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Part. C

SECRET

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Chancellor's (Lawson) Papers:
The Public Expenditure Cabinet
for the 1989 Survey.

DD's: 25 Years

[signature]
15/3/96.

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SECRET

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

Paul Gray Esq
Private Secretary to
Prime Minister
10 Downing Street
LONDON
SW1

3 July 1989

Dear Paul

PUBLIC EXPENDITURE CABINET: LINE TO TAKE

The Chancellor and Chief Secretary have been considering further the remit that Cabinet might be invited to endorse. They now propose a slightly different formulation from that in my letter on Friday:

> "Cabinet agreed to maintain the downward trend in the ratio of public spending to national output and to hold as close as possible to existing plans."

I am copying this letter Carys Evans.

Yours
Alex

A C S ALLAN

NOTE OF A MEETING HELD IN CHANCELLOR'S ROOMS AT HM TREASURY ON MONDAY 3 JULY 1989

Present:

Chancellor
Chief Secretary
Sir T Burns
Mr Anson
Mrs Lomax
Mr Gieve
Mr MacAuslan
Mrs Chaplin
Mr Tyrie

....

1989 SURVEY: CABINET REMIT

Papers: Mr Gieve of 30 June.

It was agreed to adopt the following text in place of that agreed at the Chancellor's meeting on 29 June:

> "Cabinet agreed to maintain the downward trend in the ratio of public spending to national output, and to hold as close as possible to existing plans."

A copy of the letter to the Prime Minister's Private Secretary, recording this decision, is attached.

DUNCAN SPARKES
3 July 1989

Distribution:
Those present
Sir P Middleton

gep.cj/july/lomax.3.3

covering SECRET

FROM: MRS R LOMAX (GEP)
DATE: 3 July 1989
x4499

CHIEF SECRETARY

cc Chancellor
Sir P Middleton
Mr Anson
Sir T Burns
Mr Phillips
Mr Monck
Mr Riley
Mr Gieve
Mr MacAuslan
Mrs Chaplin
Mr Tyrie

DRAFT SPEAKING NOTE FOR PRIME MINISTER

I attach a draft speaking note for the Prime Minister's use at Cabinet on 12 July. It will need further work in the light of your meeting with her tomorrow. But you may like to see it before then.

RL.

RACHEL LOMAX

DRAFT SPEAKING NOTE

SECRET

SPEAKING NOTE FOR THE PRIME MINISTER

The Chancellor's paper describes a more difficult and uncertain economic background than in recent years. Bringing inflation down must be our first priority.

Our success in controlling expenditure has helped us to pursue a prudent fiscal policy. That remains vital. Any weakening in our resolve to keep a grip on spending would be extremely damaging, not least to market confidence. The private sector is having to restrain its spending, in the battle against inflation. It is essential that the public sector should do the same. So there can be no question of using the Budget surplus to finance an unsustainable increase in spending.

Horrified at the scale of the bids this year. Highest ever. It would be quite irresponsible to increase spending on anything like this scale in the current economic situation. And it would put paid to our aim of reducing the tax burden, which remains well above the level we inherited ten years ago.

Last year Departments put in substantial further bids over the summer. I trust spending Ministers will show greater restraint this year. We shall have to find extra money for demand led programmes. But the essence of cash planning is that we must make every effort to absorb higher inflation, not accommodate it. [Very disappointing that every single Department has re-opened its three year running cost bids].

The bids for additional capital expenditure are quite unrealistic. Capital spending was increased substantially in the last Survey. A spending spree on the infrastructure would just drive up prices. It would be a wasteful use of public money, as well as fuelling inflation. We must plan investment sensibly. Bids must be scaled down, and any additional spending spread out in a sustainable way.

This will be a critical Survey. Bids must be cut back and substantial savings found. There must be a thorough review of the options across the whole range of spending, not just within bids, but within baselines as well. We have never shirked difficult decisions and, particularly at this stage in the Parliament, we cannot afford to do so now.

gep1.ip/jm/survey chx

FROM: J MACAUSLAN (GEP1)
DATE: 3 July 1989
x 4780

CHANCELLOR OF THE EXCHEQUER

cc: Chief Secretary
Mr Anson
Mr Monck
Mr H Phillips
Mrs Lomax
Mr Sedgwick
Mr Gieve (IDT)
Mr Meyrick
Miss Walker
Mrs Chaplin
Mr Tyrie

1989 PROSPECTS: MEETING WITH PRIME MINISTER: CONSTRUCTION

As promised in my note of 30 June, I now attach background briefing on construction for your meeting with the Prime Minister on Tuesday 4 July.

CON-STRUCTION

2. We will submit a refined version of this as part of the briefing for the 12 July Cabinet.

JM

J MACAUSLAN

CONSTRUCTION INDUSTRY RECENT INDICATORS

* output growth in 1987 and 1988 more than double growth rate of 1980-86.

* employment growth in 1987 and 1988 double the rate in rest of economy.

* "reports of serious shortages of skilled manpower ... have become widespread". (NEDO 12/88)

* 71% of firms working at or close to full capacity (highest balance since Survey started in 1980); problems now in all regions (BEC Survey 1989 Q1)

* construction earnings accelerating absolutely, and relative to rest of economy: 2½ percentage points higher in Q1 1989.

* construction output prices accelerating absolutely, and relative to manufacturing. In year to 1988 Q4, rose by nearly 14%, compared to 5% in manufacturing.

PROSPECTS

* business investment in new buildings etc set to grow 27% in 1989 (DTI June 1989 Investment Intentions Survey)

* bids imply public sector demands on construction industry up by well over 20% in 1990-91 on 1989-90, sustaining current rate of growth of industry despite moderated private sector demand.

Substantial imports: Channel Tunnel (+ [illegible])

* even in ignorance of possible public sector demands, (a) BEC saw"little prospect of an imminent slowdown in inflation" (May 1989); and (b) a leading firm of chartered quantity surveyors (Kensall Partnership) predicts construction tender prices up 15% in 1989, 13% in 1990

* construction inflation peak seems normally to lag output growth peak by 1-2 years. So inflation peak probably still to come.

* further demands will boost imports, already growing fast (%):

<u>Import growth</u>

	Natural aggregates	Cement
1987	10	26
1988	16	22

CONFIDENTIAL

C O N S T R U C T I O N

(% growth)

		EARNINGS GROWTH			OUTPUT PRICES		
	Output	Construction	Whole Economy	Difference	Construction	Manufacturing	Difference
1983		7.5	8.5	-1			
1984		5.8	6.0	-0.2			
1985	1.1	8.2	8.5	-0.3	4.6	5.5	-0.9
1986	3.3	7.9	7.9	0	5.0	4.1	+0.9
1987	7.9	8.0	7.8	+0.2	6.7	4.4	+2.3
1988	7.1	10.8	8.7	+2.1	11.6	4.8	+6.8
Q1		10.4	9.1	+1.3	10.2	4.7	+5.5
Q2		10.2	8.1	+2.1	11.8	4.7	+7.1
Q3		10.8	8.7	+2.1	12.4	4.8	+7.6
Q4		12.0	11.0	+1.0	13.9	5.0	+8.9
1989							
Q1		11.3	8.9	+2.4			

gep.cj/july/lomax.3.8

SECRET

FROM: MRS R LOMAX (GEP)
DATE: 3 July 1989
x4499

CHIEF SECRETARY

cc Chancellor
Sir P Middleton
Mr Anson
Sir T Burns
Mr Phillips
Mr Monck
Mr Luce
Mr Riley
Mr Gieve
Mr MacAuslan
Miss Walker
Mrs Chaplin
Mr Tyrie

DRAFT CABINET PAPER

DRAFT CABINET PAPER

I promised you a sight of your draft Cabinet paper tonight. It is still a bit rough round the edges, and we shall need to do further work on it in the light of your meeting tomorrow with the Prime Minister.

2. You will see that I have not laboured the cash planning theme, though the point is there for you and the Chancellor (and the Prime Minister) to pick up orally. I am a little wary about provoking a burst of counter-briefing from PFOs, which could make for an over-informed discussion on the day.

RL

RACHEL LOMAX

SECRET

CHIEF SECRETARY PAPER FOR CABINET

Public expenditure restraint has been a key instrument of our economic strategy over the past ten years. One of our major achievements has been to reverse decisively the remorseless upward trend in the share of national income taken by public expenditure. We have been helped recently by very strong economic growth which contributed to substantial savings in the last Survey, enabling us to increase provision on key programmes, while maintaining a modest decline in the ratio of Government spending to GDP.

