulting in a marked improvement in the split of money GDP between output and inflation. Since the spring of 1981 annual output growth has been fairly steady, averaging over $2\frac{3}{4}$%. These output gains make up nearly two-fifths of the corresponding growth of money GDP.

4. Over the whole period since 1979 the growth rate obviously looks less good, but even here a substantial improvement in the output/inflation balance shows up relative to the previous six years (see Table 2). The growth of money GDP has declined from 18 per cent in 1973-79 to under 10 per cent in 1979-86. Output growth was similar in the two periods despite the deep recession in 1980 and 1981, so that inflation was halved between the two periods. In terms of the composition of real demand between expenditure categories the later period has seen a switch towards private consumption & investment, and away from government consumption (see Table 3) & 'net trade'.

Table 2

Post Oil Shock Output/Inflation Split in the UK and Elsewhere

(per cent per annum)

	UK		**OECD Major 6**	
	1973-79	**1979-86**	**1973-79**	**1979-86**
Money GDP growth	17.7	9.6	11.2	8.0
Inflation (GDP deflator)	16.0	8.1	8.0	5.7
Output growth	1.3	1.4	2.9	2.2

Table 3

The Components of Real Final Demand

(per cent per annum)

	1973-79	**1979-86**
Private consumption	1.3	2.1
Government consumption	1.9	1.1
Fixed investment	0.2	1.0
Stockbuilding*	-0.2	-0.1
Domestic demand	1.0	1.6
Net trade*	0.6	-0.2
GDP(E) at constant market prices	1.5	1.4
GDP(A) at constant factor cost	1.3	1.4

*Change as % of GDP at market prices

5. Following the second oil price shock we have seen a bigger improvement in the output/inflation split in the UK than in the major six OECD countries (table 2). Although UK performance has still been worse in absolute terms than the average of the rest of the G7 the gap has been much reduced.

6. Some slowdown in real earnings growth has probably contributed to the slightly better inflation/output mix in the average of the rest of the G7 countries since 1979 (Table 4). Productivity performance was similar between the two periods and so the lower real earnings growth enabled these countries to contain the inflationary impact of higher oil prices without the excessive squeeze on profits that characterised the years after the first oil price shock. As a result their unemployment has risen less than it otherwise might have done.

Table 4

Earnings and Productivity Growth

(per cent per annum)

	UK		OECD Major 6	
	1973-79	1979-86	1973-79	1979-86
Whole economy earnings growth:				
- nominal	16.5	10.0	13.0	8.2
- real*	0.9	1.9	3.9	2.0
Productivity growth:				
- whole economy**	0.4	1.6	1.3	1.3
- manufacturing	0.7	3.1	2.9	3.3
Unemployment†(%)				
- first year	2.1	4.3	3.8	5.1
- final year	4.3	11.5	5.1	7.2

*nominal earnings growth less RPI inflation

**excluding North Sea for UK

†Narrow, claimants basis for UK

7. In the UK, by contrast, real earnings and productivity have grown faster since 1979 than between 1973 and 1979. The productivity gap between the UK and the other countries had widened significantly between 1973 and 1979. This provided plenty of scope for a major shake out of labour once the general economic climate changed in the early 1980s. Spurred on by the relatively higher rate of real earnings growth the result has been a much faster rate of productivity growth since 1979. Indeed since 1979 productivity growth in the economy as a whole has exceeded the average of the major six, and in manufacturing it has been on a par with that of the major six.

Note this
speech

8. This faster growth of productivity largely explains the bigger rise in UK unemployment since 1979 than in the six years before, despite similar output growth. It also partly explains the increase in UK unemployment relative to other countries since 1979. A decisive turnround in unemployment would seem to depend importantly on slower real earnings growth. — no doubt true, but not sufficient!

Table 5

Balance of Payments Current Account

(Percent of money GDP)

	1974-79	**1980-84**	**1985**	**1986** Estimate
Oil[1]	-2.6	0.6	1.3	0.8
Manufactures	3.0	0.6	-0.9	-1.6
Other goods & services	-1.9	-0.6	-0.5	-0.4
IPD[1]	1.1	1.5	2.0	1.9
Current account[2]	-1.1	1.3	1.0	0.1

[1] Oil includes and IPD excludes North Sea profits due abroad.

[2] Includes net transfers

9. The fall in the oil price has focussed attention on the balance of payments again, after a number of years of surplus on current account. Although North Sea oil was the main factor behind the surplus, the balances on goods and services other than manufactures and IPD were both significantly better than in the 1970s (Table 5). A step improvement in the balance on

agricultural trade associated with CAP production incentives and declining real commodity prices contributed to the former, while the rise in IPD reflects the increase in net overseas assets. At the same time there was a major decline in the balance of trade in manufactures as manufacturing bore the brunt of the structural adjustments of the early 1980s.

10. With the fall in the oil price halving the net oil balance in 1986 and a further decline in the manufactures balance, the current account surplus is expected to disappear in 1986. The oil balance may fall to zero by the end of the decade as oil production declines. A rise in the combined balance of all other items will be required to avoid a substantial current account deficit.

?

II. ARRANGEMENT OF THE PAPER

11. Against the background of these developments, the paper first sets out the framework for setting policy, and then interprets and comments on the current situation. Although fiscal policy is the main focus of attention, it is discussed in the context of the overall stance of policy and the evolution of monetary conditions.

12. The paper does not address the questions of the continuous assessment of monetary conditions - which variables to target, for how long, and what target ranges. Separate work is proceeding on this with MG in the lead.

13. It is taken as given that money GDP will continue in the centre of the stage. The role of interest rates and fiscal policy in influencing money GDP is discussed, in the context of the original MTFS and our more recent perspectives. It is argued that whichever way one looks at it there is a trade-off between using interest rates and fiscal policy in keeping money GDP on track over the medium term. The choice between them should depend on the implications of different mixes for the structural balance within the economy, particularly for the state of the current account and the share of consumption in GDP.

This ignores the crucial questions of (a) the relative weights you give the aims, (b) the central importance of money in doing [illegible], + (c) the supply-side case for lower taxation

14. The current position is examined first from the point of view of the overall policy stance. The October forecast is compared with the MTFS and an attempt made to explain the differences. The implications for the overall policy stance are discussed.

15. The current position is also examined in terms of the policy mix and an attempt made to set out the case for and against some shift in balance between interest rates and fiscal policy largely in relation to recent and prospective developments in monetary conditions, fiscal conditions and the structure of the economy.

16. The policy discussion is confined to monetary and fiscal policies. However, some of the most troublesome problems - the inflation/output mix, high unemployment, trade performance of manufactures - are not greatly influenced by macro-economic measures. The cure for these lies primarily on the supply side, which the Government is tackling by improving the operation of markets. Inevitably progress will only be gradual. To the extent that they can have some impact on the supply side, for example through influencing saving and investment behaviour, the role of macro-economic policies in these areas is discussed in the paper.

17. A view has to be taken about the likely evolution of some of these supply side factors in deciding on money GDP objectives over the medium term. But particular assumptions for money GDP, output growth and inflation for the MTFS are not discussed in this paper.

III. THE FRAMEWORK

Money GDP

18. We assume that the growth of money GDP remains the main objective for the medium term. The transition to giving it greater emphasis in the 1986 MTFS went fairly smoothly, although there were some critical remarks, for example from the TCSC. Its role in the MTFS can now be consolidated.

19. Last year's MTFS set out an assumed path for money GDP growth showing a decline from just under 7 per cent in 1986-87 to 5½ per cent in 1989-90 (see table 6).

Table 6

Money GDP, Output and Inflation in the 1986 MTFS

(per cent change on previous year)

	1985-86	1986-87	1987-88	1988-89	1989-90
Money GDP	9½(8¼)[1]	6¾	6½	6	5½
GDP deflator	6	3¾	3¾	3½	3
Real GDP					
Non-North Sea	3¾	3	2¾	2¾	2¾
Total	3½	3	2½	2½	2½

[1] Figure in brackets is adjusted for the coal strike

20. It was assumed that real GDP would grow at about 2½ per cent a year so that inflation would be reduced from 3¾ per cent to 3 per cent over the period.

21. At the same time we have accepted that in the short run the speed of deceleration of money GDP growth will influence the inflation-output balance. A sharper deceleration of money GDP growth will mean a slower growth of output in the short term although inflation will be brought down more rapidly. By contrast if money GDP growth is not reduced output growth in the short term may be faster but it is unlikely that inflation will fall.

Original MTFS

22. In earlier versions of the MTFS £M3 provided the central framework of policy:

- the aim was to exert downward pressure on inflation by controlling nominal demand, much as now, although the role of money GDP was implicit rather than explicit;

- a gradually reducing growth of £M3 was expected to deliver gradually reducing growth of money GDP;

NL changed relative emphasis of these two elements

- for any given growth of £M3 the path of interest rates was held to depend on the stance of fiscal policy - the PSBR - and the demand for bank lending;

- this meant a declining path for the PSBR to avoid "excessive reliance" on interest rates in reducing monetary growth.

23. Essentially the principle that was followed was one of balance. Fiscal and monetary policy would be kept in balance with a progressive tightening of monetary policy accompanied by a falling PSBR ratio.

24. There were two reasons for seeking to avoid excessive pressure on interest rates:

- to minimise the pressure on investment and interest-sensitive components of demand;

- to increase credibility that the policy would be sustained given that politically-sensitive levels of interest rates were more likely to lead to a forced easing of monetary conditions in general.

Lombard Speech

25. It has become more difficult to articulate the role of monetary and fiscal policy without the anchor of the £M3 target.

26. However the essence of the approach remains intact. The primary aim of macro-economic policy is to deliver the desired medium-term profile for money GDP growth. The Lombard speech outlined that this was to be achieved by a continuing commitment to financial discipline. Monetary targets still have a role to play although that information must be supplemented by an intelligent assessment of monetary conditions, including the exchange rate.

27. We also continue to believe that fiscal policy must support monetary policy. The Lombard Speech argued that:

- it is important that public sector debt should not rise as a percentage of GDP;

- the Budget deficit must be set at a level that can be comfortably financed in a non-inflationary way;

- there should be scope for absorbing possible fiscal shocks.

28. This maintains the principles of the original approach towards fiscal policy. A level of public sector debt that is broadly steady as a percentage of GDP is consistent with a balanced approach to monetary and fiscal policy. It means that a gradually declining path for money GDP growth should be accompanied by a falling PSBR ratio. And the degree of comfort in financing the PSBR can be interpreted as the level of interest rates that has to be paid to achieve a full fund. Thus although we have moved some way from a framework based on £M3, the need remains for the PSBR to decline as a ratio of GDP; and the essential trade-off between fiscal policy and interest rates stands.

given monetary rule

The implications of an MO target

29. In the last MTFS targets were set for both broad (£M3) and narrow (MO) money. The basic principles were as follows:

- it is necessary to monitor the growth of broad money as it is not possible to tolerate an unlimited build-up of liquidity. We must satisfy ourselves that further increases in liquidity reflect the private sector's desires;

- MO must be watched to check that any level of liquidity is not being translated into higher spending.

30. During the past year £M3 has grown even more rapidly and it has become increasingly difficult to interpret the implications. Inevitably we have been thrown into placing more emphasis on the behaviour of MO.

31. When monitoring the growth of MO it is important to take into account a number of its features (see Annex A):

- the historical velocity trend is about 3½-4 per cent a year; **ceteris paribus** money GDP growth of 6-7 per cent a year is consistent with MO growth of 2½-3 per cent;

- movements in velocity relative to trend will be influenced by interest rates. When nominal interest rates are falling a faster growth of MO is consistent with a given growth of money GDP as the desired ratio of MO to disposable income shifts upwards;

circular & ∴ doubtful

- movements in velocity will be affected by the composition of expenditure. A shift to a high share of personal consumption will also tend to mean a faster growth of MO for a given growth of money GDP;

- as it is closely related to spending it can be no more than a short leading indicator of money GDP.

32. One of the advantages of the £M3 framework was that it was easy, conceptually, to see the relationship between fiscal and monetary policy. The MO framework in fact implies a similar trade-off between fiscal policy and interest rates even though it is not as straightforward as the original £M3 framework.

33. A tighter fiscal policy will reduce MO for given interest rates as private sector post-tax money incomes grow less rapidly. Therefore to maintain the original profile for MO will require lower short-term interest rates. Returning MO to its target path will not be sufficient in itself to maintain money GDP growth unchanged because lower interest rates reduce velocity. In other words the lower interest rates have a bigger effect on MO than on money GDP. But targeting MO leads to the right kind of response.

This then requires offsetting or a looser monetary policy

34. Thus the interest rate-PSBR trade-off is also an implicit characteristic of this framework. Rapid MO growth can be restrained either by interest rate increases or tighter fiscal policy.

Disagree: and this not velocity [illegible] quantified

Determinants of money GDP

35. As a basis for discussing the likely future growth of money GDP and the influence of policy instruments it is useful to consider the determinants of money GDP:

- in addition to world factors and longer-term changes to the saving ratio and the supply side, money GDP will be influenced by interest rates and fiscal policy;

- fiscal policy works through the normal expenditure route, either changing public expenditure directly or private expenditure through changes in taxation or transfers;

ie (at least in the short term) via multiplier

- interest rates exercise their greatest leverage through exchange rate changes which have a major impact on money GDP through prices and net export demand. In addition we judge that interest rates have an influence on consumer durables demand, fixed investment (especially house building) and stockbuilding; [illegible]

ie via (fast) inflation

- exogenous, or confidence-based, changes in the exchange rate exercise a separate influence on money GDP. For given interest rates and given fiscal policy, the lower the exchange rate the higher money GDP.

Not much significance

36. It follows that a lower PSBR will lead to slower growth of money GDP over the medium term for given interest rates; and hence lower interest rates will be consistent with the original money GDP path.

37. We would also expect that sustained changes in the balance between the PSBR and interest rates would affect the structure of demand within the economy and the current account of the balance of payments.

38. For given money GDP growth a combination of a lower PSBR and lower interest rates would be expected to lead to:

- a lower real exchange rate;

- lower real interest rates;

- a slower growth of domestic demand, partly due to the lower real exchange rate and partly due to the direct effects of fiscal tightening (although offset to some degree by lower interest rates). Total consumption would actually grow more slowly unless the fiscal tightening took the form of a reduction in public capital spending;

- an improved net exports balance because of better competitiveness and lower domestic demand growth;

- lower debt service costs that would make for a more comfortable fiscal position later.

39. Whether a switch of this kind, or vice versa, is needed depends upon the prospects for the economy. If an economy is expected, over a number of years, to experience some combination of rapid real domestic growth, high real interest rates, a high real exchange rate, high debt service costs and a current account

PSBR pos? Scarcely any of this: ns pop XR deficit there would be some presumption of a move in the balance towards a lower PSBR and lower interest rates; and vice versa.

The Evidence

40. Annex B presents two charts showing the historical correlation between interest rates and fiscal policy. As we would expect the correlation was most marked when major shifts of inflation occurred. In the mid-1970s we had faster monetary growth, faster money GDP growth, higher levels of borrowing and higher nominal interest rates emerging together. In the late 1970s and 1980s the process went into reverse. But when money GDP growth does not show a sharp sustained change, as in recent years, the observed correlation is less marked. Although, for given money GDP or monetary growth, the trade-off between fiscal policy and interest rates remains fundamental it is not always clearly evident in the data. & thus scarcely exists There are a number of reasons for this:

Chart of 1980s say!

!!

- the relationship can be obscured by the cycle: buoyant output tends to reduce the budget deficit and put upward pressure on interest rates;

- world interest rates influence domestic interest rates for a given fiscal deficit;

mkts!

- highly integrated capital markets imply relatively sharp movements in the exchange rate when interest rates are changed. This weakens the trade-off between the PSBR and interest rates, because small interest rate changes can have large effects on money GDP. It makes it more likely that other factors will obscure the underlying trade-off;

✓

- the relationship depends on expectations in financial markets. If a high PSBR leads to doubts about the overall policy stance and hence pressure on the exchange rate, interest rates have to be higher than they might otherwise have to be to achieve a given GDP objective. On the other hand if there is confidence in the longer-term determination to maintain the desired growth of money GDP, interest rates need not rise so much. For any given PSBR, changes in

Wh. are not chiefly determined by the size of the PSBR confidence can have very large effects on exchange rates, requiring large changes in interest rates to keep policy on track and obscuring the link with fiscal policy.

41. But although these factors tend to obscure the relationship between fiscal deficits and interest rates **ex-post** they do not alter the message that action to reduce fiscal deficits permits lower interest rates for a given growth of money GDP or money supply than would otherwise be the case.

only to a trivial extent

42. In Annex C we show two simulations of a change in the mix towards a lower fiscal deficit (brought about by higher income tax) and lower interest rates. In one money GDP is unchanged and in the other MO is unchanged. We cannot place too much weight on the precise magnitudes involved; there is particular uncertainty about the effects on the exchange rate which depend a good deal on the markets' assessment of the implications of the policy change and the degree of international capital mobility. But they show the scale of effects currently implicit in the Treasury model, which assumes that capital is highly mobile.