2. This year, as the Chancellor's paper points out, the immediate economic outlook is more difficult and more uncertain than it has been for some years. Bringing inflation down must be our first priority. Our success in controlling expenditure has contributed to a tightening in the fiscal position, which we cannot afford to undermine. Much of the fiscal surplus is also likely to be eroded anyway as economic growth moderates. Against this background, any perception that we were weakening in our resolve to control public expenditure would be extremely damaging, not least to market confidence.

3. We face a difficult Survey. Commitments entered into since last years' plans were agreed have pre-empted our room for manoeuvre. Existing plans already take credit for the effects of recent strong growth: and we cannot expect a repeat of last year's savings through extra receipts. Higher inflation will add to demand-led programmes. Elsewhere, we must adhere to the presumption underlying cash planning that inflation should not be automatically accommodated.

The baseline

4. The planning totals we agreed last Autumn allow real growth of over 3 per cent on average over the then Survey period. This is still true even on the new inflation assumptions. There were very sharp increases for some key programmes. These plans provide the starting point for this Survey. For central Government programmes and public corporations, they have

been carried directly into the baseline. For the elements brought within the planning total under the new definition, grants and other resources for local authorities controlled by central Government, the methods of setting the baselines were endorsed by Cabinet in March [reference].

The bids

5. My minute of [x] July to the Prime Minister summarised the bids received from Departments. In addition we must take account of territorial block consequences, the nationalised industries, net contributions to the EC and Aggregate Exchequer Finance for local authorities. Additions to expenditure financed by local authorities from their own resources are outside the planning total, on the new definition, but they will still increase general government expenditure.

6. The bids imply an increase in spending that would be irresponsible and unsustainable in any circumstances. If anything like this were accepted, there would be a sharp increase in the share of public expenditure in national income. This would be seen as a major reversal of our policy of restraining the growth in public spending over the past decade, at a time when private spending is being held back by the measures needed to reduce inflation. It would put paid to our aim of reducing the tax burden as a proportion of national income and still more of getting back to the level we inherited ten years ago.

7. In current economic conditions it would also cast doubt, in financial markets and more generally, on our commitment to prudent fiscal policies, and the defeat of inflation. This would provide the worst possible basis for bringing the economy back on to course before the end of this Parliament, and run a real risk that we would be forced into a painful short term retrenchment.

8. The only prudent course is to uphold present policy and maintain the downward trend in the ratio of total public expenditure (excluding privatisation proceeds) to GDP and hold as

close as possible to existing plans. This will leave very little room for additional spending, even on priority programmes. Commitments to expenditure made since last Autumn together with the probable cost of statutory Social Security upratings will more than exhaust the likely scope for drawing down the Reserve in November. The bids will need to be severely cut back, and we shall need to scrutinise Departments' baselines rigorously for policy and other savings to offset any that are unavoidable.

9. We shall need to look particularly closely at the bids for additional capital spending. The baselines already allow for a very large increase in public sector investment, particularly on construction. If we were to agree additions on the scale implied by the bids, the public sector's demands on the construction industry would rise by some 25% between this year and next. The Chancellor's paper notes that costs and prices in the construction industry are already rising too fast. Adding to the demands on the industry would mean higher imports and further pressure on prices and earnings. Fuelling inflation in this way would be damaging to our wider economic objectives. It would also mean poor value for money. The bids will need to be drastically scaled back, and higher priority projects staged, to produce a growth in total public investment which takes realistic account of the capacity of the supplying industries, as well as the usual considerations of affordability.

<u>Aggregate Exchequer Finance for local authorities</u>

10. [Cabinet on [x] July endorsed the decisions that had been reached in E(LF)] about central Government support for local authority current expenditure for 1990-91 in England. The decisions will add around £1 billion to the public expenditure planning total, under the new definition, after taking into account the need for similar settlements in Scotland and Wales. They are designed to put downward pressure on local authority spending, while allowing local councils to set Community Charges at around this years average per capita rate bill, if they budget sensibly. While the settlement respected the need for public

expenditure restraint this year, it clearly pre-empts the room for adding to other expenditure in the remainder of the Survey.

Running Costs

11. Running costs bids exceed £800 million, with many colleagues seeking to re-open three year running cost agreements. If the bids were agreed in full, spending on the Civil Service would rise in 1990-91 by 10% or more over this year, with further significant rises in the later years.

12. I shall be urging colleagues to look for other savings within running costs to absorb the cost of pay settlements. Further savings will be needed if we are to support high priority policies including "spend to save" initiatives such as relocation, at the same time as providing realistically for future pay settlements. I am not yet satisfied with the cost improvement proposals for some areas of the Civil Service, particularly where there are large executive operations.

13. If our management of the civil service is to remain consistent with our wider expenditure and economic objectives, large reductions in bids and more ambitious plans to contain costs and improve efficiency will be necessary.

Nationalised Industries

14. All of the main ongoing nationalised industries have put in very large additional bids. In scrutinising their revised bids, which are due later this month, we must make substantial reductions and bring them to realistic levels taking account, of other major bids which add to demand on the construction industry. Where major projects are involved, we must be alive to the longer term expenditure implications, which could cause problems for future Surveys. The electricity industries will be privatised early in the Survey period but we should continue to examine their plans rigorously in this Survey, bearing in mind the implications for public expenditure while they remain within the public sector and for proceeds when they are privatised.

Conclusions

15. I ask the Cabinet:

i. to agree that we should maintain the downward trend in the ratio of public spending (excluding privatisation proceeds) to GDP, and hold as close as possible to existing plans.

ii. to agree that spending on the Civil Service should be substantially lower than implied in paragraph 11 above, and that we should look for more ambitious plans to contain costs and improve efficiency.

iii. to note that, to secure these objectives, bids for expenditure and running costs must be cut back, [additional capital spending phased] and offsetting savings found and that difficult decisions need to be taken in many areas.

iv. to agree that we should aim for substantial reductions in the additional bids from the nationalised industries.

v. to agree that I should now conduct bilaterals with colleagues on their spending programmes; and to note that if it proves impossible to reach agreement in the bilaterals, it might be necessary at the appropriate time to establish a small group which would consider outstanding issues and make recommendations to the Cabinet.

[JM]

TREASURY CHAMBERS
JULY 1989

Ch

Your Cabinet paper

Comments from CST

(1) ~~Also~~ In para 2 mention inflation is worldwide phenomenon

(2) Also in para 2 mention the knock-through to prices from capacity pressure in construction

(3) In para 14, shouldn't it be current a/c deficit almost certainly is understated (not "may well be")

(4) In para 15, worth give figure for cost of personal pensions (£3bn)?

AA

SECRET

FROM: A G TYRIE
DATE: 3 July 1989

PS/CHANCELLOR

cc: PS/Chief Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Mr Monck
Mr Scholar
Mrs Lomax
Mr Peretz
Mr Sedgwick
Mr Riley
Mrs Chaplin

PAPER FOR THE JULY CABINET

I have a few second order points.

2. Paragraph 3. At the end of that paragraph it might be worth adding a line explaining that the budget surplus is a symptom of excess demand. It's certainly not likely to be a medium term fiscal feature. At present, this point appears, possibly without quite enough pith, in paragraph 15. It's very important to disabuse colleagues of the notion that there's a kitty to raid.

3. Paragraph 8. I would redraft the first sentence. Clearly there is more than merely "the risk of higher inflation", which is with us already. Nor is it good to imply that dynamism equals inflation. Perhaps it should read: "Rapid and in some cases excessive growth in the world economy has been associated with an increase in inflationary pressure".

4. Paragraph 12. I think this analysis is pretty flawed. The residential construction industry is already off the boil. This will, to some extent, reduce pressure on the commercial construction market. By the time Channon's bids come through the likelihood is that there would be spare capacity. Nevertheless, I suppose it is worth deploying as an argument, particularly since Mr Channon is unlikely to argue much.

pp RJ
A G TYRIE

CHANCELLOR OF THE EXCHEQUER

Thanks: my
HW review.

2. PS get all
figs on table
carefully
checked (NB
also answer
journal). –

(1)

3/7/89.

During the 1980s the British economy has experienced a period of sustained economic growth, at a rate faster than that of our major European competitors. Profitability has ~~risen~~ recovered dramatically, and private investment has ~~reached record levels~~ exceeded all previous peaks. This performance has been the result of major supply side reforms carried out in a context of prudent monetary and fiscal policies.

Over the past two years growth has been particularly rapid. This has caused unemployment to fall fast; but it has also brought about a re-emergence of inflationary ~~[illegible]~~ pressures. ~~[illegible]~~ In order to deal with these pressures, monetary policy has been progressively tightened.