43. The results do not differ significantly according to whether money GDP or MO is held unchanged. They can be summarised as follows:

- a move to tighter fiscal policy with lower interest rates leads to very little change in the output/inflation trade-off in the medium term; (but presumably adverse in short term)

- the main difference over the medium term is in the structure of the economy. The simulation results suggest that these effects are modest but in the expected direction. No account is taken of the possibility of longer-term effects if investment behaviour is changed.

Policy implications

44. The implication of this analysis is that:

- interest rates and fiscal policy jointly affect both the growth of MO and money GDP; and different combinations can deliver the same outcome for money GDP;

misleading

- differences in the balance of instruments have an effect on the structural balance within the economy, particularly the state of the current account and the share of consumption in GDP.

This is the only significant consideration – though to some extent this in some ways

45. In practice the way we deal with these ideas is:

- at Budget time we seek to set the overall stance of policy in the shape of a medium-term path for growth of money GDP and to choose a mix of instruments - interest rates and fiscal instruments - that will achieve both the money GDP path and structural objectives;

- between Budgets interest rates are the main policy instrument and are directed towards maintaining monetary conditions consistent with the medium-term profile for the growth of money GDP;

- if emerging circumstances require changes to the mix of instruments this can be done at Budget time as has happened in the past; but there is a presumption against frequent changes in the fiscal stance shown in the MTFS.

✓

46. Choosing the right balance between fiscal policy and interest rates is obviously a matter for judgment and it is possible to reach different conclusions. In the second part of this paper we outline the various factors that need to be considered in the current position.

47. Ensuring that interest rates are adjusted within year to keep monetary conditions on track is also a difficult matter of judgment. In practice it is done by monitoring various key financial magnitudes as well as the progress of inflation and the real economy.

IV. THE CURRENT POSITION

48. It is useful to divide our analysis of the current position into two:

- the overall stance of policy;

- the mix of interest rates and fiscal policy.

The overall stance of policy

49. In recent years we have focussed upon the growth of money GDP as the main indictor of the overall stance of policy over the medium term. The figures are shown in table 7 for the years since 1979-80 together with some five-year averages for earlier years.

50. There was a substantial reduction in the growth of money GDP between 1979-80 and 1982-83. Between 1982-3 and 1985-6 it was broadly flat at between 8 and 9 per cent a year. Reflecting some tightening of policy in early 1985, and lower oil prices, the MTFS showed a significant reduction of money GDP growth this year. It also showed further steady reduction in money GDP in the years ahead.

51. However as the year has progressed first estimates suggest that money GDP growth this year has been less than was forecast in the FSBR. (The extent of this undershoot is still uncertain; different measures of GDP give different figures). But the October forecast showed a bounce-back occurring in 1987-88 and still higher money GDP growth in 1988-89. In other words rather than a steady reduction in money GDP growth the forecast suggests a return to the same sort of growth seen between 1982-83 and 1985-86.

52. Annex D is a diagnosis of the reasons for the faster projected growth of money GDP after 1987 compared with the MTFS. It concludes that the major identifiable factors are:

SW change prov-95

- a rather lower level of the exchange rate for given relative interest rates;

Table 7

The Overall Stance of Policy

(Percentages, except exchange rate which is 1975=100)

	Money GDP Growth	MO Growth	Short-term interest rate	Exchange Rate	PSBR/GDP Ratio Actual	PSBR/GDP Ratio Excluding Privatisation Receipts	Govt. revenues[5] from N Sea ÷ GDP
Annual averages[1]							
1951-55	7.3	5.0	2.5[7]	144.2[6]	3.2	3.2	-
1955-60	6.0	4.0	4.5[7]	144.2[6]	2.4	2.4	-
1960-64	6.6	3.4	4.5[7]	144.2[6]	2.5	2.5	-
1964-68	6.9	4.9	7.0	138.0[6]	3.3	3.3	-
1968-73	11.0	6.6	8.3	125.5	1.9	1.9	-
1973-79	17.6	12.8	11.1	90.7	6.6	6.7	0.2
Financial years							
1980-81	13.8	7.1	15.5	98.2	5.4	5.6	1.7
1981-82	10.0	5.2	14.2	92.3	3.3	3.5	2.5
1982-83	9.2	2.7	11.5	88.0	3.1	3.3	2.8
1983-84	8.3[2]	6.2	9.7	83.5	3.2	3.6	2.9
1984-85	8.6[2]	5.5	10.9	76.2	3.1[3]	3.7[3]	3.7
1985-86	8.2[2]	4.2	12.1	79.0	1.6	2.4	3.1
1986-87[4]	5.4[2] (6.7)	3.8 (2.6)	10.5 (11.2)	71.1 (73.3)	1.9 (1.9)	3.1 (3.1)	1.2 (1.6)
1987-88[4]	7.3 (6.4)	3.9 (3.9)	11.0 (9.7)	66.7 (70.6)	1.7 (1.7)	3.0 (2.9)	1.0 (1.0)
1988-89[4]	8.0 (6.0)	3.5 (4.9)	11.0 (8.5)	64.7 (69.1)	1.6 (1.6)	2.7 (2.7)	0.9 (1.0)

[1] Growth rates measured from first year to last; interest rates, exchange rate and PSBR/GDP ratios are averages of years excluding the first year

[2] Adjusted for coal strike. Unadjusted figures are:
1983-84 8.1 1984-85 7.3 1985-86 9.6 1986-87 5.5
(6.8)

[3] These figures would be 2.3 (actual PSBR) and 2.9 (PSBR excluding privatisation receipts) if they were adjusted for the coal strike

[4] The main figures are from the October forecast except for the 1986-87 PSBR/GDP ratios and North Sea revenues which are from the Autumn Statement. Those in brackets are from the MTFS projection

[5] Before ACT set off

[6] Sterling index not available prior to 1969. Figures based on movements in sterling/US$ rate

[7] Average Treasury Bill yields (later data are 3-month interbank rate)

Will this change @ some pt. - no key problem

- a lower private sector net saving ratio;

- higher real wage growth.

These changes should not be interpreted as just the result of the forecasters revising their judgements. The MTFS was presented on the basis of a better outcome for inflation than shown in the internal forecasts.

53. In each case the revised assumption means that for given interest rates and PSBR profile there are additional pressures making for faster MO and money GDP growth than implicit in the MTFS. Within a non-accommodating financial framework this means higher interest rates or a lower PSBR.

54. The October forecast assumed that the PSBR would be as in the MTFS and that interest rates would be held steady rather than fall as they did in the MTFS assumptions. Even with no decline in nominal interest rates from their current high level the forecast concluded that MO growth would be in the upper half of the target range at between 3 and 4 per cent per annum. Although this was not low enough to deliver the MTFS money GDP profile, a conscious decision was made not to project even higher interest rates. The implied movement of velocity of MO is not out of line with the previous historical experience of a 3½-4 per cent per annum trend. (In the detailed figures underlying the MTFS projections MO growth was also about 4 per cent. This was judged to be consistent with money GDP growth between 6 and 7 per cent because nominal interest rates were projected to fall significantly over the MTFS horizon thus keeping the increase in velocity well below its normal trend.)

Shd we have assumed this

55. At first sight it seems pessimistic to conclude that unchanged nominal interest rates and the declining path of the PSBR will not lead to downward pressure upon money GDP growth.

56. One possibility is that the projections are too gloomy. The record in Annex E shows that internal medium-term forecasts have tended to overstate the inflation rate and understate growth. In

other words there has been more downward pressure upon money GDP than forecast; and a much better inflation/output split.

57. But there are dangers in assuming that the rising profile of money GDP growth is simply forecasting bias:

- more recently the evidence of bias is less apparent as the forecasts have adjusted to the new information, particularly if account is taken of the effects of lower oil prices;

- part of the reason for the improved inflation/output split was the unexpected rapid growth of productivity. More ? recently productivity growth seems to have stabilised and we judge that there is less scope for large productivity gains.

  This means that if there is to be a better inflation/output split it will have to come mainly through better real wage adjustment, and progress on this front remains disappointing;

- the projection of output growth in the MTFS is quite buoyant (close to 3 per cent), by comparison with rather lower figures that were typical in earlier medium-term forecasts.

58. It is difficult to be sure that all the bias has been removed from the forecast, but much of it should have been. Indeed it is interesting to compare the forecast for 1987-88 to 1988-89 with the outturn for 1983-84 to 1985-86. The figures are shown in table 8.

59. In the earlier period:

- money GDP growth averaged 8½ per cent;

- interest rates averaged about 11 per cent;

- the exchange rate fell by between 15 and 20 per cent between 1981-2 and 1984-5;

Table 8

The Overall Stance of Policy: Recent Past and Forecast

(Percentages)

	Money GDP Growth	MO Growth	Short-term interest rate	Exchange Rate Change[2]	PSBR/GDP Ratio Excluding Privati-sation Receipts	Govt. revenues[3] from N Sea ÷ GDP
Annual averages[1]						
1982-83 to 1985-86	8.4[4]	5.3	10.9	-6.2	3.2[5]	3.2
1986-87 to 1988-89 (October Forecast)	7.6	3.7	11.0	-8.1	2.8	1.0
1986-87 to 1988-89 (MTFS)	6.2	4.4	9.1	-5.5	2.8	1.0

[1] Growth rates measured from first year to last; interest rates and PSBR/GDP ratios are averages of years excluding the first year

[2] Lagged one year (ie average change from 1981-82 to 1984-85 for first period)

[3] Before ACT set off

[4] Adjusted for coal strike

[5] Not adjusted for coal strike. The figure would be 3.0 if it was adjusted for the coal strike.

- MO growth averaged about 5 per cent;

- and excluding privatisation receipts the PSBR ratio averaged 3¼ per cent over the three years.

60. For 1986-87 to 1988-89 the October forecast shows:

- a projected outcome for money GDP growth at 7½ per cent;

- interest rates at 11 per cent;

- a fall in the exchange rate of about 15 per cent between 1985-86 and 1987-88;

- MO growth is projected at under 4 per cent;

- and excluding privatisation proceeds the PSBR is set at 2¾ per cent of GDP over the two years.

61. In other words there is not a great deal of difference between the two periods although some account needs to be taken of the much higher level of North Sea revenues in the earlier period. If anything the forecast looks a shade pessimistic on inflation but not by much. What does stand out is that with the present stance of policy the MTFS figures for money GDP growth will be difficult to achieve there are unexpectedly favourable developments, for example in the terms of trade or labour market behaviour.

(OECD point)

62. It is difficult to escape the view that the overall stance of policy is on the easy side if we wish to maintain a profile of gradually declining money GDP over the next few years.

The mix of monetary and fiscal policy

63. What is not so clear is the extent to which any tightening of policy should be achieved by changes to fiscal policy or interest rates.

64. Based upon the previous discussion it is useful to examine the choice in terms of the following criteria:

- an assessment of monetary conditions;
- the stance of fiscal policy and
- the structural balance of the economy.

65. A number of annexes outline the detailed analysis. This section draws on that analysis and orders the material by first setting out the case for relying on higher interest rates; and subsequently setting out the case for tighter fiscal policy. The supporting material for each point of view is presented separately and no attempt is made to present counter-arguments alongside each point. In each case we look, in turn, at arguments relating to monetary conditions, fiscal conditions and the general balance of the economy.

The case for higher interest rates:

66. **Monetary Conditions:**

- all monetary aggregates are now flashing danger signals; broad money growth has been very rapid since the spring, house prices have been rising rapidly, and credit growth remains buoyant in the wake of financial deregulation. Earlier in the year we had the compensating information that MO growth was well under control and PSL2 growth was fairly steady. But in recent months both MO and to a lesser degree PSL2 accelerated. Looking at the behaviour of the monetary aggregates as a whole a case can be made for higher interest rates; ✓
- the main immediate problem has been the weakness of the exchange rate and our interpretation suggests that this is an important channel in putting upward pressure upon inflation. Higher interest rates are an obvious weapon and are likely to produce a predictable response; ✓

- interest rates need to be higher in the UK than elsewhere because of private credit demand, wage growth, and uncertainties about monetary policy and the general election. Under these circumstances it will be difficult to avoid high UK interest rates.

67. **Fiscal Conditions:**

- the PSBR has been reduced. Even excluding asset sales it is lower than since the early '70s, and the projected figures are not much above the average ratio of the 1950s and 1960s;

- the ratio of net public sector debt to GDP has been on a declining trend since 1980-1. The MTFS shows this continuing. By contrast debt/GDP ratios are rising in most other main industrial countries;

- although the PSBR adjusted for asset sales has risen this year, oil revenues have fallen sharply and it is appropriate to absorb some of the revenue loss in higher borrowing;

- fiscal policy needs to be set on a long-term basis and should not be fine tuned in response to a changing assessment of the short-term prospects for money GDP;

- the present PSBR has been funded outside the banking system. The main reason for rapid broad money growth has been rapid growth of private sector credit demand.

68. **The Balance of the Economy:**

- tax reform requires some reduction in overall taxation, and tax reform is an important aspect of improving economic efficiency;

a related tax reduction

- the recent rapid growth of consumption in part reflects a rapid expansion of consumer credit largely as a result of financial deregulation. This is likely to require higher interest rates;

- the projected balance of payments deficit could turn out to be mainly a presentational problem. We have amassed huge overseas financial assets and, because of improved competitiveness, the period of deficit could turn out to be transitional;

presentational unclear, but clearly something in it

- private sector investment has risen markedly as a share of GDP and since the changes in the corporation tax regime we are likely to get better returns from that investment.

✓

The case for a tighter fiscal policy:

69. **Monetary Conditions:**

- real interest rates in the UK are already much higher than elsewhere. Financial deregulation plays a part but it may also reflect both the PSBR and the fears of further exchange rate decline. Exchange rate weakness itself may be related **inter alia** to the prospective current account deficits, which themselves are partly a reflection of fiscal policy;

??

??

- even if the main stimulus to spending originates in private sector credit growth there is a case for offsetting some of its effects by a lower fiscal deficit;

Perhaps!

- the rapid growth of monetary aggregates is partly a function of fiscal policy through its effects on nominal incomes. In any case whatever the cause some tightening of fiscal policy would reduce monetary growth and would be a way of getting policy back on track without further rises in interest rates.

How so?

pretty far-fetched

70. **Fiscal Conditions:**

- adjusted for privatisation proceeds the PSBR is still a little higher than during the average of the 1950s and early 1960s when money GDP growth averaged between 6 and 7 per cent. In addition to privatisation proceeds there are a number of other essentially capital transactions where the

(a) look @ other countries
(b) no need to make allowance correction for a single yr.

demand weight is very low (for example, council house sales, land sales, equity sales). These amount to about ½ per cent of GDP. If correction is also made for these the adjusted PSBR and PSFD are estimated at 3-3½ per cent of GDP over the next two years. This is between ½ and 1 per cent higher than the average of the 1950s and '60s;

Riley!

~~at this~~ What this means is that PSBR path needs to be such that it is sufficiently low for the proceeds from priv. [illegible] to be [illegible] [illegible] even in case for change of path on EX PP basis.

- the public sector debt to GDP ratio has only declined because of privatisation proceeds. Without these the ratio would have risen. This is significant because concern for the debt/income ratio primarily relates to sustainability. Privatisation means a continuing loss of income to the Exchequer which is analogous to the higher interest payments on additional borrowing. The implications for future taxation and sustainability are essentially the same;

- although oil revenues have fallen significantly this year they are still making a contribution between ½ and 1 per cent to the Exchequer over and above the level of 'permanent income' from the North Sea;

hope Schlesinger!

- we have made much less progress since 1979-80 in reducing the budget deficit than Germany and Japan while the deficit in France is also below ours despite our North Sea revenues;

? causality

discuss why

- in practice we are only able at present to fund the PSBR at exceptionally high real interest rates.

71. **The Balance of the Economy:**

- the economy has shifted noticeably in the direction of a higher ratio of personal consumption to GDP. Indeed if the 1987 forecast is correct, by then we shall have had the fastest five-year growth of consumer spending in decades. And recently the growth of consumption in the UK is faster than the average of the main industrial countries. This is in part a function of the rapid growth of real incomes and is not sustainable; ✓

- this picture is not changed if we take private and public sector consumption together. And it is happening at a time when relative to elsewhere the contribution of North Sea income is declining. This suggests that UK domestic demand will have to grow less rapidly than GDP whereas lower oil prices mean that for the industrialised countries as a whole domestic demand can grow faster than GDP;

So what?