2

~~REVISED DRAFT INTRO FOR CABINET PAPER~~

The British economy has enjoyed a period of ~~very~~ unusually rapid growth over the past two years. This has produced the welcome results that unemployment has fallen fast, and private investment has reached record levels - and remains very buoyant.

But it has also brought a re-emergence of inflationary pressures. If we did not act resolutely to check those, that would put at risk the success of our supply side reforms, which, backed by prudent monetary and fiscal policies, have produced sustained economic growth over the past [eight] years. Some slowdown was required, and monetary policy has been progressively tightened.

There ~~are~~ is clear ~~signs~~ evidence that this policy is ~~beginning to have~~ having its desired effects, particularly on the personal sector. The housing market has slowed right down, and retail sales have shown relatively little growth. But some worrying signs remain. Inflation has ~~been~~ risen slightly ~~higher~~ higher than forecast at the time of Budget ~~time~~, and the continuing strength of the ~~continuing~~ investment boom - welcome though that is - means that other demands on the economy must ~~continue to~~ be reined back further if the overall growth of domestic demand is to be adequately restrained~~, and we are to make progress on reducing the deficit on the current account of the balance of payments~~. And some sectors - particularly construction - are continuing to experience considerable pressures on capacity.

(3)

It is clearly essential that our first priority must be to get inflation back onto a sustained downward path. This will require monetary policy to remain tight for some time to come. It also means that we cannot allow the consequent curb in the growth of private spending ~~to be undermined~~ – achieved at no little political cost – to be undermined by any let-up in our policy of restraining the growth of public spending. The fact that we are currently running a budget surplus in no way modifies this conclusion.

BR 5/7

3/7/89.

MR RILEY

cc PS/Chief Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Mr Phillips
Mr Monck
Mr Scholar
Miss Peirson
Mrs Lomax
Mr Luce
Mr Peretz
Mr Sedgwick
Mr S Davies
Mr MacAuslan
Mr Mowl
Mr Gieve
Mr Pickford
Miss Simpson
Miss Walker
Mrs Chaplin
Mr Tyrie

PAPER FOR JULY CABINET

The Chancellor was most grateful for your minute of 29 June and the draft of his Cabinet paper, and for your further comments in your minute of 30 June (not copied to all).

... 2. He has now been through the draft himself, and I attach a copy of a version incorporating his amendments. I should be grateful for any comments by close of play on Wednesday 5 July, if possible. I have already received comments from the Chief Secretary and from Mrs Chaplin which the Chancellor did not see in time to incorporate in this draft.

3. The Chancellor would be grateful if you could check carefully all the figures in the table. He would also like the format changed slightly, as indicated on the draft below.

ACSA

A C S ALLAN

CABINET

ECONOMIC PROSPECTS

Memorandum by the Chancellor of the Exchequer

During the 1980s, the British economy has experienced a period of sustained economic growth, at a rate fast than that of our major European competitors. Profitability has recovered dramatically, and private investment has exceeded all previous peaks. This performance has been the result of major supply side reforms carried out in a context of prudent monetary and fiscal policies.

2. Over the past two years, growth has been particularly rapid. This has caused unemployment to fall fast; but it has also brought about a re-emergence of inflationary pressures. In order to deal with these pressures, monetary policy has been progressively tightened.

3. There is clear evidence that this policy is having its desired effects, particularly on the personal sector. The housing market has slowed right down, and retail sales have show relatively little growth. But some worrying signs remain. Inflation has risen slightly higher than forecast at the time of the Budget, and the continuing strength of the investment boom - welcome though that is - means that other demands on the economy must be reined back further if the growth of overall domestic demand is to be adequately restrained. And some sectors - particularly construction - are continuing to experience considerable pressures on capacity.

4. It is clearly essential that our first priority must be to get inflation back on to a sustained downward path. This will require monetary policy to remain tight for some time to come. It also means that we cannot allow the consequent curb in the growth of private spending - achieved at no little political cost - to be undermined by any let-up on our policy of restraining the growth

of public spending. The fact that we are currently running a budget surplus in no way modifies this conclusion.

WORLD ECONOMY

5. The world economy grew much more rapidly than expected in 1988, and in every country within the G7 forecasts of the growth of GNP and domestic demand were exceeded. GNP growth in the G7 as a whole reached 4½ per cent and world trade in manufactures grew by 10½ per cent.

6. The indications are that the world economy has remained very buoyant in the first half of this year. Growth in Japan and Germany appears to be particularly strong, though there are clear signs of growth slowing in the US in response to tighter monetary policy.

7. The strong growth of the past two years is in large part the result of a worldwide investment boom, in response to the more stable economic environment of the 1980s with lower inflation and less intervention by governments.

8. This dynamism in the world economy has, however, brought with it increasing inflationary pressures. Capacity utilisation is at historically high levels, and inflation has risen in all the major industrial countries. In response, all the major countries have raised interest rates since the spring of last year. While in the US interest rates may already have peaked, European interest rates were raised further in the last week in June, and a further increase is also likely in Japan.

9. Provided that countries continue to take this necessary action to restrain inflation the prospect is for further satisfactory growth in the world economy, though at a somewhat lower rate than in 1988.

THE BRITISH ECONOMY

10. There are now clear signs that growth of GDP and domestic demand have begun to moderate in response to recent rises in interest rates. GDP growth in 1989 as a whole is now forecast to be 2¼ per cent, just a little below the budget forecast. But this is entirely due to lower North Sea production following recent accidents, and non-oil GDP growth looks like being ½ per cent above forecast for 1989, at [X] per cent.

11. The growth of personal sector spending has slowed down sharply. Retail sales have risen only slowly so far this year, and indicators of consumer confidence indicate that growth will continue to be slow. Reduced mortgage lending and a pretty depressed housing market suggest that consumers will be more cautious from now on and will gradually increase net saving from the very low recent levels. Even with continued strong growth of private investment the growth of total domestic demand is likely to be much lower in 1989, at 3 per cent, than the 6½ per cent recorded last year. Nevertheless in the circumstances this is still too rapid, and needs to come down further if inflation and the current account deficit are to fall significantly. This will require policy to remain tight for some time yet.

12. There was evidence of widespread pressure on capacity in manufacturing industry in the second half of last year. These pressures have eased a little in 1989, and should ease further as output grows more slowly and new capacity comes on stream as a result of the investment boom. The construction industry, however, has shown more worrying symptoms of capacity constraints, with serious shortages of labour and evidence that prices are rising much faster than in the rest of the economy - well into double figures. The latest DTI and CBI surveys, together with evidence from the industry itself, suggests continuing growth of construction demand; capacity constraints are likely to persist for some while yet in this sector.

13. Underlying inflation has been slightly higher so far in 1989 than envisaged at Budget time, having risen throughout the recent

period of very strong growth. The RPI excluding mortgage interest payments - the nearest equivalent to the measures of consumer prices used in nearly all other major countries - was 6 per cent higher than a year ago in May. Including mortgage interest payments, RPI inflation in May was 8.3 per cent. And pay is continuing to grow more rapidly than is desirable, especially in the public sector.

13a. I now expect total RPI inflation to be 6¾ per cent in the fourth quarter of this year, above the forecast of 5½ per cent published at that time of the Budget. By this time, however, other less distorted measures of inflation - such as producer prices and the RPI less mortgage interest payments - should also have clearly stabilised and begun to fall. Growth of the GDP deflator may nevertheless be about 7 per cent in 1989-90 as a whole, compared with 5½ per cent in the Budget forecast, reflecting strong pressures on prices in the investment sector where demand is particularly buoyant.

14. There was a recorded current account deficit of £15 billion in 1988 and a substantial deficit has persisted so far this year - though in the light of the enormous balancing items in the accounts the true deficit may well be overstated. It should be possible gradually to reduce this deficit, and in the meantime to finance it, provided we maintain a policy stance that severely restrains the growth of domestic demand.

15. The public finances remain strong, though there are some signs that the PSDR in 1989-90 may prove slightly smaller than I budgeted for in March. Our policies to boost personal pensions have been more successful than anyone foresaw and the consequential rebates of national insurance contributions will reduce government revenues, though in the longer term there will be substantial savings on SERPS spending. And the favourable cyclical influences which have boosted the surplus over the past two years will tend to unwind as the economy slows down. The fiscal projections in the MTFS showed minimal scope for discretionary tax reductions given present public expenditure plans, even with the budget reverting gradually to balance. It

would clearly be a very dangerous reversal of policy if increased public expenditure obliged us to raise taxes to maintain an adequately tight fiscal stance.