- the balance of payments could become a serious problem. We should not take too much comfort from external assets and the invisible balance. External assets largely reflect revaluations and the effect of a falling exchange rate. Only £21 billions of the increase since 1979 reflects cumulative current account surpluses. The effect of the revaluations could of course be reversed with a weakening decline in the dollar or weaker stock markets. And much of the invisible surplus represents profits and dividends which in practice tend to be invested abroad rather than repatriated. So the underlying level of capital outflows might be increasing;

✓

depends on supply-side constraints

- the fall we have had in the exchange rate associated with the oil price fall points to the need for restraint of domestic demand to help shift resources into the external balance;

?

- the present levels of unemployment and capacity utilisation strongly suggest that we are in need of an expansion of industrial capacity, which in turn means a higher investment ratio. The prospective decline in revenues from North Sea oil point in the same direction;

Not necessarily: as relative costs of labour & capital

- the declining share of the public sector in total investment and the need to encourage private investment both point to a lower level of public borrowing and lower interest rates.

V. ASSESSMENT

72. The balance of evidence suggests that the present combination of interest rates and fiscal policy may not be sufficient to deliver the desired path of money GDP over the medium term. The lower exchange rate and continued rapid growth of earnings are the main difficulties.

73. Without being too precise it is helpful to the subsequent discussion of policy to make some judgment of the extent to which policy should be tightened. We should probably discount some of the money GDP growth in the October forecast. But even so, my own view is that if we want to improve the chances of getting inflation back onto a downward track policy changes to the extent of reducing money GDP growth by 1 per cent a year after 1987-88 should be considered. In the spirit of 'coarse' tuning it would be unwise to try to constantly adjust policy fully for changes to the forecast. But the evidence for a partial adjustment is very strong.

higher than what? MTFS?

74. According to our model simulations that might involve 1 per cent higher real interest rates next year or cutting the PSBR by approaching 1 per cent of GDP or a bit of both (see Annex K). Obviously these are only very rough magnitudes and, given the relatively small scale of policy adjustment, assume only modest exchange rate responses. But they help in some degree to guide the discussion.

grossly overstated

75. In my view there is an overwhelming case for not forcing interest rates to bear all the adjustment, for reasons set out in paragraphs 69-71. In particular I give considerable weight to the arguments relating to the very high UK real interest rates, the balance of payments and the share of consumption in GDP. I fear that a sustained current account deficit will severely damage confidence and make the handling of policy much more difficult. This would be especially true if consumer spending remains buoyant.

76. A balanced tightening of policy might involve a reduction of the PSBR profile of ½ per cent GDP - about £2 billion - below the MTFS path. Such a tightening of fiscal policy would mean:

- the PSBR adjusted for privatisation proceeds would fall from 3½ per cent of GDP in 1986-87 to 2½ per cent in 1987-88 and 2 per cent in 1990-91 (Table 9);

- the PSBR adjusted for all capital transactions and the PSFD adjusted for council house sales would be ½ per cent point above this level, the same in 1990-91 as the average of the 1950s and 1960s;

- the net public sector debt ratio would decline by more than the amount of privatisation proceeds.

assumed path: tightening > 1987/88 than in next 4 yrs combined

Table 9

Alternative Paths for PSBR Excluding Privatisation Receipts

(per cent of money GDP)

	Average 1952-73	**1986-87**	**1987-88**	**1988-89**	**1989-90**	**1990-91**
	pp		1.25	1.2	1.1	1.0
MTFS	2.6	3.1	3.0	2.7	2.6	n.a
Balanced tightening	2.6	3.1	1.25 2.5	1.0/1.25 2.2/2.45 2.35	1.0 2.1 2.2	1.0 2.0 2.05
Fiscal tightening (adjusted for essentially capital transactions)	2.6	3.1 (3.7)	2.0 (2.4)	1.7 (2.1)	1.6 (2.0)	1.5 (2.0)
Gradual tightening(A)	2.6	3.1	2.5	2.1	1.7	1.5
Gradual tightening(B)	2.6	3.1	2.7	2.3	1.9	1.5

see later

77. That should be a more sustainable position and increase confidence in the anti-inflationary policy. It might be sufficient to improve confidence in the exchange rate without suffering the effect of higher mortgage rates on inflation. Real interest rates would still be high but there would be a reasonable chance of modest tax cuts if the revenue overrun this year was projected to continue.

intentions

! 78. If it were not for the important role of tax reform and the scope that lower taxes give in helping that process I would be inclined to favour an even tougher fiscal stance. The rather strong case for this is that the calculations above make no allowance for the extent to which the Exchequer is still benefiting from North Sea oil revenues over and above the permanent income we can expect.

79. If all the emphasis was placed on the fiscal side in bringing down money GDP growth, the PSBR excluding privatisation proceeds might be reduced to 1½ per cent of GDP in 1990-91. After allowing for all capital transactions this is ½ point below the average for the 1950s and 1960s when there were no oil revenues. A fiscal tightening of this order is illustrated in Table 9.

80. Two intermediate paths are also shown in Table 9 (Gradual tightening (A) and (B)). In Gradual tightening (A), for next year the PSBR excluding privatisation receipts is reduced to 2.5 per cent; and the subsequent speed of decline is increased so that by the end of the MTFS it is down to 1.5 per cent of GDP. In Gradual tightening (B) the path starts a little higher and declines more steeply.

Only if FA is £4 bn

81. The implication of the balanced tightening path and Gradual tightening (A) in Table 9 is that £2 billion of the fiscal adjustment available in 1987-88 (relative to the MTFS path) should be devoted to reducing the PSBR itself. This is on the assumption ~~assuming~~ that the revenue prospects next year will provide a larger fiscal adjustment than projected in the October forecast. In other words my preference would be to see the bulk of it directed at reducing borrowing, while leaving some room for lower taxes. If it turns out that we are limited to a fiscal adjustment of £2 billion the profile could be revised to some extent; but I would stick to the principle of devoting the larger part to reducing the PSBR (for example Gradual tightening (B)).

82. The past year has reinforced my view that we have had too little room for manoeuvre. The combination of rapidly rising consumption, the disappearance of the current account surplus, and market doubts about anti-inflationary policy, have put a burden on interest rates. Confidence has been retained through a willingness to take difficult action on interest rates despite the premium over foreign interest rates. Markets will become increasingly nervous that political circumstances will make this more difficult and that the overall policy stance will turn out to be too lax. The safety net of a tighter fiscal policy looks very attractive.

N.B. if markets take the view it's an election loser!

I disagree to a considerable extent with this extreme conclusion. ~~A~~ much more balanced approach is desirable. The path recommended looks panicky, wd lack conviction, & wd unsettle markets (which wd recognise political factors when they see it, & draw the consequences).

NB: much of this is the most awful pseudo-science.

Note, too, that the main conclusion to emerge from all this is the need to hold the XR at levels no lower & probably slightly higher. This alone undermines low rate the case for the low PSBR/low IR variant.

ANNEX A:
VELOCITY OF
M0

CONFIDENTIAL

ANNEX A: VELOCITY OF M0

The velocity of M0 has grown at an average rate of 3½% over the last 20 years. This trend has been fairly steady and was associated with institutional and technological changes such as the decline in payment of wages in cash and the spread of bank accounts and credit cards.

2. From year to year there have been considerable fluctuations in velocity measured contemporaneously (Table A.1). These are partly explicable by movements in interest rates. Falls in interest rates have tended to lead to slower than average increases in velocity for a time as people increased their cash holdings to a higher level relative to money GDP. Similarly increases in interest rates have been associated with above-average growth in velocity.

3. Interest rates affect the demand for M0 fairly quickly: nearly all the effect is through within a year. They affect money GDP more slowly: the extra impact in the second year is probably greater than in the first. Partly as a result of this difference in the lags there is a tendency for movements in M0 to anticipate those in money GDP, as both respond to changes in interest rates. As a result there is greater stability of the growth of velocity when it is measured as the ratio of money GDP to M0 in the previous year than when it is measured contemporaneously (Table A.1).

This illustrates
the value of M0
– a pity this not recognised

LIST OF ANNEXES

A	Velocity of M0
B	The fiscal deficit and interest rates
C	Simulations of changes in the mix of policies
D	Money GDP in the October forecast
E	Errors in medium-term forecasts
F	Indicators of monetary conditions
G	Indicators of fiscal stance
H	Structure of expenditure
J	International comparisons
K	Simulations of changes in the stance of policy

Table A.1

Velocity of M0

(percentages)

	M0 Growth	Money GDP Growth	Growth of Velocity of M0 M0 in current year	 M0 in previous year	Short-term interest rate
1976-77	11.0	16.7	5.1	3.0	12.0
1977-78	11.5	15.8	3.9	4.3	6.8
1978-79	15.1	14.1	-0.9	2.3	10.7
1979-80	12.1	19.6	6.7	3.9	14.9
1980-81	7.1	13.8	6.3	1.5	15.5
1981-82	5.2[1]	10.0	4.6	2.7	14.2
1982-83	2.7[1]	9.2	6.3	3.8	11.5
1983-84	6.2	8.3[2]	2.0	5.5	9.7
1984-85	5.5	8.6[2]	2.9	2.3	10.9
1985-86	4.2	8.2[2]	3.8	2.6	12.1
1986-87	3.8	5.4[2]	1.5	1.2	10.5

[1] Adjusted for change in bankers' balances in 1981

[2] Adjusted for coal strike

ANNEX B:
FISCAL DEFICIT,
INTEREST RATES

ANNEX B: THE FISCAL DEFICIT AND INTEREST RATES

The attached charts compare annual movements in the public sector financial deficit with those in short- and long-term interest rates. Chart B.1 shows the ratio of the PSFD to GDP and the 3-month interbank rate, and Chart B.2 the PSFD/GDP ratio and the yield on 20-year gilts.

2. The series move together over the medium term. In particular they both show a steep rise in the first half of the 1970s and a gradual decline since then. But, for the reasons explained in the text, we would not expect to observe a close year-to-year correlation in practice.

Ignored request for graph over shorter period.

Must be done

CHART B1

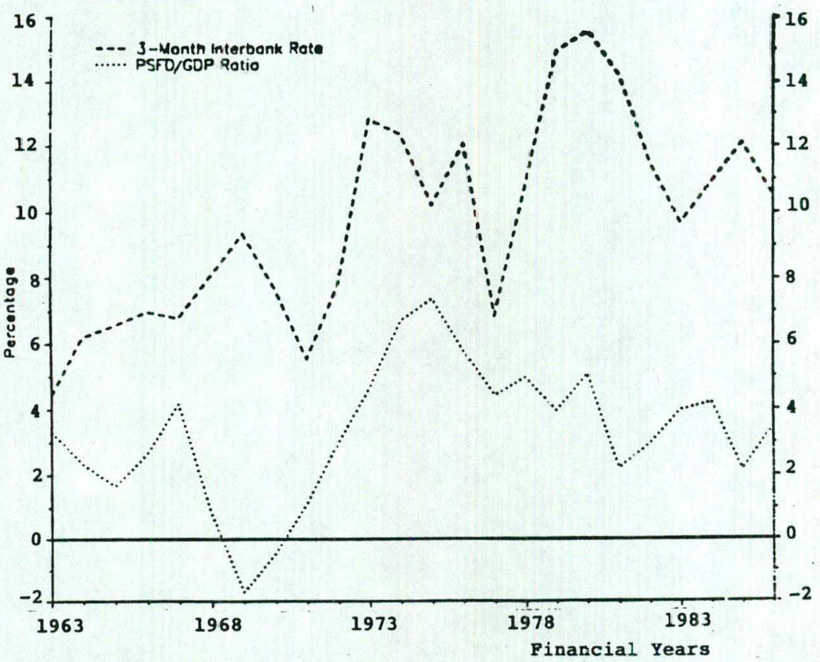
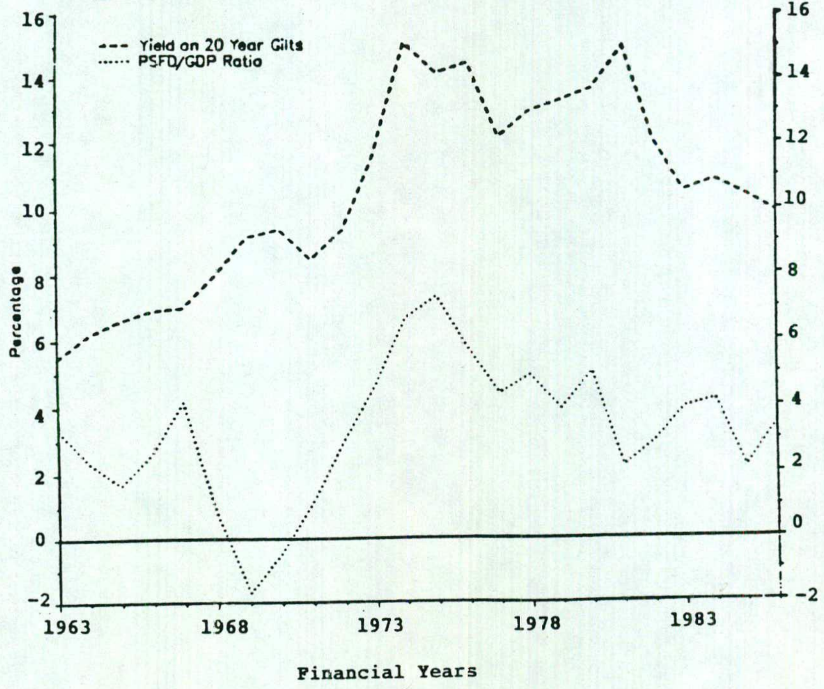


CHART B2



ANNEX C: SIMULATION OF MIX OF POLICIES

Interesting speculations & short run simulations!

Basis what model? What params?

ANNEX C: SIMULATIONS OF CHANGES IN THE MIX OF POLICIES

This Annex presents the results of simulations in which the mix of fiscal deficits and interest rates is changed while still maintaining monetary conditions, measured by money GDP and M0, unchanged. The PSBR is raised by reducing income tax, and interest rates are then altered to ensure that first money GDP and second M0 are unchanged from base. The results would be qualitatively the same if an alternative fiscal instrument were used to raise the PSBR.

Fixed money GDP

2. The figures in table C1 assume that confidence in the overall stance of policy is unchanged, with markets accepting that future money GDP growth will not be changed by the switch in policy mix. A move to tighter fiscal policy and lower interest rates has little net effect on inflation and output. Given the assumption about confidence the real exchange rate is likely to fall, reflecting the reduction in interest rates, and the current account will tend to improve. The estimated effect on the current account is eventually of the order of ½% of GDP for a 1 point PSBR reduction, with the full effect coming through by the third year.

Table C1: Effects of reducing the PSBR by 1% of GDP, with fixed money GDP — ie by £4bn

	Short term Interest Rates Nominal	Short term Interest Rates Real	Growth of M0	GDP(%)	RPI Infla- tion	Real exchange rate (%)	Current Account % of GDP	Current Account £billion
Year 1	-1.4	-1.2	+0.2	-	-0.2	-1.9	+0.2	+0.6
Year 2	+0.1	-0.4	-0.5	-	+0.5	-1.2	+0.3	+1.0
Year 3	-0.7	-0.8	-	-0.2	+0.1	-1.4	+0.5	+2.2
Year 4	-1.6	-1.2	+0.4	-0.2	-0.4	-1.3	+0.6	+2.8

3. If the market were to interpret the cut in the PSBR as foreshadowing a tightening of the overall stance of policy rather than just a change in the mix, the effects would be slightly different. The real exchange rate would tend to fall less (or possibly even rise) in which case the effects on inflation and (initially) output would be rather more favourable. But for essentially the same reason the gain to the current account would be slightly less.

Fixed M0

4. Another way of looking at changes in the policy mix is to focus on PSBR and interest rates changes which leave M0, rather than money GDP, unchanged. The effects of reducing the PSBR by 1% of GDP with fixed M0 are illustrated in Table C2, again assuming the fiscal instrument is income tax, and using the same assumption about confidence as in table C1.

Table C2: **Effects of reducing PSBR by 1% of GDP, with fixed M0**

	Short term Interest Rates		Growth of Money GDP	GDP(%)	RPI Inflation	Real exchange rate (%)	Current Account	
	Nominal	Real					% of GDP	£billion
Year 1	-1.2	-1.0	-0.2	-0.1	-0.2	-1.5	+0.2	+0.7
Year 2	-0.6	-0.6	+0.1	-	-	-0.5	+0.2	+0.9
Year 3	-1.0	-0.8	-0.4	-0.2	-0.2	-0.4	+0.4	+1.7
Year 4	-1.7	-0.9	-0.4	-0.3	-0.8	-	+0.5	+2.2

5. The main difference from the earlier results is that tighter fiscal policy tends to reduce the growth of money GDP a little. This is because the fall in interest rates required to bring M0 back to track reduces velocity; a given path for M0 means lower money GDP. (This effect is somewhat less pronounced with income tax than with other fiscal instruments because the direct effect of higher taxes is to reduce personal disposable income, and hence the demand for M0 at given level of money GDP.) The beneficial effects on the current account are eventually slightly smaller than with fixed money GDP because the real exchange rate falls rather less.

ANNEX D:
MONEY GDP IN
OCT. FORECAST

ANNEX D: MONEY GDP GROWTH IN THE OCTOBER FORECAST

1. The path of money GDP in the October forecast was significantly different from that set out in the MTFS. The growth rate in 1986-87 was put over 1 point lower than at budget time, largely reflecting weaker world activity. But after a rebound in 1987-88, taking the level of money GDP close to that in the MTFS, the growth rate was forecast to increase yet further in 1988-89. The details are set out in table D1.

Table D1: Money GDP growth in the October forecast and the MTFS

% per annum	**1985-86**	**1986-87**	**1987-88**	**1988-89**
MTFS	9.6	6.8	6.4	6.0
October forecast	9.6	5.5	7.3	8.0

2. The stance of fiscal policy as measured by the PSBR ratio was the same in October as in the MTFS. The paths of M0 were also similar, as shown in table D2. But from 1987-88 onwards the level of interest rates was significantly higher in October. The October forecast thus incorporated an ex ante boost to nominal demand which was offset partially, but not wholly, by higher interest rates. To some extent this reflected the removal of adjustments made to the January internal forecast in order to prepare the MTFS projection, rather than a change of judgement by the forecasters.

Surely only a v limited extent: what are the figs

3. Although the higher interest rates in the October forecast were sufficient to bring M0 growth more or less back to the track in the MTFS projection, the resulting increase in velocity meant that money GDP growth remained above the MTFS path. In order to have brought money GDP growth back to track it would have been necessary to raise interest rates, with the consequence that M0 growth would have been in the bottom half of its target ranges.*

---

* The target ranges were set on the assumption that nominal interest rates would fall over the MTFS period, and hence velocity would rise at less than its trend rate.

Nobody asked for this to be done: it reflects the officials' obsession with getting interest rates down

Table D2: M0 and interest rates in the October forecast and the MTFS

	1985-86	1986-87	1987-88	1988-89
Growth of M0 (% pa)				
MTFS	4.4	2.6	3.9	4.9
October	4.4	3.8	3.9	4.5
Target Range		2-6	2-6	1-5
Short term interest rates (%)				
MTFS	12.1	11.3	9.7	8.5
October	12.1	10.5	11.0	11.0

4. An attempt has been made to assess the main factors underlying the increase in money GDP growth between the October forecast and the MTFS. Inevitably it is not possible to isolate all the differences of judgement and environment which have contributed, so the focus has been on a limited number of important variables. These are:

- a lower path for the exchange rate
- faster growth of real earnings
- lower private net saving†

Differences in these variables from 1987-88 onwards between the October forecast and the MTFS are set out in table D3.

Table D3: Changes between the MTFS and the October forecast

	1987-88	1988-89
Exchange Rate (%)	-5.9	-7.0
Real Earnings (% growth over pay round*)	+1.1	+1.3
Private Net Saving** (% of GDP)	-0.6	-0.8

* Nominal earnings growth over the pay round less the rate of RPI inflation at the beginning of the round (Q3)
** Change since 1986-87

---

† Saving less investment.

5. The effects of these changes have been evaluated by means of simulations on the assumption of fixed growth in M0 and a fixed PSBR ratio. This provides an assessment of their contribution to the difference in money GDP growth and the path of interest rates, and the results are set out in table D4. But inevitably this is a rather approximate exercise, designed to illustrate the orders of magnitude of the main factors involved. By its nature it cannot provide an exact analysis of all the influences on the money GDP forecast.

Table D4: Contributions to changes in money GDP and interest rate forecasts

	1987-88	**1988-89**
Money GDP growth (%)		
Total change	+0.9	+2.0
Exchange rate	+1.3	+1.7
Real earnings	+0.2	+0.7
Net private saving	+0.9	+0.4
Interest rates (%)		
Total change	+1.3	+2.5
Exchange rate	+0.4	+1.5
Real earnings	+0.3	+0.5
Net private saving	+0.5	+0.9

6. The factors identified all add to the growth rate of money GDP over the timescale of the October forecast. The effect of the lower nominal exchange rate arises mainly from higher prices. Higher real earnings growth raises money GDP because it arises from higher nominal earnings growth. Lower net saving raises money GDP growth because it arises from higher expenditure.

7. The most important single factor is the lower exchange rate. This alone accounts for the bulk of the difference since the MTFS in the money GDP growth forecast for 1988-89. Taken together, the factors identified appear to over-explain the difference in forecast money GDP growth, though note that they are not strictly additive. There are, of course, other changes between the October forecast and the MTFS which will have tended to reduce money GDP growth.

8. Two of these offsetting factors can be readily identified. First, world activity is expected to be lower in 1986 than in the FSBR. Although growth in 1987 is now forecast to be higher than before, the level remains below that underlying the MTFS projections throughout the medium term. The revised view in the October forecast implies a less buoyant world economy than in the MTFS, tending to reduce money GDP growth over the period as a whole.

9. Second, there were different assumptions about trade performance. The MTFS took a more favourable view about the extent of the improvements in trade performance compared with long-term trends, for given levels of competitiveness and domestic demand in the UK and abroad. This implies that the October forecast had larger balance of payments deficits (smaller surpluses) on this account than the MTFS, contributing to lower rather than higher money GDP.

10. In conclusion, there are a number of factors which have pushed up the growth of money GDP in the October forecast relative to the path in the MTFS. This increase has occurred even though M0 growth was assumed to remain on broadly the same track, because higher interest rates mean higher velocity. The main factor appears to have been the lower nominal exchange rate, though different judgements on earnings and private saving have also made a noticeable contribution.

NB:-

ANNEX E:
ERRORS IN MEDIUM
TERM FORECASTS

ANNEX E: ERRORS IN MEDIUM-TERM PROJECTIONS

This Annex looks at the errors in past medium-term projections of money GDP growth, inflation and output growth in the three internal forecasts undertaken in the autumn (A), winter (W) and summer (S) of each year. The MTFS projections are omitted because of their rather stylised nature.

2. The errors in forecasting money GDP growth, output growth and inflation are shown in Charts 1-3 and summarised in Table E.1. In each chart, the horizontal line shows the actual outturn for each variable for the year indicated on the vertical axis. The dotted lines show the values forecast for each variable by internal forecasts up to 4½ years ahead. The forecast errors are thus given by the gaps between the solid horizontal lines and the dotted lines. Table E.1 summarises the results; the upper panel shows average forecast errors for each variable, while the lower panel, showing root mean squared errors, gives an indication of the degree of uncertainty about each forecast (high numbers indicate greater uncertainty).

3. The important features displayed in the charts and table are the following:

- inflation has been over-estimated and output growth underestimated on average

- these errors have not entirely offset each other in forecasts of money GDP growth which have been too high on average

4. An important part of the explanation of the over-estimation of inflation and under-estimation of output growth in the early 1980s was that productivity growth was under-estimated. In more recent years the under-estimation of output growth seems to have been associated with the under-estimation of public consumption, private investment and world activity (and hence exports).

Table E.1

Errors in Medium-Term Projections(1)

(percentage points)

	Same year	One year ahead	Two years ahead	Three years ahead
Mean error				
Money GDP growth	-0.5	0.3	0.6	1.5
GDP deflator growth	0.1	1.2	2.1	3.5
Real GDP growth	-0.5	-0.8	-1.6	-1.7
Root mean squared error				
Money GDP growth	0.6	1.1	2.1	1.7
GDP deflator growth	0.5	1.8	2.8	3.8
Real GDP growth	0.7	0.9	1.7	1.9

(1) Averages of all internal summer, autumn and winter forecasts made in each financial year for financial years 0, 1, 2 and 3 years ahead. The averages include 12 observations: 3 forecasts a year for 4 years. Thus the average for same year projections includes forecasts made in 1982-83 to 1985-86 inclusive, and that for three year ahead projections includes forecasts made in 1979-80 to 1982-83.

Chart 1: Actual and Forecast Nominal GDP (% Change)

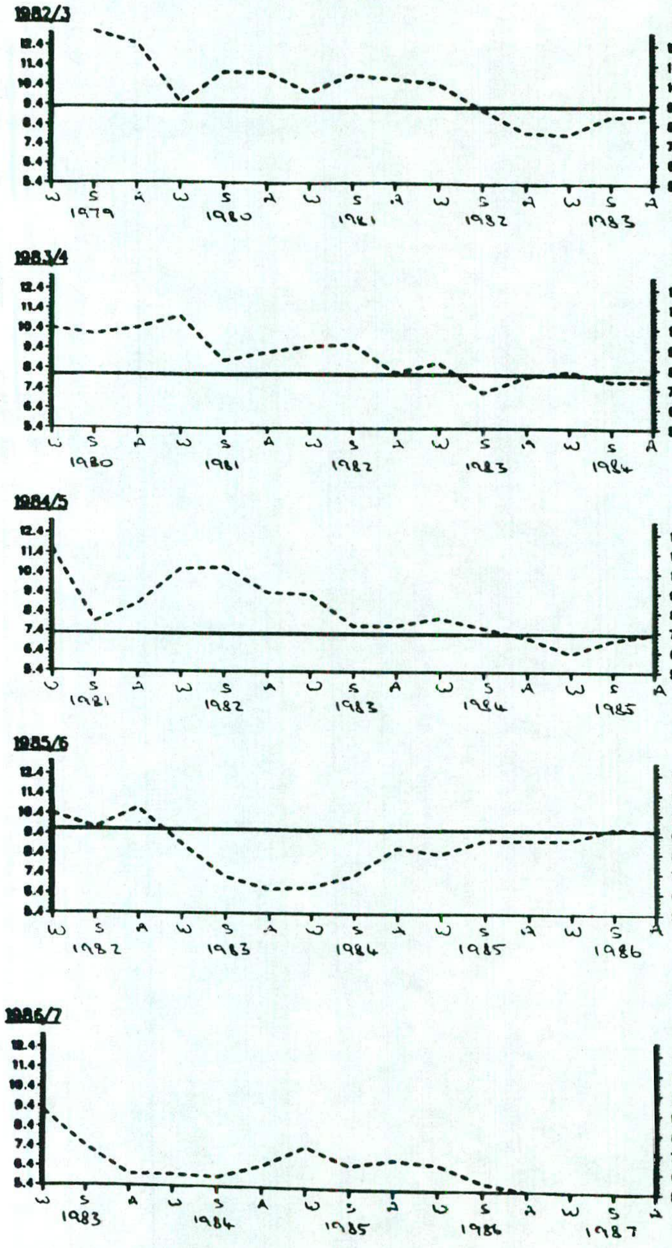


Chart 2: Actual and Forecast Real GDP (% Change)

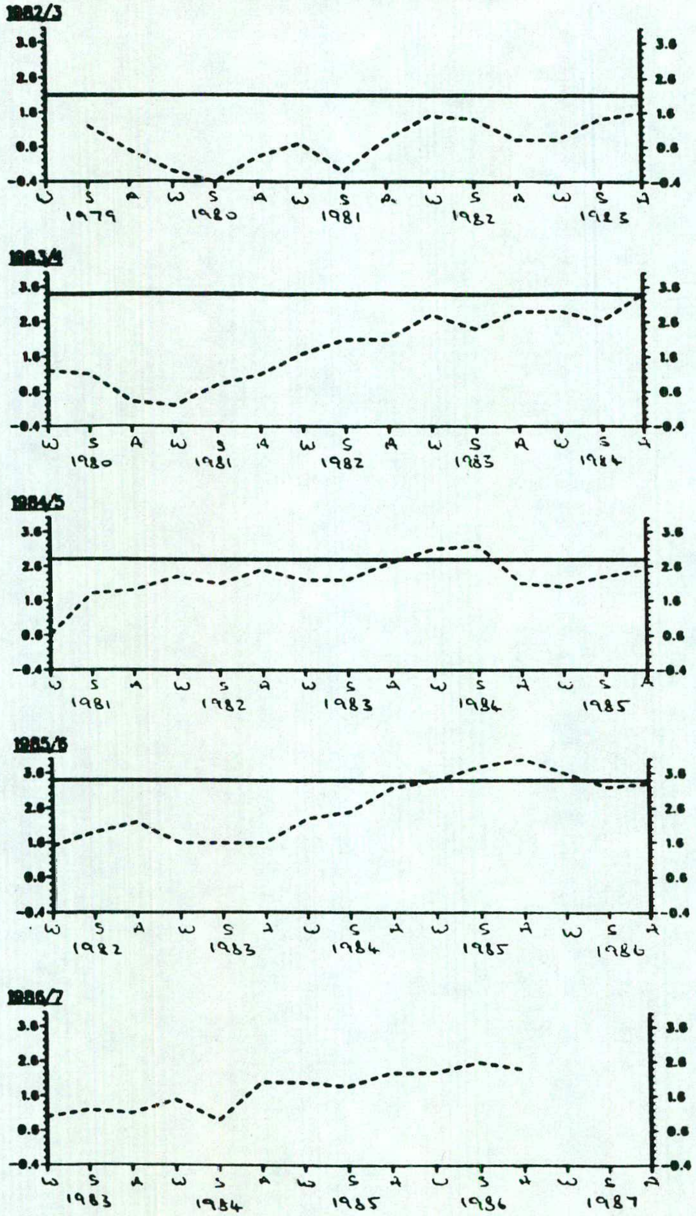
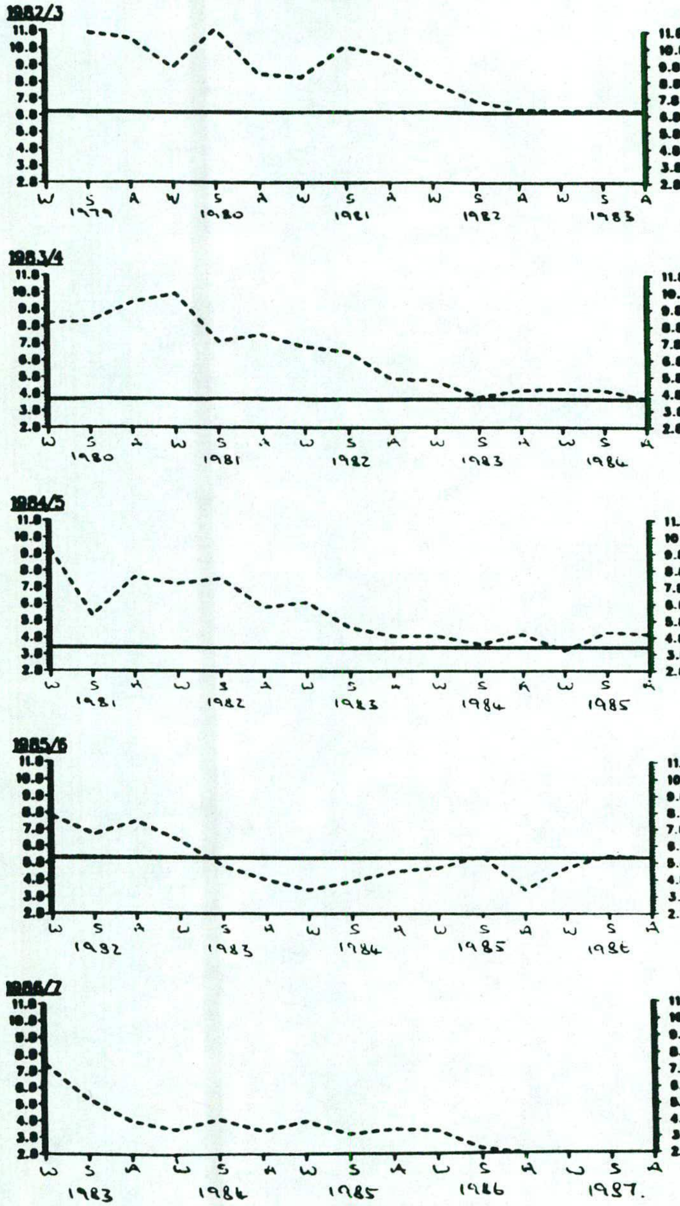


Chart 3: Actual and Forecast GDP Deflator (% Change)



E3

ANNEX F:
MONETARY
CONDITIONS

ANNEX F: INDICATORS OF MONETARY CONDITIONS

The table below shows movements in the main indicators of monetary conditions:

	M0 growth (%)	£M3 growth (%)	Growth of credit[1] (%)	Exchange rate (1975=100)	House price inflation[2] (%)
1980-81	7.1	17.1	19.0	98.2	18.7
1981-82	5.2[4]	15.5	17.3[3]	92.3	5.5
1982-83	2.7[4]	10.4	21.7[3]	88.0	4.6
1983-84	6.2	10.9	17.4	83.5	10.5
1984-85	5.5	9.2	17.8	76.2	8.3 (7.8)
1985-86	4.2	13.4	18.0	79.0	8.2 (8.5)
Latest observation	4.9[5]	18.3[5]	19.5[5]	68.3[6]	21.5(13.6)[5]

[1] Bank and building society lending

[2] Percentage increase in DoE New House Price (Completions) Index. Halifax Index in brackets

[3] Affected by change from banking to monetary sector in 1981 Q4

[4] Adjusted for change in bankers' balances in 1981

[5] Twelve months to October

[6] 11 December

ANNEX G:
FISCAL
STANCE

CONFIDENTIAL

ANNEX G: INDICATORS OF FISCAL STANCE

This annex looks at recent movements in the PSBR and various other factors affecting the fiscal stance; and it traces some of the revisions made to the PSBR path in successive versions of the MTFS. Since there is no uniquely correct measure of fiscal stance, a number of alternatives are considered.