CONCLUSION

16. The policies which we have pursued in the 1980s have greatly strengthened the British economy. But there are clear risks in the present situation. We must not weaken in the fight against inflation. At a time when we are seeking to reduce the growth of private sector demand it is vital not add to our difficulties by expanding to public sector's claims on resources.

17. It is essential, therefore, that we follow the recommendations in the Chief Secretary's paper.

MAJOR ECONOMIC INDICATORS

	UK			Forecasts UK	G7 excl UK
	1986	1987	1988	1989	1989
A. Demand & Activity					
GDP	3	4½	4½††	2¼††	3¼
Domestic demand	4¼	5	6½	3	3¼
of which					
- consumers'expenditure	5¾	5½	6½	3½	2¾
- fixed investment	1¾	8	12¼	6½	5½
Exports of Goods & Services	3¾	5½	-1	4½	8½**
Imports of goods & Services	6½	7½	12	6¾	7**
B. Inflation					
RPI (Q4 on year year earlier)	3½	4	6½	6¾)	4¼
RPI excluding mortgage interest payments	3½	4	5¼	5½)	
GDP deflator (financial years)	3¼	5¼	7½	7	4
C. Other items (levels)					
Current balance (£bn)	0	-3	-15	-16	
Unemployment (per cent, narrow definition)	11½	10	8	6½	6½
Average earnings (per cent change: financial years)	7½	7¾	8½	9½	
3 month interest rate	11	9½	10½	13¾	8*
Sterling index (1985=100)	92	90	96	91*	
Oil price (Brent, $barrel)	14½	18	15*	18*	

* close June 22
** goods only
† manufacturing earnings
†† Output measure

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SECRET

pwp

FROM: MRS R LOMAX (GEP)
DATE: 4 July 1989
x4499

CHIEF SECRETARY

At the PS's discretion.

Passed to Mrs Lomax 4/7

cc Chancellor
Sir P Middleton
Mr Anson
Sir T Burns
Mr Phillips
Mr Monck
Mr Luce
Mr Riley
Mr Gieve
Mr MacAuslan
Miss Walker
Mrs Chaplin
Mr Tyrie

PUBLIC EXPENDITURE CABINET : CHIEF SECRETARY PAPER

... I attach a redraft of your Cabinet paper incorporating your initial comments, and a few further points from copy recipients. You will want to consider how it reads alongside the redraft (behind) of the Chancellor's paper, circulated by Mr Allan earlier today. The reference to E(LF) may need changing after Thursday's meeting.

2. I would be grateful for any comments by **Thursday morning at the latest** so that I can let your office have a final version to send over to No 10 that evening. As last year, we plan to circulate the paper on Monday, but to allow PFOs to read advance copies during the course of the meeting which Mr Phillips will be chairing early on Monday morning. For logistical reasons, therefore, it would be helpful if we could know that the Prime Minister is content **before** the weekend.

RL

RACHEL LOMAX

SECRET

It was much more than modest! Look @ the figs!

CHIEF SECRETARY PAPER FOR CABINET

Public expenditure restraint has been a key instrument of our economic strategy over the past ten years. One of our major achievements has been to reverse decisively the remorseless upward trend in the share of national income taken by public expenditure. We have been helped recently by very strong economic growth which contributed to substantial savings in the last Survey, thus enabling us both to increase provision on key programmes, and to maintain a modest decline in the ratio of Government spending to GDP.

2. This year, as the Chancellor's paper points out, the economic situation carries clear risks. Bringing inflation down must continue to be our first priority. Our success in controlling expenditure has contributed to a tightening in the fiscal position, which we cannot afford to undermine. The present fiscal surplus is likely to be eroded as economic growth moderates. Against this background, any perception that we were weakening in our resolve to control public expenditure would be extremely damaging, not least to market confidence.

3. We face a difficult Survey. Commitments we have collectively undertaken since last years' plans were agreed have pre-empted our room for manoeuvre. Existing plans already take credit for the effects of recent strong growth: and we cannot expect a repeat of last year's savings through extra receipts. Higher inflation will add to demand-led programmes. Elsewhere, we must adhere to the presumption underlying cash planning that inflation ~~should~~ not ~~be~~ automatically accommodated.

is

The baseline

4. The plans we agreed last Autumn included very sharp increases for some key programmes. These plans provide the starting point for this Survey, which will be conducted using a new definition of the planning total. The methods of setting the baselines for those items affected by the change in definition were endorsed by

Cabinet in March. General government expenditure is unaffected by the change to the planning total.

The bids

5. My minute of 6 July to the Prime Minister summarised the bids received from Departments. In addition we must take account of territorial block consequences, the nationalised industries, net contributions to the EC and the Revenue Support Grant and non-domestic rate elements of Aggregate Exchequer Finance for local authorities. Additions to expenditure financed by local authorities from their own resources are outside the planning total, on the new definition, but they will still increase general government expenditure.

6. The bids imply a total increase in spending that would be irresponsible in present circumstances and probably unsustainable in the future. It would mean a sharp increase in the share of public expenditure in national income for the first time since the beginning of the decade. This would be seen as a complete reversal of our policy of restraining the growth in public spending, and would be particularly damaging at a time when private spending is being held back by the measures needed to reduce inflation. It would mean that, for the foreseeable future, there would be no chance of reducing the tax burden as a proportion of national income and still less chance of getting back to the level we inherited ten years ago. This would be seen as another significant shift in policy.

Since war

7. In current economic conditions it would also cast doubt, in financial markets and more generally, on our commitment to prudent fiscal policies, and the defeat of inflation. This would provide the worst possible basis for bringing the economy back on ~~to~~ course before the end of this Parliament, and run a real risk that we would be forced into a painful ~~short term~~ retrenchment.

8. The only prudent course is to uphold present policy and maintain the downward trend in the ratio of total public expenditure (excluding privatisation proceeds) to GDP and hold as

close as possible to existing plans. This will leave very little room for additional spending, even on priority programmes. Commitments to expenditure made since last Autumn together with the probable cost of statutory Social Security upratings will more than exhaust the likely scope for drawing down the Reserve in November. The bids will need to be severely cut back, and we shall need to scrutinise Departments' baselines rigorously for policy and other savings to offset any that are unavoidable.

9. We shall also need to look ~~particularly~~ closely at the bids for additional capital spending. The baselines already allow for some very large increases in public sector investment, much of it on construction. If we were to agree additions on the scale implied by the bids, the public sector's demands on the construction industry would rise by some 25% between this year and next. The Chancellor's paper notes worrying symptoms of capacity constraints in the construction industry, where prices are already rising too fast. Adding to the demands on the industry would mean higher imports and further pressure on prices and earnings. Fuelling inflation in this way would be damaging to our wider economic objectives. It would also mean poor value for money. The bids will need to be drastically scaled back, and higher priority projects staged, to produce a growth in total public investment which takes realistic account of the capacity of the supplying industries, as well as the usual considerations of affordability.

Aggregate Exchequer Finance for local authorities

10. [E(LF) has now decided on the level of central Government support for local authority current expenditure for 1990-91 in England.] The settlement is designed to put downward pressure on local authority spending, while allowing local councils to set Community Charges at around this years average per capita rate bill, if they budget sensibly. While respecting the need for public expenditure restraint this year, this decision has added £1 billion to the public expenditure planning total and therefore clearly pre-empts the room for adding to other expenditure in the remainder of the Survey.

Running Costs

11. Running costs bids exceed £800 million, with many colleagues seeking to re-open three year running cost agreements. If the bids were agreed in full, spending on the Civil Service would rise in 1990-91 by 10% or more over this year, with further significant rises in the later years.

12. I shall be urging colleagues to look for other savings within running costs to absorb the cost of pay settlements. Further savings will be needed if we are to support high priority policies including "spend to save" initiatives such as relocation, at the same time as providing realistically for future pay settlements. I am not yet satisfied with the cost improvement proposals for some areas of the Civil Service, particularly where there are large executive operations.

13. If our management of the Civil Service is to remain consistent with our wider expenditure and economic objectives, large reductions in bids and more ambitious plans to contain costs and improve efficiency will be necessary.

Nationalised Industries

14. All of the main ongoing nationalised industries have put in very large additional bids. In scrutinising their revised bids, which are due later this month, we must make substantial reductions and bring them to realistic levels, taking account, of other major bids which add to demand on the construction industry. Where large projects are involved, we must be alive to the longer term implications for future Surveys. The electricity industries will be privatised early in the Survey period but we should continue to examine their plans rigorously in this Survey, bearing in mind the implications for public expenditure while they remain within the public sector and for proceeds when they are privatised.