2. Table G1 presents figures for the PSBR and the PSFD with some relevant information: (& some distinctly less relevant)

- privatisation proceeds rose from ¼% of GDP in 1979-80 to 1¼% in 1986-87 and future years

- council house sales have been reasonably steady. In 1986-87 and future years they are projected at 0.3 per cent of GDP

- there has been a small rise in other essentially capital transactions; these include net sales of land and other physical assets, and some net lending. By 1987-88 total capital transactions amount to about 1¾ per cent of GDP, falling to 1½% in 1989-90.

- North Sea revenues rose from 1% of GDP in 1979-80 to 3¾% in 1984-85, and are now near to 1% again.

3. The PSBR has fallen from about 5% of GDP in 1979-80 and 1980-81 to around 2% in 1986-87. But the increase in privatisation proceeds and other capital transactions mean that the fall in adjusted PSBRs is rather less. Excluding privatisation proceeds, the PSBR has declined from 5% in 1979-80 to 3% in 1986-87. Adjusting for all capital items the decline has been from 6% in 1980-81 to 3.7 per cent this year.

4. In the MTFS the unadjusted PSBR declines to 1½% of GDP in 1989-90. The various adjusted measures also show a decline, but remain above the unadjusted PSBR. When adjusted for all essentially capital transactions, the PSBR in 1989-90 is about 3%

Comprising?

Shame [illegible]

CONFIDENTIAL

Table G1: Fiscal Indicators in Recent Years

% of money GDP	**1979-80**	**1980-81**	**1981-82**	**1982-83**	**1983-84**	**1984-85**	**1985-86**	**Autumn Statement 1986-87**	**October Forecast 1987-88**	**October Forecast 1988-89**	**October Forecast 1989-90**
PSBR	**4.8**	**5.4**	**3.3**	**3.1**	**3.2**	**3.1**	**1.6**	**1.9**	**1.7**	**1.6**	**1.5**
Essentially capital transactions*	...	0.6	0.8	0.9	1.2	1.4	1.5	1.8	1.7	1.5	1.4
of which:											
privatisation proceeds	0.2	0.2	0.2	0.2	0.4	0.6	0.7	1.2	1.2	1.1	1.1
council house sales	0.3	0.3	0.5	0.7	0.5	0.4	0.3	0.3	0.3	0.3	0.3
North Sea revenues:	1.1	1.7	2.5	2.8	2.9	3.7	3.1	1.2	1.0	0.9	0.9
Adjustment for transitory component**	0.5	1.1	1.9	2.3	2.4	3.3	2.9	1.0	0.9	0.8	0.8
PSBR adjusted for privatisation proceeds	5.0	5.6	3.5	3.3	3.6	3.7	2.4	3.1	3.0	2.7	2.6
PSBR adjusted for essentially capital transactions	...	6.0	4.1	4.0	4.4	4.5	3.1	3.7	3.4	3.1	3.0
PSFD	**3.9**	**5.0**	**2.2**	**3.0**	**4.0**	**4.2**	**2.2**	**3.3**	**3.1**	**2.8**	**2.9**
PSFD adjusted for council house sales	4.2	5.3	2.7	3.7	4.5	4.6	2.5	3.7	3.4	3.2	3.2

good!

* Riley adjustments — Meaning?
** Includes interest saving
... Not available

of GDP, 1% below the levels attained in 1981-83. However, North Sea oil revenues have declined over this period by more than 1 percentage point.

5. The PSFD moves in a broadly similar way to the PSBR adjusted for essentially capital transactions. Thus it fell from 4-5% in 1979-81 to 3¼% in 1986-87 and a little under 3% expected in 1989-90. Whereas it is above the PSBR now, in the 1950s and 1960s it was usually below it, because of positive net lending and the absence of privatisation proceeds (Table G2). The PSFD adjusted for council house sales is projected to be 3¼% of GDP in 1989-90, compared with 2½-3% in the 1950s and 1960s. But North Sea revenues are still about 1% of GDP in 1989-90.

ridiculous

Table G2: Fiscal Indicators: Period Averages
(Percent of money GDP)

	1952-55	1956-60	1961-64	1965-68	1969-73	1974-79	1980-81 to 1986-87
PSBR	3.2	2.4	2.5	3.3	1.9	6.6	3.1
PSBR adjusted for privatisation proceeds	3.2	2.4	2.5	3.3	1.9	6.7	3.6
PSFD	3.0	2.4	2.4	2.5	0.9	5.5	4.0

6. The PSBR is higher than envisaged in earlier versions of the MTFS. The 1980 and 1981 versions, for example, envisaged PSBRs of 1½% and 1% in 1983-84 and 1984-85 respectively (Chart G1). But in more recent version, the paths for the unadjusted PSBR have not changed much, particularly from 1985-86 onwards. However, the path of the PSBR adjusted for privatisation proceeds has been revised upwards fairly steadily since the 1982 MTFS (see Chart G2).

7. Behaviour of public sector net debt in relation to the PSBR and money GDP is set out in table G3. The net debt/GDP ratio fell by about 1½ points in 1985-86, having been on a gently falling path since 1980-81. It is expected to fall by a further ½ point in 1986-87, and the PSBR path in the MTFS implies a steady decline in the medium term. The fall in the debt ratio up to 1986-87, and the subsequent fall to 1989-90, are both less than the proceeds of privatisation over the relevant period.

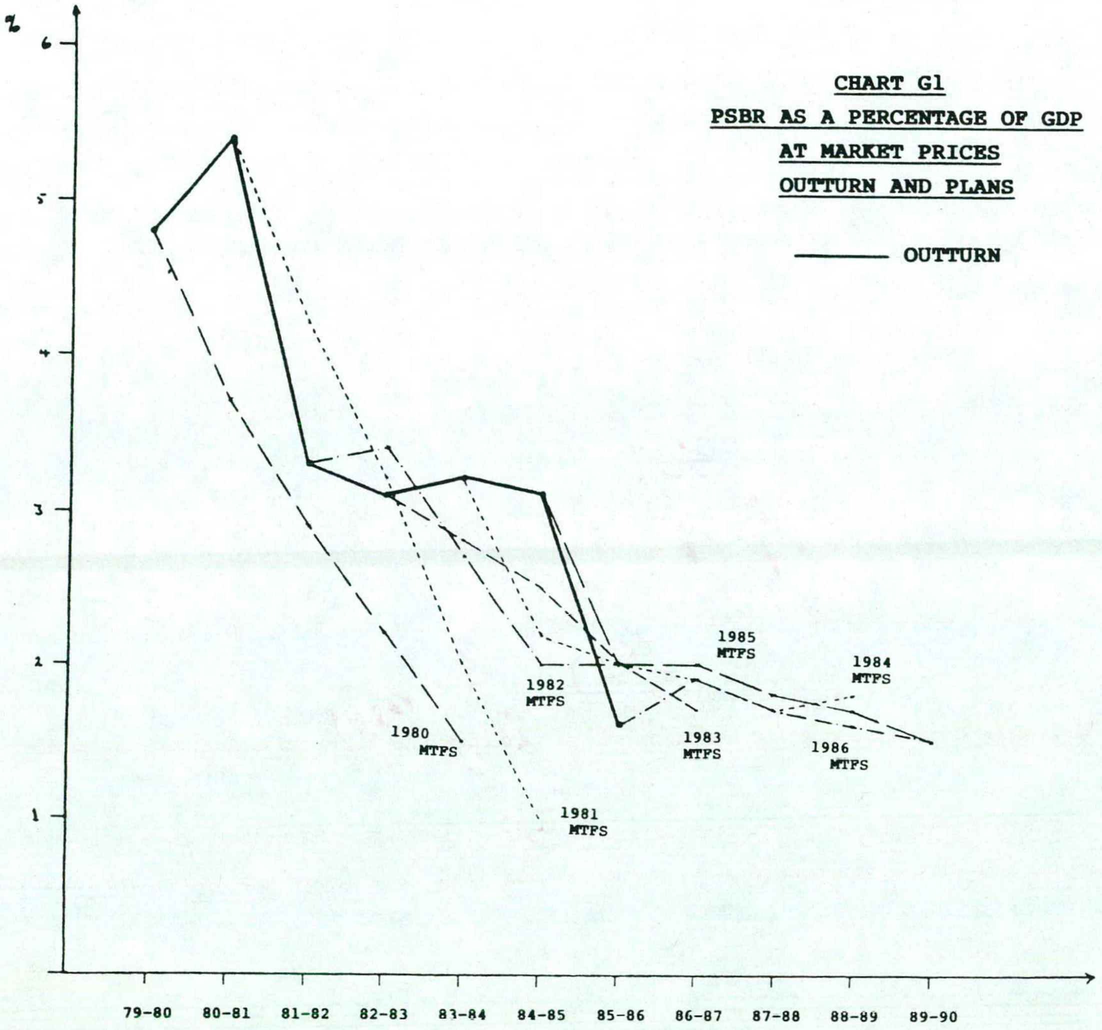


CHART G1

PSBR AS A PERCENTAGE OF GDP

AT MARKET PRICES

OUTTURN AND PLANS

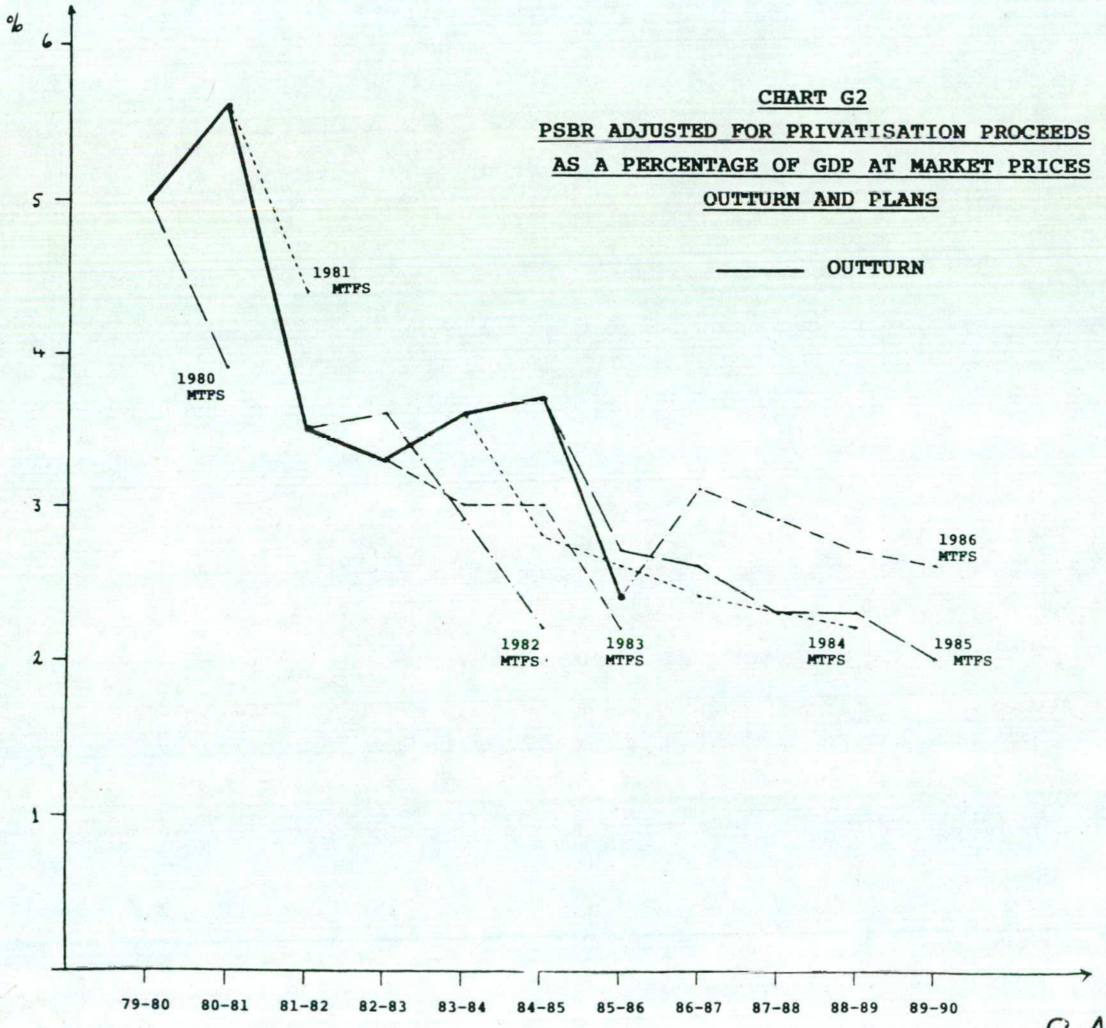


CHART G2

PSBR ADJUSTED FOR PRIVATISATION PROCEEDS

AS A PERCENTAGE OF GDP AT MARKET PRICES

OUTTURN AND PLANS

Table G3: The PSBR and Changes in Public Sector Debt

	Latest Outturn							1986 MTFS			
£ billion	**1979-80**	**1980-81**	**1981-82**	**1982-83**	**1983-84**	**1984-85**	**1985-86**	**1986-87**	**1987-88**	**1988-89**	**1989-90**
PSBR	**10.0**	**12.7**	**8.6**	**8.9**	**9.8**	**10.2**	**5.8**	**7.1**	**7.1**	**6.8**	**7.0**
Adjustments*	-2.0	+1.8	+1.8	-1.2	+2.5	+3.5	+0.9	+1.1	+0.7	+1.2	+1.2
Change in Net Public Sector Debt	8.0	14.5	10.4	7.7	12.3	13.7	6.7	8.2	7.8	8.0	8.2
Net Public Sector Debt (end year)	103.3	117.8	128.2	136.0	148.2	161.9	168.6	176.8	184.6	192.6	200.8
Money GDP**	223.3	247.3	271.4	294.7	317.2	345.4	370.2	393.8	418.9	442.5	466.0
Net Debt Ratio (%, end year)	**46.3**	**47.6**	**47.2**	**46.1**	**46.7**	**46.9**	**45.5**	**44.9**	**44.1**	**43.5**	**43.1**
Memo Item: **Privatisation Proceeds** (% of GDP)	**0.2**	**0.2**	**0.2**	**0.2**	**0.4**	**0.6**	**0.7**	**1.2**	**1.2**	**1.1**	**1.1**

---

* Adjustments required to reconcile the PSBR with changes in net public sector debt. They comprise discounts and uplift on gilts, revaluations of net foreign currency debt, timing and coverage adjustments.

** GDP at current market prices for year, centred on 31 March. Forecast figures are constructed from 1985-86 outturn and MTFS growth rates.

ANNEX H: STRUCTURE OF EXPENDITURE

ANNEX H: THE STRUCTURE OF EXPENDITURE

There has been one long cycle over the last 30 years in the overall structure of expenditure. Total private plus public consumption fell gradually from the mid-1950s to the mid-1960s and remained at a fairly constant level until the late 1970s, since when it has risen and is expected to return to the mid-1950s level again this year (Table H1).

2. Within total consumption there was a steady shift away from private to public consumption until 1981. In recent years this has been reversed as the rise in public consumption levelled off and private consumption grew more rapidly than GDP.

3. The rapid growth of private consumption recently is illustrated in Chart H1, which shows growth rates over five-year periods up to the years shown. The growth rate over the five years to 1986 has been exceeded on only four occasions (on a five year basis) during the previous 25 years: twice in the early 1960s and twice in the early 1970s. If the October forecast for consumers' expenditure in 1987 and 1988 is correct, the five-year periods ending in these years will see growth rates greater than in any five-year period since 1960. On the other hand recent and forecast growth rates for individual years are not without precedent having been substantially exceeded in both the early and late 1970s. They differ in being on a more sustained basis.