Conclusions

15. I ask the Cabinet:

i. to agree that we should maintain the downward trend in the ratio of public spending (excluding privatisation proceeds) to GDP, and hold as close as possible to existing plans.

ii. to agree that spending on the Civil Service should be substantially lower than implied in running cost bids, and that we should look for more ambitious plans to contain costs and improve efficiency.

iii. to note that, to secure these objectives, bids for expenditure and running costs must be cut back, additional capital spending phased, and offsetting savings found in many areas.

iv. to agree that we should aim for substantial reductions in the additional bids from the nationalised industries.

v. to agree that I should now conduct bilaterals with colleagues on their spending programmes; and to note that if it proves impossible to reach agreement in the bilaterals, it might be necessary at the appropriate time to establish a small group which would consider outstanding issues and make recommendations to the Cabinet.

[JM]

TREASURY CHAMBERS
JULY 1989

gep.cj/july/lomax.4.2

SECRET

FROM: MRS R LOMAX (GEP)
DATE: 4 July 1989
x4499

CHANCELLOR

cc Chief Secretary
Sir P Middleton
Mr Anson
Sir T Burns
Mr Phillips
Mr Monck
Mr Gieve
Mr MacAuslan
Mrs Chaplin
Mr Tyrie

OK -

SPEAKING NOTE FOR THE PRIME MINISTER

I attach a draft speaking note for the Prime Minister's use at the Public Expenditure Cabinet on 12 July. It reflects comments from the Chief Secretary, Mr Anson and others.

Subject to your comments, it would be desirable, if not absolutely essential, to send this over to No 10 on Thursday night, together with the two draft Cabinet papers.

RL.

RACHEL LOMAX

gep.cj/june/lomax.29.6

SECRET

SPEAKING NOTE FOR THE PRIME MINISTER

The Chancellor's paper describes a more difficult and uncertain economic background than in recent years. Bringing inflation down must be our first priority.

Our success in controlling expenditure has been a vital part of our economic management. With inflation at its present level any weakening in our grip on spending would be extremely damaging, not least to market confidence. The private sector is having to restrain its spending, in the battle against inflation. It is essential that the public sector should do the same. So there can be no question of using the Budget surplus to finance an unsustainable increase in spending.

Horrified at the scale of the bids this year. Highest ever. It would be quite irresponsible to increase spending on anything like this scale in the current economic situation. And it would put paid to our aim of reducing the tax burden, which remains well above the level we inherited ten years ago.

Last year Departments put in substantial further bids over the summer. I hope spending Ministers will show greater restraint this year. We shall have to find extra money for demand led programmes. But the essence of cash planning is that we must make every effort to absorb higher inflation, not accommodate it.

The bids for additional capital expenditure are quite unrealistic. Capital spending was increased substantially in the last Survey. A spending spree on the infrastructure would just drive up prices. This would be a wasteful use of public money, as well as fuelling inflation. It would also suck in imports which would be very damaging. We must plan investment sensibly. Bids must be scaled down, and any additional spending spread out in a sustainable way.

This will be a critical Survey. Bids must be cut back and substantial savings found. There must be a thorough review of the options across the whole range of spending, not just within bids, but within baselines as well. We have never shirked difficult decisions and, particularly at this stage in the Parliament, we cannot afford to do so now.

both on programmes and on running costs — and

FROM: C J RILEY (MP)
DATE: 5 July 1989
Extn: 4439

CHANCELLOR

cc Chief Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Mr Phillips
Mr Monck
Mr Scholar
Miss Peirson
Mrs Lomax
Mr Luce
Mr Peretz
Mr Sedgwick
Mr S Davies
Mr MacAuslan
Mr Mowl
Mr Gieve
Mr Pickford
Miss Simpson
Miss Walker
Mrs Chaplin
Mr Tyrie

Ch
OK? We plan to send to No 10 on Thursday night. AA

OK.

PAPER FOR JULY CABINET

I attach some, generally minor, drafting suggestions on the text which Alex Allan circulated yesterday. May I draw attention to just two of them.

2. In the second sentence of paragraph 3, it may be better to say that retail sales have "slowed down considerably" rather than "shown relatively little growth", given the upward revision to the May figure.

DCLP made similar point. (I'd stick to original).

3. In the final sentence of paragraph 10, you propose to add a figure for forecast growth of non-oil GDP in 1989. The difficulty is that it rounds to the same figure (3%) as was published in the FSBR; the ½% increase in the forecast quoted in the present draft is only 0.3% in unrounded terms. My suggested redraft omits both of the figures, though there would be no harm in quoting the ½% increase - or possibly ¼% if you wish to round to quarters.

4. The figures in the table have been checked, Peter Sedgwick will submit another version with the latest figures on interest rates etc before the final version goes to No 10.

CJR

C J RILEY

CABINET

ECONOMIC PROSPECTS

Memorandum by the Chancellor of the Exchequer

During the 1980s, the British economy has experienced a period of sustained economic growth, at a rate fast er than that of our major European competitors. Profitability has recovered dramatically, and private investment has exceeded all previous peaks. This performance has been the result of major supply side reforms carried out in a context of prudent monetary and fiscal policies.

2. Over the past two years, growth has been particularly rapid. This has caused unemployment to fall fast; but it has also brought about a re-emergence of inflationary pressures. In order to deal with these pressures, monetary policy has been progressively tightened.

3. There is clear evidence that this policy is having its desired effects, particularly on the personal sector. The housing market has slowed right down, and retail sales have ~~shown relatively little growth~~ slowed down considerably. But some worrying signs remain. Inflation has risen slightly higher than forecast at the time of the Budget, and the continuing strength of the investment boom - welcome though that is - means that other demands on the economy must be reined back further if the growth of overall domestic demand is to be adequately restrained. And some sectors - particularly construction - are continuing to experience considerable pressures on capacity.

AA (drafting)

4. [~~It is clearly essential that~~] Our first, and overriding, priority must be to get inflation back on to a sustained downward path. This will require monetary policy to remain tight for some time to come. It also means that we cannot allow the consequent curb in the growth of private spending - achieved at no little political cost - to be undermined by any let-up on our policy of restraining the growth

of public spending. The fact that we are currently running a budget surplus in no way modifies this conclusion.

WORLD ECONOMY

5. The world economy grew much more rapidly than expected in 1988, and in every country within the G7 forecasts of the growth of GNP and domestic demand were exceeded. GNP growth in the G7 as a whole reached 4½ per cent and world trade in manufactures grew by 10½ per cent.

6. The indications are that the world economy has remained very buoyant in the first half of this year. Growth in Japan and Germany appears to be particularly strong, though there are clear signs of growth slowing in the US in response to tighter monetary policy.

7. The strong growth of the past two years is in large part the result of a worldwide investment boom, in response to the more stable economic environment of the 1980s with lower inflation and less intervention by governments.

8. This dynamism in the world economy has, however, brought with it increasing inflationary pressures. Capacity utilisation is at historically high levels, and inflation has risen in all the major industrial countries. In response, all the major countries have raised interest rates since the spring of last year. While in the US interest rates may already have peaked, European interest rates were raised further in the last week in June, and a further increase is also likely in Japan.

9. Provided that countries continue to take this necessary action to restrain inflation the prospect is for further satisfactory growth in the world economy, though at a somewhat lower rate than in 1988.

THE BRITISH ECONOMY

10. There are now clear signs that growth of GDP and domestic demand have begun to moderate in response to recent rises in interest rates. GDP growth in 1989 as a whole is now forecast to be 2¼ per cent, just a little below the Budget forecast. But this is ~~entirely / due to~~ more than accounted for by lower North Sea production following recent accidents, and non-oil GDP growth looks like being [~~½ per cent~~ Somewhat] above forecast for 1989, ~~at [X] per cent.~~

NB ~~X is still 3~~

11. The growth of personal sector spending has slowed down sharply. Retail sales have risen only slowly so far this year, and indicators of consumer confidence indicate that growth will continue to be slow. Reduced mortgage lending and a ~~pretty~~ very depressed housing market suggest that consumers will be more cautious from now on and will gradually increase net saving from the very low recent levels. Even with continued strong growth of private investment the growth of total domestic demand is likely to be much lower in 1989, at 3 per cent, than the 6½ per cent recorded last year. Nevertheless in the circumstances this is still too rapid, and needs to come down further if inflation and the current account deficit are to fall significantly. This will require policy to remain tight for some time yet.

12. There was evidence of widespread pressure on capacity in manufacturing industry in the second half of last year. These pressures have eased a little in 1989, and should ease further as output grows more slowly and new capacity comes on stream as a result of the investment boom. The construction industry, however, has shown more worrying symptoms of capacity constraints, with serious shortages of labour and evidence that prices are rising much faster than in the rest of the economy - well into double figures. The latest DTI and CBI surveys of investment intentions, together with evidence from the industry itself, suggests continuing growth of construction demand; capacity constraints are likely to persist for some while yet in this sector.

13. Underlying inflation has been slightly higher so far in 1989 than envisaged at Budget time, having risen throughout the recent

period of very strong growth. The RPI excluding mortgage interest payments - the nearest equivalent to the measures of consumer prices used in nearly all other major countries - was 6 per cent higher than a year ago in May. Including mortgage interest payments, RPI inflation in May was 8.3 per cent. And pay is continuing to grow more rapidly than is desirable, especially in the public sector.

13a. I now expect total RPI inflation to be 6¾ per cent in the fourth quarter of this year, above the forecast of 5½ per cent published at ~~that~~ the time of the Budget. By ~~this~~ that time, however, other less distorted measures of inflation - such as producer prices and the RPI less mortgage interest payments - should also have clearly stabilised and begun to fall. Growth of the GDP deflator may nevertheless be about 7 per cent in 1989-90 as a whole, compared with 5½ per cent in the Budget forecast, ~~reflecting~~ with especially strong pressures on prices in the investment sector where demand is particularly buoyant.

14. There was a recorded current account deficit of £15 billion in 1988 and a substantial deficit has persisted so far this year - though in the light of the enormous balancing items in the accounts the true deficit may well be overstated. It should be possible gradually to reduce this deficit, and in the meantime to finance it, provided we maintain a policy stance that severely restrains the growth of domestic demand.

15. The public finances remain strong, though there are some signs that the PSDR in 1989-90 may prove slightly smaller than I budgeted for in March. Our policies to boost personal pensions have been more successful than anyone foresaw and the consequential rebates of national insurance contributions will reduce government revenues, though in the longer term there will be substantial savings on SERPS spending. And the favourable cyclical influences which have boosted the surplus over the past two years will tend to unwind as the economy slows down. The fiscal projections in the MTFS showed minimal scope for discretionary tax reductions given <u>present</u> public expenditure plans, even with the budget reverting gradually to balance. It

would clearly be a very dangerous reversal of policy if increased public expenditure obliged us to raise taxes to maintain an adequately tight fiscal stance.

CONCLUSION

16. The policies which we have pursued in the 1980s have greatly strengthened the British economy. But there are clear risks in the present situation. We must not weaken in the fight against inflation. At a time when we are seeking to reduce the growth of private sector demand it is vital not add to our difficulties by expanding to public sector's claims on resources.

17. It is essential, therefore, that we follow the recommendations in the Chief Secretary's paper.

MAJOR ECONOMIC INDICATORS

	UK 1986	UK 1987	UK 1988	FORECAST UK 1989	FORECAST G7 excl UK 1989
A. Demand & Activity					
GDP	3	4½	4½†	2¼†	3¼
Domestic demand of which	4¼	5	6½	3	3¼
- consumers'expenditure	5¾	5½	6½	3½	2¾
- fixed investment	1¾	8	12¼	6½	5½
Exports of Goods & Services	3¾	5½	-1	4½	8½**
Imports of goods & Services	6½	7½	12	6¾	7**
B. Inflation					
RPI (Q4 on year earlier)	3½	4	6½	6¾	4¼***
RPI excluding mortgage interest payments	3½	4	5¼	5½	
GDP deflator (financial years)	3¼	5¼	7½	7	4
C. Other items (levels)					
Current balance (£bn)	0	-3	-15	-16	
Unemployment (per cent, narrow definition)	11	10	8	6½	6
Average earnings (per cent change: financial years)	7½	7¾	8½	9½	4½††
3 month interest rate	11	9½	10½	14¼*	8½*
Sterling index (1985=100)	92	90	96	90.2*	
Oil price (Brent, $barrel)	14½	18	15	18.15*	

* close June 30

** goods only

*** Of the rest of the G7 only Canada has mortgage interest payments in its consumer price index

† Output measure

†† manufacturing earnings

FROM: D I SPARKES
DATE: 5 JULY 1989

MRS LOMAX

cc PS/Chief Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Mr Phillips
Mr Monck
Mr Gieve
Mr MacAuslan
Mrs Chaplin
Mr Tyrie

Ch
One amendment from John Anson (marked) to add ref to running costs - OK?

OK.

SPEAKING NOTE FOR THE PRIME MINISTER

The Chancellor was grateful for your minute of 4 July covering a speaking note for the Prime Minister's use on 12 July. He was entirely content with the text.

D.S.

DUNCAN SPARKES

chex.dc/aa/8

SECRET

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

6 July 1989

Paul Gray
10 Downing Street
LONDON
SW1

cc: PS/Chief Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Mr Phillips
Mr Monck
Mrs Lomax
Mr Gieve
Mr Sparkes
Mrs Chaplin
Mr Tyrie

Dear Paul

PUBLIC EXPENDITURE CABINET

I attach a draft speaking note for the Prime Minister for Cabinet next Wednesday. I also attach a draft of the Chancellor's paper; since Cabinet this year is on Wednesday, our timetable has been compressed, and it would be most helpful if it was possible to have any comments during the course of tomorrow.

Yours,
Alex

A C S ALLAN

SECRET

SPEAKING NOTE FOR THE PRIME MINISTER

The Chancellor's paper describes a more difficult and uncertain economic background than in recent years. Bringing inflation down must be our first priority.

Our success in controlling expenditure has been a vital part of our economic management. With inflation at its present level any weakening in our grip on spending would be extremely damaging, not least to market confidence. The private sector is having to restrain its spending, in the battle against inflation. It is essential that the public sector should do the same. So there can be no question of using the Budget surplus to finance an unsustainable increase in spending.

Horrified at the scale of the bids this year. Highest ever. It would be quite irresponsible to increase spending on anything like this scale in the current economic situation. And it would put paid to our aim of reducing the tax burden, which remains well above the level we inherited ten years ago.

Last year Departments put in substantial further bids over the summer. I hope sending Ministers will show greater restraint this year. We shall have to find extra money for demand led programmes. But the essence of cash planning is that we must make every effort to absorb higher inflation, not accommodate it.

The bids for additional capital expenditure are quite unrealistic. Capital spending was increased substantially in the last Survey. A spending spree on the infrastructure would just drive up prices. This would be a wasteful use of public money, as well a fuelling inflation. It would also suck in imports which would be very damaging. We must plan investment sensibly. Bids must be scaled down, and any additional spending spread out in a sustainable way.

This will be a critical Survey. Bids must be cut back and substantial savings found. There must be a thorough review of the options across the whole range of spending, both on programmes and on running costs - and not just within bids, but within baselines as well. We have never shirked difficult decisions and, particularly at this stage in the Parliament, we cannot afford to do so now.

CABINET

ECONOMIC PROSPECTS

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During the 1980s, the British economy has experienced a period of sustained economic growth at a rate faster than that of our major European competitors. Profitability has recovered dramatically, and private investment has exceeded all previous peaks. This performance has been the result of major supply side reforms carried out in a context of prudent monetary and fiscal policies.

2. Over the past two years, growth has been particularly rapid. This has caused unemployment to fall fast; but it has also brought about a re-emergence of inflationary pressures. In order to deal with these pressures, monetary policy has been progressively tightened.

3. There is clear evidence that this policy is having its desired effects, particularly on the personal sector. The housing market has slowed right down, and retail sales have slowed down considerably. But some worrying signs remain. Inflation has risen slightly higher than forecast at the time of the Budget, and the continuing strength of the investment boom - welcome though that is - means that other demands on the economy must be reined back further if the growth of overall domestic demand is to be adequately restrained. And some sectors - particularly construction - are continuing to experience considerable pressures on capacity.

4. Our first, and overriding, priority must be to get inflation back on to a sustained downward path. This will require monetary policy to remain tight for some time to come. It also means that we cannot allow the consequent curb in the growth of private spending - achieved at no little political cost - to be undermined by any let-up on our policy of restraining the growth of public

spending. The fact that we are currently running a budget surplus in no way modifies this conclusion. As the economy slows down, the surplus is likely to fall.

WORLD ECONOMY

5. The world economy grew much more rapidly than expected in 1988, and in every country within the G7 forecasts of the growth of GNP and domestic demand were exceeded. GNP growth in the G7 as a whole reached 4[illegible] per cent and world trade in manufactures grew by 10[illegible] per cent.