4. There have also been some changes in the composition of total investment. The main differences between the 1950s and 1960s and now are:

- a fall in the share of stockbuilding, probably reflecting a structural change in desired stock-output ratios

- a fall in the public sector's share of total fixed investment.

On the other hand the shares of both fixed investment and net exports in GDP are very similar, despite considerable fluctuations in the meantime.

5. There are various features of these figures on the current structure of expenditure in relation to past trends that are relevant for the consideration of policy:

- fixed investment and stockbuilding are not historically high relative to GDP, while the forecast share of total (private and public) consumption tends in the opposite direction. A sustained growth of output above productive potential may require a higher share of fixed investment over the medium term ?

- at the same stage the forecast trend in net exports will have to be reversed. If the pressures for higher public expenditure limit the practical scope for reducing the share of public consumption in GDP, and the share of fixed investment is not to fall, then a shift of resources into the balance of payments would necessarily require a lower share of private consumption in GDP.

Table H1

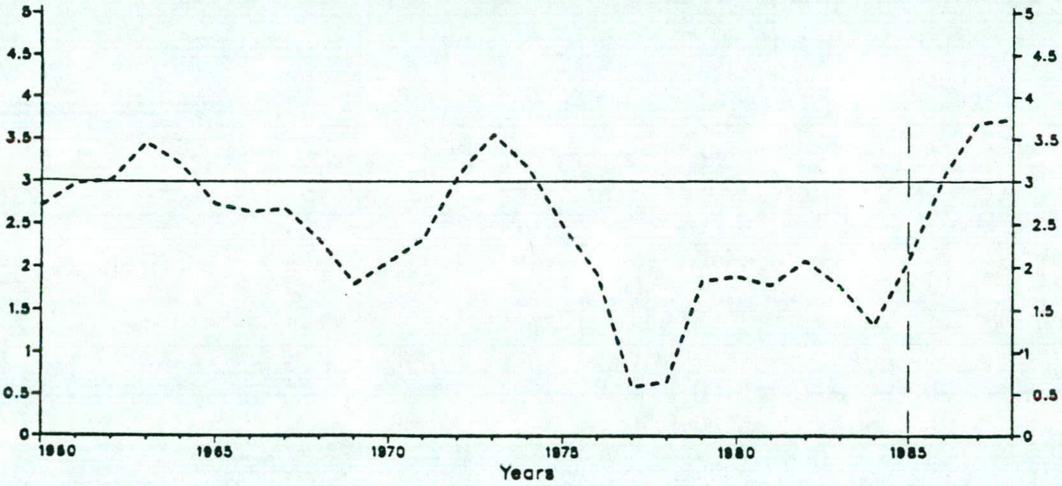
Structure of Total Expenditure

(percent of GDP(E) at current market prices)

	1955-59	1960-64	1965-69	1970-74	1975-79	1980-84	1985	1986	1987
		65.5			61.0			61.8	
Consumers' expenditure	67.0	65.9	63.5	62.6	60.1	60.4	60.6	62.2	62.5
		16.8			20.3			21.2	
Government consumption	16.6	16.7	17.3	18.3	20.6	21.7	21.1	21.3	21.3
		82.3			81.3			83.0	
Total consumption	83.6	82.6	80.8	80.9	80.7	82.1	81.7	83.5	83.8
Domestic fixed investment	15.5	17.2	18.8	19.4	19.0	16.9	17.1	17.3	17.1
of which:									
public sector	6.6	6.9	8.3	7.8	6.8	4.5	3.5	3.5	3.0
private sector	8.9	10.2	10.5	11.6	12.2	12.3	13.6	13.8	14.1
Stockbuilding	1.0	1.2	1.0	0.9	0.6	-0.5	0.2	0.2	0.4
Net exports	-0.1	-0.9	-0.6	-1.2	-0.3	1.5	1.1	-0.9	-1.3
GDP	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Components may not sum to totals due to rounding

Chart H1: Real Private Consumption: 5-year Moving Average (percentage change)



CONSUMP.CONCOGRA

ANNEX J: INTERNATIONAL COMPARISONS

ANNEX J: INTERNATIONAL COMPARISONS

This Annex contains data for the main industrial countries for real interest rates, fiscal deficits, government debt, current account deficits and consumption.

Real Interest Rates

2. The real interest rates in Table J.1 are measured, for both short and long rates, as nominal interest rates less the rate of growth of the consumer expenditure deflator over the previous year. There is a general pattern of low real interest rates in the 1970s and high rates in the 1980s, although German rates remained relatively high in the 1970s. The UK experienced more negative rates than elsewhere in the second half of the 1970s, and has higher real short-term, but not long-term, rates now.

Fiscal Deficits

3. The general government financial balances are shown in Table J.2 as percentages of GDP or GNP. Deficits and surpluses were generally small until the mid-1970s, since when all countries have experienced large deficits. Italy has a longer history of a large deficit, and its deficit since the mid-1970s has been an order of magnitude greater than elsewhere.

[illegible]

4. There has been some decline in recent years in deficits, especially in Germany and Japan. The decline in the UK is less marked, being partly obscured by the coal strike and other short-term factors. The decline in the public sector financial deficit has been greater than that in the GGFD in the UK, as the public corporations' deficit, which was 1.1% at its peak in 1980, has been eliminated; and the decline in the PSBR has been greater still, mainly because of the rise in privatisation proceeds.

Government Debt

5. All countries except the UK have experienced rising net debt/income ratios (Table J.3). The level of the ratio is higher in the UK than elsewhere, except Italy, which is why the UK can have higher than average deficits and still achieve a falling debt/income ratio.

Balance of Payments Current Account

6. Most G7 countries have experienced relatively small surpluses or deficits, less than 1% of GDP, in most periods (Table J.4). Apart from the present disequilibrium between the US, Japan and Germany, the main exceptions have been the surpluses of Germany in the 1960s and early 1970s and the UK in the 1980s, and the Canadian deficit of the late 1970s. Non-G7 OECD countries have often had larger surpluses and deficits.

Consumption

7. The growth of private consumption in the UK was until recently below that in other countries, reflecting the lower overall growth rate. However, forecasts of the growth of consumption over the 5-year periods ending in 1987 and 1988 show a faster rise in the UK than elsewhere (Chart J.1).

Table J.1

Real Interest Rates

(per cent)

	1965-69	1970-74	1975-79	1980-84	1985	1986
Short-term rates(1)						
US	1.6	-0.2	-1.4	3.4	4½	3¾
Japan	1.8	-2.9	-0.5	3.8	4¼	4½
Germany	2.7	3.2	0.6	3.9	3½	5
France		1.1	-1.5	2.1	4½	5
UK	3.2	-0.5	-5.1	3.0	7	7
Long-term rates(2)						
US	1.8	0.7	0.3	4.9	7	5½
Japan	1.7	-3.4	0.5	4.1	4½	4¼
Germany	4.7	3.3	3.0	4.2	4½	6¾
France	2.3	0.7	-0.8	3.0	5	6
UK	3.1	0.9	-2.3	3.0	4½	6½

(1) In most cases 3-month interest rates less rate of growth of the consumer expenditure deflator.

(2) Yield to maturity on medium-/long-term government bonds less rate of growth of the consumer expenditure deflator over previous year.

NB: UK sht term real ints 2% higher
than of Germany: long term lower:
— which [illegible] term [illegible] diff. of expectations —
Suggests — given same [illegible] 1% at home [illegible]
UK rates [illegible]

Table J.2

General Government Financial Balances

(Per cent of GDP/GNP at market prices)

	1965-69	1970-74	1975-79	1980-84
US	-0.4	-0.6	-1.3	-2.5
Japan	-0.5	0.9	-4.1	-3.5
Germany	-0.3	-0.1	-3.3	-2.9
France*	0.1	0.8	-1.2	-2.1
UK*	-1.0	-0.6	-4.0	-3.2
Italy*	-2.8	-7.6	-9.6	-11.4
Canada		0.8	-2.3	-4.6

v. surprised

	1979	1980	1981	1982	1983	1984	1985	1986	1987
US	0.6	-1.3	-1.0	-3.5	-3.8	-2.7	-3.4	-3.4	-2.3
Japan	-4.8	-4.4	-3.8	-3.6	-3.7	-2.2	-1.4	-1.5	-1.4
Germany	-2.6	-2.9	-3.7	-3.3	-2.5	-1.9	-1.1	-1.0	-0.9
France*	-0.7	0.2	-1.8	-2.7	-3.1	-2.9	-2.6	-2.9	-2.7
UK*	-3.5	-3.5	-2.8	-2.4	-3.6	-3.9	-2.6	-2.8	-2.9
Italy*	-9.5	-8.0	-11.9	-12.6	-11.7	-13.0	-14.0	-12.7	-12.2
Canada	-1.8	-2.8	-1.5	-5.7	-6.6	-6.6	-6.6	-5.4	-5.3

*Per cent of GDP; others GNP

Germany/Japan low deficit on both –

US/UK/France medium –

Italy/Canada high –

Table J.3

General Government Net Debt

(per cent of GDP/GNP at market prices)

Surely wrong here

	1974	1979	1984	1985
US	22.2	19.8	26.0	28.1
Japan	-5.4	14.8	26.4	26.2
Germany	-4.7	11.5	23.0	23.1
France*	8.8	9.8	15.1	16.6
UK*	54.9	48.7	49.0	47.8
Italy*	49.2	65.5	91.0	95.7
Canada	1.0	12.3	30.0	33.9

*Per cent of GDP; others GNP

Table J.4

Balance of Payments Current Accounts

(Per cent of GDP/GNP at market prices)

	1965-69	1970-74	1975-79	1980-84	1985	1986	1987
US	0.3	0.0	0.0	-0.8	-3.0	-3.3	-3.1
Japan	0.8	0.9	0.6	0.9	3.7	4.3	3.7
Germany	0.2	1.1	0.7	-0.1	2.1	4.2	3.4
France*	-0.3	-0.1	0.4	-1.0	0.1	0.5	0.3
UK*	0.0	-0.3	-0.4	1.3	1.0	0.1	-0.4
Italy*	2.9	-0.4	0.6	-1.4	-1.1	1.8	1.7
Canada	-1.1	0.1	-2.2	-0.1	-0.6	-1.6	-1.2

*Per cent of GDP; other GNP

ANNEX K:
SIMULATIONS-
CHANGE IN STANCE
OF POLICY

Not v convincing ✓
(but special [illegible] ✓)

ANNEX K: SIMULATIONS OF CHANGES IN THE STANCE OF POLICY

This annex describes estimates of the effects of changing the stance of policy derived from the Treasury model. Changes in stance are defined for this purpose as combinations of changes in monetary and fiscal instruments which alter the growth rate of money GDP.

2. There are a number of ways in which money GDP growth can be reduced through changes in macroeconomic policy. Each involves lower monetary growth but they differ in the mix of changes in monetary and fiscal instruments. A number of particular combinations are;

- a balanced tightening of monetary and fiscal policy
- tighter monetary policy only
- tighter fiscal policy only

3. **A balanced tightening of monetary and fiscal policy** would entail

- a lower PSBR ratio
- for a time, higher real interest rates.

Monetary growth would also need to be lower, though probably less than one for one.

4. The possible effects of such a balanced change in policy are illustrated in the upper panel of table K1 where the fiscal change is assumed to take the form of higher personal income tax. Some important features of the simulation are as follows;

- reducing money GDP growth by 1% per annum through a balanced tightening of policy might reduce the level of GDP by around ½% in the first few years, with the effect on inflation building up quickly to 1% per annum;

- although real interest rates would need to be increased, nominal rates could actually be a little lower from the second year onwards because inflation is lower;

- the consequence is that the growth of M0 might be reduced by only about ½-¾% per annum;

- a lower PSBR means lower funding, so £M3 growth might be reduced by only around ½% per annum.

Table K1: Policies to achieve 1 per cent slower money GDP growth

(i) Balanced tightening of monetary and fiscal policies

		Short term Interest Rates		Monetary Growth			RPI
	PSBR(%)	Nominal	Real	MO	£M3	GDP(%)	Inflation
Year 1	-0.5	+0.1	+0.5	-0.7	-0.3	-0.5	-0.4
Year 2	-0.5	-0.4	+0.5	-0.8	-0.5	-0.6	-0.9
Year 3	-0.5	-0.8	+0.3	-0.6	-0.4	-0.7	-1.1
Year 4	-0.5	-1.0	+0.1	-0.5	-0.6	-0.5	-1.1

(ii) Tightening of monetary policy, fixed PSBR ratio

	Short term Interest Rates		Monetary Growth			
	Nominal	Real	M0	£M3	GDP(%)	Inflation
Year 1	+0.7	+0.9	-0.7	-1.0	-0.4	-0.2
Year 2	-0.3	+0.7	-0.6	-0.4	-0.6	-1.0
Year 3	-0.4	+0.6	-0.7	-0.9	-0.6	-1.0
Year 4	-0.3	+0.7	-0.8	-0.9	-0.6	-1.0

(iii) Tightening of fiscal policy, fixed monetary growth*

		Short term Interest Rates		Monetary Growth			RPI
	PSBR(%)	Nominal	Real	MO	£M3	GDP(%)	Inflation
Year 1	-0.7	-0.5	-0.2	-0.4	+0.4	-0.3	-0.3
Year 2	-1.1	-1.5	-0.6	-0.3	+0.3	-0.4	-0.9
Year 3	-1.0	-1.7	-0.6	-	-	-0.4	-1.1
Year 4	-0.6	-2.2	-0.9	+0.1	-0.1	-0.2	-1.3

* Average of M0 and £M3

5. **Tighter monetary policy only**, with the PSBR path unchanged, is illustrated in the middle panel of table K1. Some characteristics of the simulation are;

- larger and more sustained rises in real interest rates. Foregoing the ½ point cut in the PSBR ratio might mean real interest rates eventually ½-¾ points higher than with a balanced policy change.

- this and the maintenance of unchanged funding would mean a somewhat greater reduction in monetary growth, especially broad money;

- but the effect on output and inflation would be much as before.

6. **Tighter fiscal policy alone**, with monetary growth unchanged, is illustrated in the lower panel of table K1. Some characteristics of the simulation are;

- reliance on fiscal policy alone would mean cutting the PSBR by about 1% of GDP in the second and third years, and a little less thereafter;

- this would permit reductions in both nominal and real interest rates, and hence less upward pressure on the exchange rate (see table K3);

- if anything the loss of output might be a little smaller than in the other cases, because of the impact of lower interest rates on the RPI and hence earnings growth, but the difference is fairly marginal.

7. The precise changes in policy instruments necessary to achieve lower money GDP growth depend on how the shift is perceived in the markets. The figuring above assumes that the tightening of policy would be accompanied immediately by some appreciation - perhaps in the range 1-3% - of the exchange rate. To the extent that this does not occur, perhaps because the markets interpret any

XR assumed to be the same in each variant !!!

announced change in policy settings as simply confirming what they anyway thought necessary for the government to achieve its objectives, the initial rise in interest rates would have to be higher for any given PSBR path. This would mean a slower adjustment of inflation, a somewhat larger initial loss of output, and a slightly more pronounced reduction in the growth of M0.

8. Even allowing for different behaviour of expectations, the different ways of reducing money GDP growth are likely to have much the same effects on output and inflation. But there are important structural differences, as shown in tables K2 and K3;

- with a pure monetary tightening the increase in real interest rates would need to be sustained, whereas with a balanced tightening the effect dies away. A pure fiscal tightening permits lower real interest rates, as already noted.

- a lower PSBR would mean progressively lower debt interest payments, so that with a balanced tightening of policy the need for higher taxes/lower public expenditure would fall progressively. The same is true eventually with a pure fiscal tightening. But with a pure monetary tightening, rising real debt interest payments mean progressively higher taxes/lower expenditure;

- a balanced tightening or a pure fiscal tightening will normally result in a lower share of consumption in GDP than with a pure monetary tightening. The main exception would be if reductions in the PSBR were achieved by reducing public investment rather than by, say, raising income tax.