6. The indications are that the world economy has remained very buoyant in the first half of this year. Growth in Japan and Germany appears to be particularly strong, though there are clear signs of growth slowing in the US, in response to tighter monetary policy.

7. The strong growth of the past two years is in large part the result of a worldwide investment boom, in response to the more stable economic environment of the 1980s with lower inflation and less intervention by governments.

8. This dynamism in the world economy has, however, brought with it increasing inflationary pressures. Capacity utilisation is at historically high levels, and inflation has risen in all the major industrial countries. In response, all the major countries have raised interest rates since the spring of last year. While in the US interest rates may already have peaked, European interest rates were raised further in the last week in June, and a further increase is also likely in Japan.

9. Provided that countries continue to take this necessary action to restrain inflation the prospect is for further satisfactory growth in the world economy, though at a somewhat lower rate than in 1988.

THE BRITISH ECONOMY

10. There are now clear signs that growth of GDP and domestic demand have begun to moderate in response to recent rises in interest rates. GDP growth in 1989 as a whole is now forecast to be 2¼ per cent, just a little below the Budget forecast. But this is more than accounted for by lower North Sea production following recent accidents.

11. The growth of personal sector spending has slowed down sharply. Retail sales have risen only slowly so far this year, and indicators of consumer confidence indicate that growth will continue to be slow. Reduced mortgage lending and a very depressed housing market suggest that consumers will be more cautious from now on and will gradually increase net saving from the very low recent levels. Even with continued strong growth of private investment the growth of total domestic demand is likely to be much lower in 1989, at 3 per cent, than the 6½ per cent recorded last year. Nevertheless in the circumstances this is still too rapid, and needs to come down further if inflation and the current account deficit are to fall significantly. This will require policy to remain tight for some time yet.

12. There was evidence of widespread pressure on capacity in manufacturing industry in the second half of last year. These pressures have eased a little in 1989, and should ease further as output grows more slowly and new capacity comes on stream as a result of the investment boom. The construction industry, however, has shown more worrying symptoms of capacity constraints, with serious shortages of labour and evidence that prices are rising much faster than in the rest of the economy - well into double figures. The latest DTI and CBI surveys of investment intentions, together with evidence from the industry itself, suggests continuing growth of construction demand; capacity constraints are likely to persist for some while yet in this sector.

13. Underlying inflation has been slightly higher so far in 1989 than envisaged at Budget time, having risen throughout the recent

period of very strong growth. The RPI excluding mortgage interest payments - the nearest equivalent to the measures of consumer prices used in nearly all other major countries - was 6 per cent higher than a year ago in May. Including mortgage interest payments, RPI inflation in May was 8.3 per cent. And pay is continuing to grow more rapidly than is desirable, especially in the public sector.

14. I now expect the RPI inflation to be [illegible] per cent in the fourth quarter of this year, above the forecast of 5[illegible] per cent published at the time of the Budget. By that time, however, other less distorted measures of inflation - such as producer prices and the RPI less mortgage interest payments - should also have clearly stabilised and begun to fall. Growth of the GDP deflator may nevertheless be about 7 per cent in 1989-90 as a whole, compared with 5½ per cent in the Budget forecast, with especially strong pressures on prices in the investment sector where demand is particularly buoyant.

15. There was a recorded current account deficit of £15 billion in 1988 and a substantial deficit has persisted so far this year - though in the light of the enormous balancing items in the accounts the true deficit may well be overstated. It should be possible gradually to reduce this deficit, and in the meantime to finance it, provided we maintain a policy stance that severely restrains the growth of domestic demand.

16. The public finances remain strong, though there are some signs that the PSDR in 1989-90 may prove slightly smaller than I budgeted for in March. Our policies to boost personal pensions have been more successful than anyone foresaw and the consequential rebates of national insurance contributions will reduce government revenues, though in the longer term there will be substantial savings on SERPS spending. And the favourable cyclical influences which have boosted the surplus over the past two years will tend to unwind as the economy slows down. The fiscal projections in the MTFS showed minimal scope for discretionary tax reductions given present public expenditure plans, even with the budget reverting gradually to balance. It

would clearly be a very dangerous reversal of policy if increased public expenditure obliged us to raise taxes to maintain an adequately tight fiscal stance.

CONCLUSION

17. The policies which we have pursued in the 1980s have greatly strengthened the British economy. But there are clear risks in the present situation. We must not weaken in the fight against inflation. At a time when we are seeking to reduce the growth of private sector demand it is vital not add to our difficulties by expanding the public sector's claims on resources

18. It is essential, therefore, that we follow the recommendations in the Chief Secretary's paper.

MAJOR ECONOMIC INDICATORS

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Exports of Goods & Services	[illegible]	5½	-	4½	8½**
Imports of goods & Services	6½	7½	12	6¾	7**
B. Inflation					
RPI (Q4 on year earlier)	3½	4	6½	6¾)	4¼***
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* close July 5
** goods only
*** Of the rest of the G7 only Canada has mortgage interest payments in its consumer price index

† output measure
†† manufacturing earnings

pmp

FROM: S P B WALKER
DATE: 7 July 1989
EXT: 5522

CHIEF SECRETARY

cc Chancellor
Mr Anson
Mr Phillips
Mr Monck
Mrs Lomax
Mr MacAuslan
Mr Gieve
Mr Tyrie
Mrs Chaplin

any comments?

DIS

PUBLIC EXPENDITURE CABINET: PRESS BRIEFING

I attach draft question and answer briefing for use by the Treasury and No. 10 press offices. It takes account of comments by Mr Gieve on a previous version.

2. If you and the Chancellor are content, it can be sent to No. 10 tomorrow.

S P B WALKER

OK – subject to a) no change b) need to remind people that ~~[illegible]~~ [illegible] view is [illegible] the same as last year's. [illegible]

Told APS/CST

[illegible] 10/7

Positive Points

(i) Cabinet agreed objective for public expenditure Survey: to maintain the downward trend in the ratio of public spending (excluding privatisation proceeds) to GDP, and hold as close as possible to existing plans.

(ii) Government's consistent objective has been downward trend in share of public spending in national income. That objective reaffirmed today.

- Objective is being achieved: ratio has fallen by 7 percentage points since 1982-83 - longest sustained fall since wartime economy unwound. Ratio now at lowest since mid-1960s.

- Public spending under control: over 10 years to 1988-89 has grown about 1¼ per cent a year in real terms, well below growth rate of economy. Made room for cuts in tax rates which have contributed to improved performance of economy.

- Not the time to let up. Priority is defeat of inflation. Tight policies already restraining private demand. Cannot allow that to be undermined by imprudent public spending. Budget surplus does not change that conclusion: Chancellor's Budget judgement was that surplus was necessary - nothing has happened since to suggest he was wrong.

Defensive points

(i) **Why no mention of planning total?**

Because - as announced in July 1988 - this year we will be using new definition of planning total. [The main change is to include government grants to local authorities rather than local authorities' total spending.] So the planning totals agreed last year not directly relevant. Still agreed to stick as close as possible to existing plans: no less tough an objective than last year. Maintain Government's policy for public spending.

(ii) **What does remit mean? What are "existing plans"?**

Remit means maintaining present policy. Overall objective of declining trend in GGE/GDP ratio. Achieve this by sticking as close as possible to existing cash plans - reference to "existing plans" in remit reaffirms long-standing commitment to cash planning. New planning total based on plans agreed last year, (though translation not easy for local authority elements) but GGE (excluding privatisation proceeds - £210 billion in 1990-91) unaffected by new definition of planning total.

(iii) **Surely plans for health service, roads, etc. mean spending must increase - or will there be no new money to back these policies?**

Too soon to anticipate particular programmes. Substantial increases for key programmes already in the existing plans, and always scope for redistribution within plans agreed last year. Reserves of £7 billion for 1990-90 and £10½ billion for 1991-92 included in those plans, which we would expect to reduce. Should be scope for savings in some areas.

(iv) **Increasing inflation must put pressure on programmes?**

Bound to affect cost of social security upratings. Elsewhere, cash planning means presumption that departments should stick to existing plans by reordering priorities, improving efficiency and looking for offsetting savings. All additions to programmes have to be argued for.

(v) **Cash planning can't work when inflation accelerating?**

More difficult, certainly, but all the more important in order to avoid automatic accommodation of inflation. Central part of Government's general approach to defeating inflation. [No new cash totals agreed: never are at this time of year.]

(vi) **Time to increase spending? Held well below growth of economy for past 7 years**

Aim is sustainable growth in spending. Depends on overall success of economic policies. Wrong to put that at risk by taking on excessive commitments. Existing plans allow large increases in key programmes.

(vii) **What is total of bids?**

Not giving any figures. Bids at this stage are always high. Cabinet has agreed they must be reduced or offset by savings elsewhere.

(viii) **High money GDP will allow large increases consistent with overall declining trend in ratio?**

Chancellor will not give forecast of money GDP until Autumn Statement. Objective is to stick as close as possible to existing plans: plans not adjusted automatically to level implied by particular ratios.

(ix) **Could the ratio rise in 1990-91?**

The Cabinet has reaffirmed the policy of maintaining the downward trend. Never aimed for particular ratios for particular years. [If Chief Secretary's remarks to TCSC in Autumn 1988 raised - yes he did say that a downward trend was consistent with ratio rising in a particular year - that was a general comment and not a forecast. Ideally, of course, Cabinet would like to see the ratio going down steadily.]

(x) **Very tough round this year? Will Star Chamber be needed?**

Various factors mean this year's round likely to be tough. Cabinet agreed, as in previous years, to set up Star Chamber if necessary. Too soon to say if it will.

(xi) **Who will be on Star Chamber? Will Mr Parkinson be chairing it again?**

No decisions yet.

(xii) **What is likely outturn in 1989-90?**

Still subject to major uncertainties. No reason to expect that it will not be broadly in line with plans (of £167.1 billion, old planning total).

(xiii) **Budget surplus means room for more spending?**

Chancellor's Budget judgement only 4 months ago was that fiscal policy had to remain tight in support of battle against inflation. Remains the priority. Surplus likely to be less than projected at Budget time, due to effect on national insurance contributions of higher take-up of personal pensions. Will also fall as economic growth moderates. Policies to defeat inflation already restricting private demand: cannot allow that to be undermined by imprudent expansion of public spending.

CHANCELLOR OF THE EXCHEQUER

HONI SOIT QUI MAL Y PENSE

I suggest: omit para 1 altogether; amend para 2 as redrafted; accept PM's proposed changes to paras 4 & 13.

Ch

PM had one general comment

"Ch's paper not worrying enough. Needs to be graver"

Plus two specific comments marked. (Paras 4 + 13)

I have suggested a couple of optional changes to meet first point.

AA

10/7/89.

CABINET

ECONOMIC PROSPECTS

Memorandum by the Chancellor of the Exchequer

AA We must set present economic concerns in their context.

~~During the 1980s, the British economy has experienced a period of sustained economic growth, at a rate faster than that of our major European competitors. Profitability has recovered dramatically, and private investment has exceeded all previous peaks. This performance has been the result of major supply side reforms carried out in a context of prudent monetary and fiscal policies.~~

2. Over the past two years, (Britain's economic) growth has been particularly rapid. This has caused unemployment to fall fast; but it has also brought about a (destabilising) re-emergence of inflationary pressures. In order to deal with these pressures, monetary policy has been progressively tightened.

3. There is clear evidence that this policy is having its desired effects, particularly on the personal sector. The housing market has slowed right down, and retail sales have slowed down considerably. But some worrying signs remain. Inflation has risen slightly higher than forecast at the time of the Budget, and the continuing strength of the investment boom - welcome though that is - means that other demands on the economy must be reined back further if the growth of overall domestic demand is to be adequately restrained. And some sectors - particularly construction - are continuing to experience considerable pressures on capacity.

4. Our first, and overriding, priority must be to get inflation back on to a sustained downward path. This will require monetary policy to remain tight for some time to come. It also means that we cannot allow the consequent curb in the growth of private spending - achieved at no little political cost - to be undermined by any let-up on our policy of restraining the growth of public

spending. The fact that we are currently running a budget surplus in no way modifies this conclusion; as the economy slows down, the surplus is likely to fall.

PM's Add'l

WORLD ECONOMY

5. The world economy grew much more rapidly than expected in 1988, and in every country within the G7 forecasts of the growth of GNP and domestic demand were exceeded. GNP growth in the G7 as a whole reached 4½ per cent and world trade in manufactures grew by 10½ per cent.

6. The indications are that the world economy has remained very buoyant in the first half of this year. Growth in Japan and Germany appears to be particularly strong, though there are clear signs of growth slowing in the US in response to tighter monetary policy.

7. The strong growth of the past two years is in large part the result of a worldwide investment boom, in response to the more stable economic environment of the 1980s with lower inflation and less intervention by governments.

8. This dynamism in the world economy has, however, brought with it increasing inflationary pressures. Capacity utilisation is at historically high levels, and inflation has risen in all the major industrial countries. In response, all the major countries have raised interest rates since the spring of last year. While in the US interest rates may already have peaked, European interest rates were raised further in the last week in June, and a further increase is also likely in Japan.

9. Provided that countries continue to take this necessary action to restrain inflation the prospect is for further satisfactory growth in the world economy, though at a somewhat lower rate than in 1988.

THE BRITISH ECONOMY

10. There are now clear signs that growth of GDP and domestic demand have begun to moderate in response to recent rises in interest rates. GDP growth in 1989 as a whole is now forecast to be 2¼ per cent, just a little below the Budget forecast. But this is more than accounted for by lower North Sea production following recent accidents.

11. The growth of personal sector spending has slowed down sharply. Retail sales have risen only slowly so far this year, and indicators of consumer confidence indicate that growth will continue to be slow. Reduced mortgage lending and a very depressed housing market suggest that consumers will be more cautious from now on and will gradually increase net saving from the very low recent levels. Even with continued strong growth of private investment the growth of total domestic demand is likely to be much lower in 1989, at 3 per cent, than the 6½ per cent recorded last year. Nevertheless in the circumstances this is still too rapid, and needs to come down further if inflation and the current account deficit are to fall significantly. This will require policy to remain tight for some time yet.

12. There was evidence of widespread pressure on capacity in manufacturing industry in the second half of last year. These pressures have eased a little in 1989, and should ease further as output grows more slowly and new capacity comes on stream as a result of the investment boom. The construction industry, however, has shown more worrying symptoms of capacity constraints, with serious shortages of labour and evidence that prices are rising much faster than in the rest of the economy - well into double figures. The latest DTI and CBI surveys of investment intentions, together with evidence from the industry itself, suggests continuing growth of construction demand; capacity constraints are likely to persist for some while yet in this sector.

PM: Omit

13. Underlying inflation has been ~~slightly~~ higher so far in 1989 than envisaged at Budget time, having risen throughout the recent

period of very strong growth. The RPI excluding mortgage interest payments - the nearest equivalent to the measures of consumer prices used in nearly all other major countries - was 6 per cent higher than a year ago in May. Including mortgage interest payments, RPI inflation in May was 8.3 per cent. And pay is continuing to grow more rapidly than is desirable, especially in the public sector.

14. I now expect total RPI inflation to be 6¾ per cent in the fourth quarter of this year, above the forecast of 5½ per cent published at the time of the Budget. By that time, however, other less distorted measures of inflation - such as producer prices and the RPI less mortgage interest payments - should also have clearly stabilised and begun to fall. Growth of the GDP deflator may nevertheless be about 7 per cent in 1989-90 as a whole, compared with 5½ per cent in the Budget forecast, with especially strong pressures on prices in the investment sector where demand is particularly buoyant.

15. There was a recorded current account deficit of £15 billion in 1988 and a substantial deficit has persisted so far this year - though in the light of the enormous balancing items in the accounts the true deficit may well be overstated. It should be possible gradually to reduce this deficit, and in the meantime to finance it, provided we maintain a policy stance that severely restrains the growth of domestic demand.

16. The public finances remain strong, though there are some signs that the PSDR in 1989-90 may prove slightly smaller than I budgeted for in March. Our policies to boost personal pensions have been more successful than anyone foresaw and the consequential rebates of national insurance contributions will reduce government revenues, though in the longer term there will be substantial savings on SERPS spending. And the favourable cyclical influences which have boosted the surplus over the past two years will tend to unwind as the economy slows down. The fiscal projections in the MTFS showed minimal scope for discretionary tax reductions given <u>present</u> public expenditure plans, even with the budget reverting gradually to balance. It

would clearly be a very dangerous reversal of policy if increased public expenditure obliged us to raise taxes to maintain an adequately tight fiscal stance.

CONCLUSION

17. The policies which we have pursued in the 1980s have greatly strengthened the British economy. But there are clear risks in the present situation. We must not weaken in the fight against inflation. At a time when we are seeking to reduce the growth of private sector demand it is vital not add to our difficulties by expanding to public sector's claims on resources.

18. It is essential, therefore, that we follow the recommendations in the Chief Secretary's paper.

Treasury Chambers
10 July 1989

NL
10 July 1989