1 Copy
Without Red & Pencil
Comments
P1

Table K2: Effects on Debt Interest and the Share of Consumption in GDP

	Net debt interest(£b)	Other net expenditure (£bn)	PSBR(£b)	Share of consumption in GDP Private	Share of consumption in GDP Total
Balanced Tightening					
Year 1	-0.1	-1.9	-2.0	-	+0.1
Year 2	-0.4	-1.8	-2.2	-	+0.1
Year 3	-0.7	-1.7	-2.4	-0.2	-
Year 4	-1.1	-1.5	-2.6	-0.2	-0.1
Monetary Tightening					
Year 1	+0.1	-0.1	-	+0.1	+0.2
Year 2	+0.1	-0.2	-0.1	+0.2	+0.3
Year 3	+0.1	-0.3	-0.2	+0.1	+0.3
Year 4	+0.2	-0.5	-0.3	+0.1	+0.2
Fiscal Tightening					
Year 1	-0.2	-2.5	-2.7	-0.1	-0.1
Year 2	-0.9	-3.8	-4.7	-0.2	-0.1
Year 3	-1.7	-2.7	-4.4	-0.3	-0.2
Year 4	-2.5	-0.7	-3.2	-0.2	-0.1

9. Of particular significance at present is the effect on the current account of alternative ways of tightening policy. This is illustrated in table K3;

- a balanced tightening of policy would probably have little effect on net exports if the real exchange rate appreciates for a while. The effects of lower domestic demand would be offset by the loss of competitiveness; nevertheless, there would probably be some small improvement in the current account because the terms of trade would improve. With a weaker exchange rate there would still be some current account improvements, with a more favourable movement in trade volumes but worse terms of trade.

- a pure fiscal tightening would also tend to improve the current account, with effects approaching £1 billion after two or three years;

- but a monetary tightening would cause the current account to deteriorate after a while because of the greater upward pressure on the real exchange rate. There would be a smaller reduction in domestic demand and an increasing loss of net exports. After 3 or 4 years the current account would be worse by around £1¼ billion (over ¼% of GDP) with a monetary tightening than with a fiscal tightening.

Table K3: External Effects

	Real exchange rate (%)	Real domestic demand (% of GDP)	Real net exports (% of GDP)	Current Account	
				% of GDP	£billion
Balanced Tightening					
Year 1	+2.4	-0.53	+0.02	+0.2	+0.7
Year 2	+1.8	-0.67	-0.04	+0.1	+0.5
Year 3	+1.5	-0.72	-0.05	+0.1	+0.5
Year 4	+1.3	-0.58	-0.04	+0.1	+0.5
Monetary Tightening					
Year 1	+3.0	-0.33	-0.11	+0.1	+0.4
Year 2	+2.4	-0.51	-0.17	-	+0.2
Year 3	+2.3	-0.41	-0.28	-0.1	-0.3
Year 4	+2.2	-0.29	-0.30	-0.1	-0.6
Fiscal Tightening					
Year 1	+1.1	-0.42	+0.08	+0.1	+0.6
Year 2	+1.0	-0.46	+0.03	+0.2	+0.8
Year 3	+1.2	-0.46	-0.01	+0.2	+0.9
Year 4	+1.2	-0.07	-0.14	+0.1	+0.6

BANK PAPER

COVERING SECRET

Bank of England
London EC2R 8AH

The Governor

22 December 1986

CH/EXCHEQUER
REC. 22 DEC 1986 ✓ 22/12
~~ACTION~~ CST FST EST MST
SIR P MIDDLETON
COPIES TO
SIR T BURNS
MR F E R BUTLER
SIR G LITTLER
MR CASSELL
MR MONCK
MR A WILSON
MR SEDGWICK
MR SCHOLAR
MR ODLING-SMEE
MISS C. EVANS
MR CROPPER
MR TYRIE
MR ROSS GOOBEY
PS/IR
PS/C+E

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
London
SW1P 3AG

Dear Nigel,

I enclose the Bank's contribution to the papers for your meeting at Chevening in January.

Yours ever,

Robin

BANK BUDGET SUBMISSION

I Summary

The immediate prospect is for growth at a satisfactory pace. The fact that it is being led by buoyant consumption is an important consideration in thinking about the form of any fiscal adjustment. Underlying trends and the balance of developments point to a need for measures with favourable supply-side effects.

If the pre-Budget forecast follows the Autumn Statement, and the Bank's present expectations, MTFS commitments are likely to be compatible with a fiscal adjustment of about £3 bn. We argue below that not more than £1 bn of this should be utilised.

The reasons for this are: that a larger PSBR than £5 bn is likely to represent an underlying increase at a time of strong economic expansion; that a PSBR of more than £5 bn is not compatible with the long-term objective of reducing the debt/income ratio (broadly defined): and that to use the full MTFS headroom would involve placing excessive weight on monetary policy in restraining the growth of nominal incomes.

Although the recent depreciation of sterling does not seem likely to trigger a rapid deterioration of inflation, an improvement of performance in the next three or four years upon that of the last three or four years will not easily be achieved.

We recognise that some virtual commitments have already been made, and that the scope for making sufficient progress with supply side measures to affect the underlying prospects of the economy within a £1 bn fiscal adjustment is very small.

II The Immediate Economic Outlook

Prospects for 1987 and 1988 are quite bright. Treasury forecasts on unchanged policies show real GDP growth averaging about 3% pa and nominal GDP of about 7 1/4%, with the GDP deflator rising at just over 4%. Manufacturing output grows more rapidly than GDP at around 4% pa. Inflation measured by the RPI runs at about the same rate of increase as the GDP deflator, albeit with a slight tendency to rise in 1988. Unemployment is broadly stable at something very like its present level. The PSBR is a little over 1 1/2% of GDP, and falling. Fiscal adjustments of £2 1/2 bn and £5 bn are assumed for 1987-88 and 1988-89 respectively.

Our own forecasts, done later than the Treasury's, are not dissimilar, with, if anything, an even more buoyant view of demand and output. The PSBR is put at below £7 bn this year and is projected to be slightly lower than in the Treasury forecast in the next two years, in part because we assume some recovery in oil prices and revenues. The scope for fiscal adjustments within the MTFS constraints is, however, much the same.

As last year, when we were wrong in this respect, growth looks likely to be stronger in the immediate future than thereafter. We were not, however, wrong to predict strong consumption and a weaker current account. These trends persist: the current balance is in a position of worsening deficit of about £1 1/2 bn in 1987, £3 1/2 bn in 1988, according to the Treasury, with a particularly large deterioration in visible trade, only part of which is in oil. While consumption grows at 1 1/2 times the growth rate of GDP (in our forecast), investment grows no faster than GDP, of which it remains a relatively modest proportion. This imbalanced pattern is not sustainable for very long.

[illegible]

Although we predict a significant supply response to the recently improved competitive position, and a continuation of recent high levels of profitability, this is insufficient to correct the disturbing underlying trends. The weight of the evidence is against any claim that overheating is imminent, but nominal GDP growth hardly falls below 7% as we look further ahead, thus inflation continues in the range where it has been stuck for three or four years already.

III

It is clear that there is scope for some positive fiscal adjustment within the current framework of policy. There is room for argument about the exact scope depending on whether one relies on the letter of the most recent MTFS or on the broader arguments underlying the strategy. That issue is postponed to the next section where the case for leaving some of the scope untouched is examined. Here we look at alternative possible forms of fiscal adjustment.

As ministers have frequently had occasion to say, and is underlined by the latest export and retail sales figures, the economy is not suffering from deficient demand. What are required are measures which:

a improve competitiveness;
b switch expenditure from consumption to investment, increasing the capacity to supply;
c increase the responsiveness of domestic supply to demand.

Macro-fiscal instruments which might be considered include:-

- cuts in income tax which would stimulate consumption demand, might stimulate supply of labour and effort, and (in the view of some) might contribute to wage restraint;

- cuts in employers' NICs which are analytically very similar. If not pre-empted by wage increases, however, they have different supply-side effects (in the short run) by reducing costs and prices and raising profitability and possibly investment, while also encouraging the substitution of labour for capital;

- additional public expenditure designed to complement or induce private investment in physical plant or in human capital and skills, and to lower the costs of production throughout the economy.

We take these in reverse order. Recent forecasting and control of public expenditure suggests that over-runs are less likely to pre-empt the scope for fiscal adjustment than we have feared in previous years. Moreover, if not dissipated in pay, a programme could be targetted to meet the criteria set out above. Nevertheless the market response to the realistic projection for public expenditure in the Autumn Statement suggest that any further increase might be difficult to present.

We also see some attractions in a possible further restructuring of employers' NICs, including, perhaps, an element of regional variation. This might achieve some of the effects of a desirable increase in the response of relative wages to different local conditions without eliminating the incentive for such adjustment. Some form of profit-related pay may be another way of increasing such flexibility in the longer term. The expectations of income tax cuts that have already been raised must, however, increase the ever-present danger that any cuts in employers' NICs would be seized upon by wage negotiators to fulfil their net income aspirations.

It is thus difficult to identify feasible macro-fiscal measures which are clearly superior to income tax cuts, although, as already mentioned, the latter would stimulate consumption and imports and might trigger an adverse response on the exchange market with inflationary consequences. These dangers should not, however, be exaggerated as some political commitments in this area are undoubtedly already discounted by the markets.

There also remains the choice between higher thresholds and lower rates. Earlier measures have already transformed the problem of the poverty and employment traps, but there remain many people whose marginal "tax rate" exceeds 75% and whose incentive to work therefore remains modest. Further progress in this area remains a priority consistent with the criteria suggested above.

IV

We have seen that, as long as the pre-budget forecasts fulfil our present expectations, there should be scope for a fiscal adjustment of £2-3 bn in 1987 while meeting the MTFS commitment that the PSBR not exceed 1 3/4% of GDP. The wisdom of making the full adjustment must depend in part on the relation of that commitment to the underlying rationale of the strategy.

This has had three elements: the long-run sustainability of the lower rates of tax; including their compatibility with a declining "debt/income ratio"; and their consistency with the requirements of a counter-inflationary monetary policy.

We address these in turn.

The sustainability of lower taxes is very sensitive to the long run trend growth of public expenditure. A permanent reduction in its growth rate relative to that of GDP is more important than a temporary freeze (even for several years) if it subsequently grows in line with GDP.

On the assumption that public expenditure grows at about 1 1/2% pa in cost terms, and given the planned level of asset sales, the stock of gilts outstanding would rise less rapidly than GDP for several years with an income tax rate of 25p in the £. The stock of gilts does not, however, fully reflect the strength or weakness of the public sector balance sheet. The sales of various assets, including council houses, land and any excess of oil revenues over their permanent value, need also to be taken into account, as we argued in some detail a year ago.

With debt about 45% of GDP, and target growth for nominal GDP of less than 7%, the "deficit" must be below about 2 1/2% of GDP if the "debt"/income ratio is to fall perceptibly. If total asset sales are regarded as a financing item they alone, at £5 bn, account for about 1 1/4% of GDP, leaving only as much again for the PSBR itself. Both this argument, and the case against raising the PSBR from the low figure likely to be achieved this year, as the economy expands, point to a PSBR objective of about £5 bn.

Secondly our projections assume that social security benefits are indexed to prices rather than wages. With real incomes in general rising this implies a falling safety net in relative terms. Although this may have supply side advantages, at some point it, like falling relative pay in public services, is likely to have to cease.

1. Relative pay in pub serv not falling
2. Supply side advantages of indexation to prices are not nec [illegible] [illegible] for some time.

Furthermore, as was highlighted in the Green Paper on long term public expenditure, there are a number of adverse implications for public expenditure growth, particularly in health care, implicit in the ageing of the population. The failure to meet ambitious targets for contracting public expenditure in recent years undermines confidence that these demands can be met by switching resources from other areas.

Fears remain that the quality of some elements of the infrastructure is not being maintained and that pressure to do so may mount - as well as pressures from our EC partners to match the growth of their contributions to common programmes.

Oh?

All these considerations urge caution in reducing tax rates in 1987/8 even if their eventual reduction would be warranted by the fulfilment of current expenditure plans and revenue hopes. They do, moreover, relate exclusively to real considerations (at the aggregate level) which bear on appropriate tax rates, to the exclusion of the criteria of Section II and the need for fiscal policy to join monetary policy in restraining the excessive growth of nominal incomes. These two factors are related in that an exclusive reliance on interest rates, which would be liable to have to rise if the full MTFS scope for tax cuts were achieved, would itself be damaging from a supply side point of view.

agreed ?

!!!

We would thus recommend a PSBR of £5 bn at most and a fiscal adjustment of up to £1 bn.

NATIONAL BUREAU OF ECONOMIC RESEARCH, INC.

1050 MASSACHUSETTS AVENUE, CAMBRIDGE, MASSACHUSETTS 02138

cc Sir T Burns
x Sir G Littler
Mr Evans
Mr Sedgwick

MARTIN FELDSTEIN
President and
Chief Executive Officer

Recd. Thanks.

December 24, 1986

Sir Peter Middleton
Permanent Under Secretary
H.M. Treasury
Parliament Street
London SW1
ENGLAND

Cx I have this in my chewing folder

Dear Peter:

I am enclosing two pieces that I think will interest you.

One is a short outlook for the American economy in 1987 that will appear in the <u>Financial Times</u>. The other discusses the optimistic longer-term prospects for reducing the U.S. trade deficit and the implications of this for the dollar and for the pace of activity in the world economy.

Not enclosed

Yes! Thanks

With my best wishes for the New Year.

Sincerely,

Mart

Martin Feldstein

MF/cat
enclosure

The American Economy in 1987

Martin Feldstein*

Although the performance of the American economy in 1987 is likely to be quite satisfactory, the problems and risks that lie just below the surface will be exacerbated by political neglect. The key risks to the outlook are the uncertainties about international trade and the dollar, uncertainties that are also very important for the economy's long-term evolution. Indeed, it is the potential clash between the neglected budget deficit at home and a shift in foreign investors' willingness to continue their rapid increase of investment in dollar securities that represents the greatest risk to the economy's future.

The strength of domestic demand in the United States has fortunately been substantially greater in 1986 than the headlines about the weak growth of GNP would suggest. Although real GNP rose only 2.3 percent in the year between the third quarter of 1985 and the third quarter of 1986, domestic final demand increased by a very substantial 3.8 percent. The primary reason for this difference was the sharp rise of net imports, an increase equal to 1.4 percent of GNP. Although domestic demand was strong, more than a third of the demand growth was siphoned away into increased net imports from abroad.

---

*Professor of Economics, Harvard University and President, The National Bureau of Economic Research. These comments will be published in the _Financial Times_ in January 1987.

The contrast between weak GNP growth and the strong rise in domestic final demand was even greater in the most recent six months for which data are now available. Between the first and third quarters of 1986, real GNP grew at a rate of only 1.7 percent while real domestic final demand rose at a startling 6.2 percent annual rate.

The powerful recent growth of demand implies that GNP in 1987 can expand at a healthy rate despite the inevitable slowdown in the growth of domestic spending. Virtually every major category of domestic demand can be expected to grow more slowly in the months ahead than it has in the past year. Consumer spending has been on a credit-financed surge that will slow as consumers seek to rebuild their saving rate and contain their credit exposure. Business investment will slow down because of the anti-investment features of the recent tax bill and as a natural reaction to the accelerated 1986 pace of investment that was aimed at capturing the depreciation rates that prevailed under the old tax rules. And the deficit-cutting legislation enacted in 1986 will mean a slower growth of outlays for defense and nondefense programs.

But even if domestic demand growth were to fall to only one-third of its pace in the past two quarters, demand would be growing at an annual rate of more than two percent. The total rise in GNP would be raised above this rate by the likely rebuilding of recently depleted inventories and, even more importantly, by a reduction in the trade deficit in response to the dollar's sharp decline since the beginning of 1985. If the merchandise trade deficit shrinks by the roughly $30 billion that experts now project, that will add three-fourths of a percent to the GNP growth rate, bringing the overall GNP growth rate up to nearly three percent. If domestic demand expands at 2.5 percent or faster, overall GNP could even rise by more than three percent.

These figures make it clear that a turnaround of the trade deficit holds the key to satisfactory GNP growth in 1987. A repeat of last year's trade deterioration would leave GNP growth well below two percent and cause unemployment to rise. But this is very unlikely. The U.S. trade deficit can be expected to decline because the dollar's fall since February 1985 has erased three-quarters of its previous real increase against a very broad basket of other currencies. Although the month-to-month trade statistics are so inaccurate that it will be difficult to identify a turn in the trade deficit with confidence, I now believe that the U.S. trade deficit has either already begun to shrink or will start to decline within the next few months.

The legislative actions taken in 1986 and earlier years will reduce the government's budget deficit from 1986's $220 billion to about $180 billion in 1987. The precise level is particularly difficult to forecast this year because the recent tax legislation will induce unpredictable changes in the timing of tax payments. But the deficit is likely to decline significantly because of the cuts in defence spending, the fall in the interest ates on government debt, and the extra revenue resulting from the 1984 "downpayment" tax package. In contrast, the slower than predicted GNP growth in 1986 actually raised the deficit, contrary to the predictions of those who had hoped we would grow our way out of the massive deficits.

Although a 1987 deficit of about four percent of GNP is substantially better than the six percent of GNP deficit that would have prevailed without the legislative action of the past few years, it is still far too high. With the deficit at this level, government borrowing will be absorbing half of all of the net saving of households, firms and state-local governments.

Unfortunately no legislative progress on the deficit is likely in 1987. The Republican loss of the Senate in the recent election means that Congress lacks the ability to send clearly bipartisan legislation to the White House. With the bipartisan blame-sharing mechanism gone, the only likely result is a budget stalemate.

The absence of any additional legislative progress in reducing future government borrowing creates a serious risk of a substantial rise in real interest rates. The key to this risk is the potential behavior of foreign portfolio investors. If foreign investors are willing to go on supplying massive amounts of additional credit to the United States, interest rates in the United States can remain at the current level or even decline in the year ahead. The progress that has already been made in deficit reduction would lower interest rates. Similarly the effects of the recent tax legislation on the demand and supply of credit should also put downward pressure on interest rates.

But in the current environment, a reduction in the willingness of foreign investors to buy dollar bonds could cause a jump in interest rates. If foreign investors decide that high real interest rates in Germany and the likely future movements of the exchange rates make German bonds a more attractive investment than dollar bonds, the exchange value of the dollar could drop sharply. The lower dollar would mean a smaller future trade deficit and therefore a reduced inflow of foreign capital. The capital markets would respond to this prospect of a reduced capital inflow by immediately raising long-term real interest rates.

After a year in which the Federal Reserve has cut the discount rate four times and allowed the monetary aggregates to grow faster than the upper limits of their target ranges, the Fed would be in no position to offset such upward pressure on interest rates by a further easing of money. Any easing of monetary policy could increase the fear of inflation and further depress the dollar's value. In this context, an easier monetary policy could actually increase both the nominal and real interest rates.

A fall in the dollar and a rise in the real interest rate could destabilize the economic expansion and push the economy into recession. Although the lower dollar would give a boost to net exports and therefore total economic activity, the higher al interest rates would depress investment in plant and equipment and other interest sensitive kinds of spending. There is no way to know which of these forces would have a more powerful impact on the economy's short-term performance. If the contractionary impact of the higher interest rate is stronger than the expansionary impact of the lower dollar, the economy would be pushed into recession.

That risk is one of the adverse effects of our nation's failure to take action to reduce the budget deficit in earlier years when its potential magnitude first became clear. Now it is a risk that the United States and the world economy will have to live with until at least 1989 when there is a new Congress and a new President.

MINISTRY OF AGRICULTURE, FISHERIES AND FOOD
WHITEHALL PLACE, LONDON SW1A 2HH

From the Minister

PGST

BST

CONFIDENTIAL

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
London SW1P 3AG

30 December 1986

EQL
31 DEC 1986
P Walters
TO
CST, FST, EST, MST,
Sir P Middleton
Sir G Littler, Sir T Burns,
Mr Lavelle, Mr Monck,
Mr Edwards, Mr Bugner
Mr Crabbie, Mr Mortimer,
Mr Bonney.

Dear Chancellor,

Very shortly I shall be writing to you giving my views on the tax law changes that I hope you will introduce in your Budget Speech. I shall be referring to the very serious situation now being faced by many farmers and to the importance this year of finding ways, through your tax proposals, of holding out a lifeline for the farming industry as farmers struggle to cope and to adjust to the cutbacks in production and to their funding problems.

My purpose in writing this letter is to give advance warning of one particular area where a modest measure could do much to demonstrate the Government's recognition of the difficulties now confronting our farmers. Far from easing, the pressures will surely increase as the reforms secured in Brussels work through. I refer to first year allowances in respect of capital expenditure on plant and machinery.

You will recall that one of the reasons you gave when you announced the phasing out of first year allowances was that they had been used for tax avoidance purposes. My experience, however, is that few farm businesses and certainly the smaller family businesses, have ever been guilty of the purchasing of unnecessary machinery. Indeed, because of the great technical improvements made by agriculture over the years, the ability to purchase suitable machinery has become an essential component in the productivity achievements of the industry. And I should add that the bulk of farm businesses, being unincorporated, gained nothing from the reduction in the rate of Corporation Tax. In the circumstances, I would urge you to give special consideration to the introduction of a new 100% first year allowance on say the first £30,000 of expenditure on plant and machinery. Such an arrangement would particularly assist the smaller family farm. It is a concession I would envisage applying generally to provide further encouragement to the growth of all small businesses.

Yours sincerely,

Elizabeth Morris

for MICHAEL JOPLING
(approved by the Minister and

ps2/62R

CONFIDENTIAL

PM

FROM: CATHY RYDING
DATE: 2 January 1987

SIR T BURNS

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Mr F E R Butler
Sir G Littler
Mr Cassell
Mr Odling-Smee
Mr Peretz
Mr Scholar
Mr Sedgwick
Mr Riley
Mr Allan
Mr Cropper
Mr Ross Goobey
Mr Tyrie

Mr Battishill - IR
Sir A Fraser - C&E

3 I must speak to the Private Office about this

POLICY BACKGROUND TO THE 1987 BUDGET

The Chancellor was grateful for your minute of 19 December attaching a paper on the policy background to the 1987 Budget.

2. The Chancellor was not convinced by the conclusions of your paper. In particular, he thought that a more balanced approach was desirable. He thought that the path recommended looked panicky, would lack credibility, and would unsettle markets. He has noted that the main conclusion to emerge is the need to have the exchange rate at worst no lower, and preferably slightly higher. He thinks that this alone undermines the case for the low PSBR/low interest rate variant.

3. The Chancellor also had a number of specific comments on your paper which are detailed below:-

Paragraph 7

The Chancellor thought that this was useful material for his next House of Commons speech.

Paragraph 13

The Chancellor thought that this ignored the crucial question of:

(a) the relative weights of the two instruments;

(b) the central position of monetary policy in curbing inflation; and

(c) the Supply Side case for lower taxation.

Paragraph 54

The Chancellor has noted that nominal interest rates have been projected to fall significantly over the MTFS horizon, thus keeping the increase in velocity well below its normal trend. He is very doubtful about this assumption.

Paragraph 70

The Chancellor thought that the first point in this paragraph should also include examples from other countries. He has also commented that there is no need to make any necessary correction in a single year.

Paragraph 76

The Chancellor was unhappy with the "balanced tightening" path shown in Table 9, which assumed greater tightening in 1987-88 than in the next four years combined.

Annex B

The Chancellor would be grateful if Chart B.1 could be redrawn to cover the 1980s only.

Annex C

The Chancellor would be grateful to know what model was used for the simulations and what period they covered.

Annex D, paragraph 2

The Chancellor would be grateful to know the size of the adjustments that were made to the January internal forecast to prepare the MTFS projections. He thinks that the ex ante boost to nominal demand in October compared to the MTFS, offset partially by higher interest rates, can only be due to a very limited extent to the removal of these adjustments.

Annex G, paragraph 4

The Chancellor would be grateful to know what adjustments were made for essentially capital transactions and would also be grateful for an explanation of the "Riley adjustments".

Table J.3

The Chancellor would be grateful if you could check the figures for France.

CR

CATHY RYDING

ps2/62R

CONFIDENTIAL

FROM: CATHY RYDING
DATE: 2 January 1987

SIR T BURNS

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Mr F E R Butler
Sir G Littler
Mr Cassell
Mr Odling-Smee
Mr Peretz
Mr Scholar
Mr Sedgwick
Mr Riley
Mr Allan
Mr Cropper
Mr Ross Goobey
Mr Tyrie

Mr Battishill - IR
Sir A Fraser - C&E

Ch

I very much doubt your comments (as opposed to your motives) should have been minuted out. But too late to withdraw.

AA
8/1.

CR to SIR T BURNS 2/1

POLICY BACKGROUND TO THE 1987 BUDGET

The Chancellor was grateful for your minute of 19 December attaching a paper on the policy background to the 1987 Budget.

2. The Chancellor was not convinced by the conclusions of your paper. In particular, he thought that a more balanced approach was desirable. He thought that the path recommended looked panicky, would lack credibility, and would unsettle markets. He has noted that the main conclusion to emerge is the need to have the exchange rate at worst no lower, and preferably slightly higher. He thinks that this alone undermines the case for the low PSBR/low interest rate variant.

3. The Chancellor also had a number of specific comments on your paper which are detailed below:-

Paragraph 7

The Chancellor thought that this was useful material for his next House of Commons speech.

CHANCELLOR OF THE EXCHEQUER

Paragraph 13

The Chancellor thought that this ignored the crucial question of:

(a) the relative weights of the two instruments;

(b) the central position of monetary policy in curbing inflation; and

(c) the Supply Side case for lower taxation.

Paragraph 54

The Chancellor has noted that nominal interest rates have been projected to fall significantly over the MTFS horizon, thus keeping the increase in velocity well below its normal trend. He is very doubtful about this assumption.

Paragraph 70

The Chancellor thought that the first point in this paragraph should also include examples from other countries. He has also commented that there is no need to make any necessary correction in a single year.

Paragraph 76

The Chancellor was unhappy with the "balanced tightening" path shown in Table 9, which assumed greater tightening in 1987-88 than in the next four years combined.

Annex B

The Chancellor would be grateful if Chart B.1 could be redrawn to cover the 1980s only.

Annex C

The Chancellor would be grateful to know what model was used for the simulations and what period they covered.

Annex D, paragraph 2

The Chancellor would be grateful to know the size of the adjustments that were made to the January internal forecast to prepare the MTFS projections. He thinks that the ex ante boost to nominal demand in October compared to the MTFS, offset partially by higher interest rates, can only be due to a very limited extent to the removal of these adjustments.

Annex G, paragraph 4

The Chancellor would be grateful to know what adjustments were made for essentially capital transactions and would also be grateful for an explanation of the "Riley adjustments".

Table J.3

The Chancellor would be grateful if you could check the figures for France.

CR

CATHY RYDING

ps2/63R

SECRET

FROM: A W KUCZYS
DATE: 2 January 1987

MR SCHOLAR

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir G Littler
Sir T Burns
Mr F E R Butler
Mr Cassell
Ms Evans
Mr Cropper
Mr Ross Goobey
Mr Tyrie

Mr Battishill - IR
Sir A Fraser - C&E

CHEVENING 1987: TAX ISSUES

The Chancellor was grateful for your minute of 19 December covering a paper on tax issues.

2. The Chancellor had the following questions and comments:

Paragraph 18

The Chancellor would be grateful to know whether the increase could be confined to basic rate for existing loans?

Paragraph 20

The Chancellor has asked if this is on the 15 per cent on interest basis?

Annex 2.B - Personal taxation - freestanding AVCs

The Chancellor has noted that the revenue cost for 1988-89 is estimated to be £75-100 million. He has asked if it is really as much as this? He wonders how much would be recovered by tightening up in this field, and he would be grateful to know the basis of this calculation.

CHANCELLOR OF THE EXCHEQUER

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

2 January 1987

John Footman Esq
Private Secretary to the
Governor
Bank of England
Threadneedle Street
LONDON
EC2

Dear John

BANK BUDGET SUBMISSION

The Chancellor was most grateful for the Bank's contribution to the papers for Chevening attached to the Governor's letter of 22 December.

Yours ever,

Tony

A W KUCZYS
Private Secretary

SECRET

CHANCELLOR OF THE EXCHEQUER

Annex 3, Table 1

The Chancellor has commented that this table should cover single persons, as well as families. What does the column headed "average" signify? (He has noted that, in this column, the figures for one-earner couples with children are twice those for all families). And does "annual gross income" mean "income before tax, NICs and benefits"?.

A W KUCZYS

ps2/67R

CONFIDENTIAL

PWP

CR
to
B/CST
5/2

FROM: CATHY RYDING
DATE: 5 January 1987

PS/CHIEF SECRETARY

cc Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Mr F E R Butler
Sir G Littler
Mr Cassell
Mr Monck
Mr A Wilson
Mr Sedgwick
Mr Scholar
Mr Odling-Smee
Miss C Evans
Mr Cropper
Mr Tyrie
Mr Ross Goobey

PS/Inland Revenue
PS/Customs & Excise

BANK BUDGET SUBMISSION

The Chancellor has seen the Bank Budget submission attached to the Governor's letter of 22 December. The Chancellor thought that although (inevitably) the paper was excessively tilted towards the lowest possible PSBR, it was more measured than last year's paper from the Bank.

CR

CATHY RYDING

FROM: J ODLING-SMEE
DATE: 6 JANUARY 1987

CHANCELLOR

cc
Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Mr F E R Butler
Sir G Littler
Mr Cassell
Mr Peretz
Mr Scholar
Mr Sedgwick
Mr Riley
Mr Allan
Mr Cropper
Mr Ross Goobey
Mr Tyrie

Mr Battishill (I/R)
Sir A Fraser (C & E)

* Thanks. Cd I now pse see this, re-done on a quarterly basis, in time for Chevening. N.

POLICY BACKGROUND TO THE 1987 BUDGET

You asked for Chart B.1 in Sir Terence Burns' paper to be redrawn to cover the 1980s only. I attach a blown-up version.

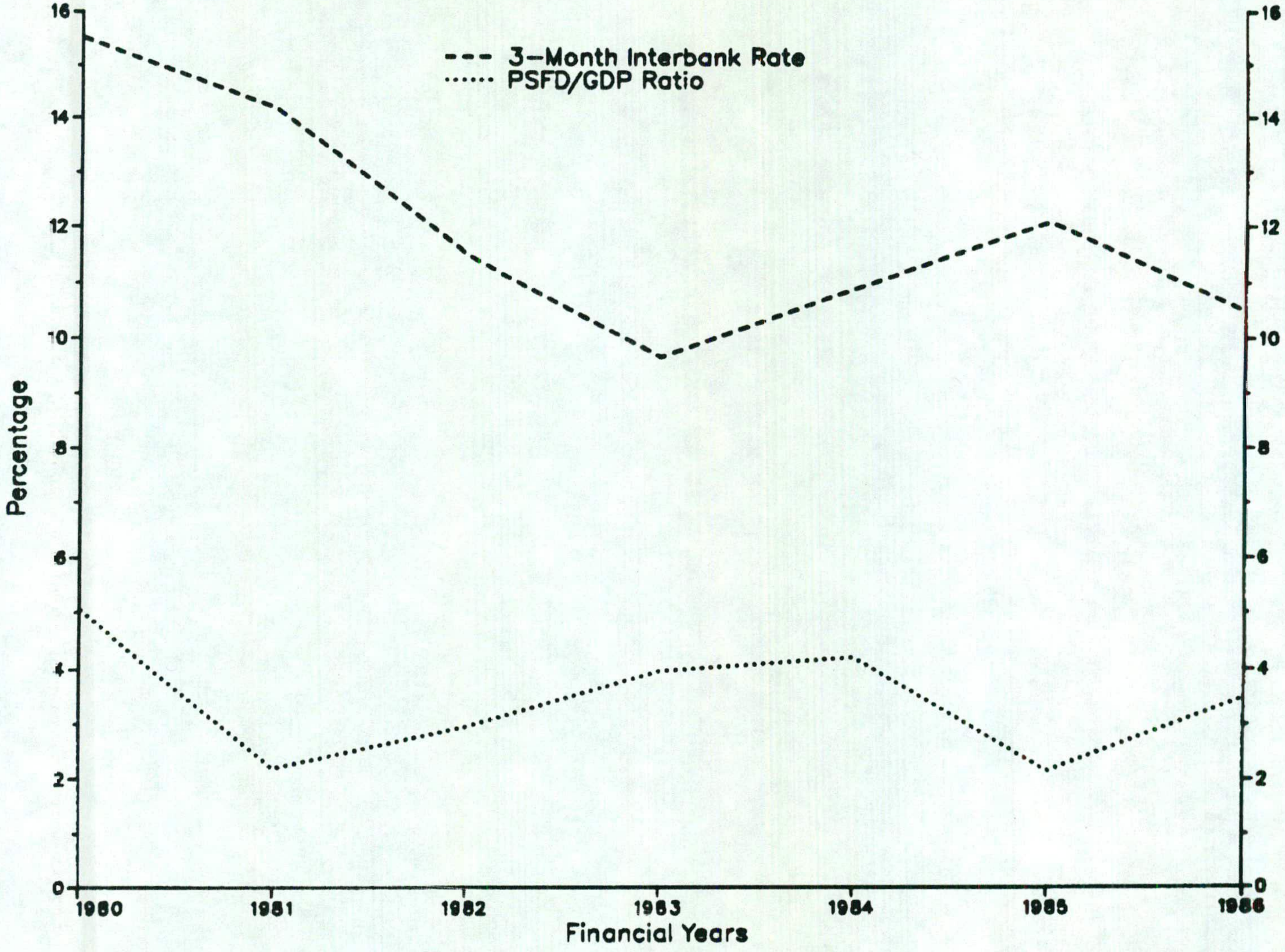
2. The answers to the other questions you raised will come later.

John 07

J ODLING-SMEE

ENC

Chart B1



MARK.DEBTGRA