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PRIME MINISTER

You agreed that I should put a paper to Cabinet before Christmas reviewing the economic outlook in the light of most recent economic developments which might first be considered by a smaller group of Ministers under your Chairmanship.

... 2. A draft paper is enclosed. I understand we are to discuss it in the smaller group on Thursday, 6th December. – now 0900 on Friday, 7 December.

3. The Chief Secretary and I have also in hand a second paper setting out some ideas on the possible timing and method of re-opening the public expenditure plans. We hope to let you see this very shortly.

4. I am copying this minute, with the draft paper, to the Home Secretary, the Secretaries of State for Industry, Trade, Energy, Employment and Social Services, and the Chief Secretary.

(G.H.)
27 November, 1979.

THE ECONOMIC OUTLOOK

Memorandum by the Chancellor of the Exchequer

Introduction

I have been taking stock of the economic situation in the light of the most recent developments. We knew when we took office that we had inherited an extremely difficult situation; and I have no doubt that our general strategy for tackling it remains the right one. But it is now clear that the difficulties we face - both domestic and international - are greater than we had any reason to expect, and I think the time is ripe to re-examine our specific approach in the future.

Recent Developments

2. I would single out three particular developments of concern:-

(i) With strong wage inflationary pressures, poor trading, productivity and competitiveness performance and the unpromising outlook for world trade following the further large increases in oil prices, the economy is moving into a recession from which there could well be only a slow recovery;

(ii) in particular, despite the action I took in the Budget, the recent figures have shown that underlying monetary growth is much higher than we had expected (£M3 has grown at an annual rate of over 14 per cent in the last four months - higher than at the time of the Budget);

(iii) although I believe that the message has got through that we shall stick to our monetary strategy, inflationary expectations, and hence pay pressures, are remaining high and intractable.

3. This more sombre outlook was reflected in the Industry Act forecast that I published last week. This brought out in particular the deteriorating prospects for output and for reducing the rate of inflation in the coming year. I would not wish to attach too much weight to the specific figures in the forecast; but the general direction in which the economy is now moving is clear and agreed by most outside forecasters.

Action so far

4. Given the timing of the election we made a good start in dealing with our dismal inheritance in the Budget. The combination of direct measures on the monetary side (including the increase in MLR to 14 per cent) and reductions in public expenditure in the current year established our credibility from the start and signalled our resolve to maintain strict monetary control backed by fiscal policies consistent with it. And the measures I announced on 15th November demonstrated our determination to maintain those policies in the face of the disappointing deterioration in the underlying monetary and PSBR situation that had come to light. The initial reaction in the markets was favourable and we have secured substantial sales of gilts to help fund the PSBR. I hope that the other effects of the change will now come through so that the growth of the money supply comes into the target range, without even higher interest rates than the already very high ones which we have had no alternative but to accept. But this will depend on a number of factors some of which we can influence - particularly the market's assessment of our determination to carry through our policies, including its reaction to the next expenditure White Paper - and others which we cannot, e.g. the effect of Iranian and US policies on the foreign exchange markets.

Future Action

5. But I fear that, faced with the sombre prospects referred to above, the action we have recently taken may only provide a temporary respite. I remain convinced that, if we are to master inflation as a necessary condition of resumed and sustainable

growth, the progressive reduction of the money supply must continue to have overriding emphasis. It is, in any case, a policy over which we have little choice in a world of floating exchange rates, as the experience of the previous Government has shown. But it is increasingly clear that we shall not be able to achieve this - at any rate in the lifetime of this Parliament - unless we are prepared to modify at least one of our other intentions or objectives.

6. To put this more explicitly, our declared policies at present embrace the following:

(i) An overriding commitment to deceleration in the rate of growth of the money supply at tolerable interest rates;

(ii) an objective of further reductions in the burden of personal taxation, with the long-term aim of reducing the basic rate of income tax to 25 per cent;

(iii) substantial reductions in the inherited public expenditure plans and in the size and role of the public sector generally.

7. In my view no compromise is possible on (i). Otherwise the credibility of our whole economic strategy would be destroyed. And, although I have made it clear publicly that the room for manoeuvre in next year's Budget is very restricted, I believe there is only limited scope for modifying our longer-term tax objective at (ii). At the very least - and this really falls far short of what we have set out to achieve - there must be no increase in the real burden of taxation. But, given the worsening of our economic prospects, I have to confirm that I see no way in which the above objectives can be attained on the basis of the public expenditure plans agreed by the Cabinet in July for 1980-81 and more recently for the later years of the Public Expenditure Survey period.

8. It is now clear that a measure of disappointment with the public expenditure plans for 1980-81 announced in the recent White Paper (which fell some £2 billion short of the target the Chief Secretary and I had set) was an important element in the unsettled market conditions that forced me to take further action on 15th November. The markets were expecting a reduction in the volume of expenditure, and the PSBR in 1980-81 and these expectations were disappointed. For the period after 1980-81 I fear that a similar situation is in prospect. The Chief Secretary and I warned the Cabinet in September that even with the expenditure reductions we were proposing for the later years it would be hard to hold the borrowing requirement to around its present proportion of GDP without some real increase in taxation. In the event the plans agreed by the Cabinet look like being more than £1 billion higher for most of the years concerned; and the economic prospect generally has worsened. On any prudent assessment, therefore, of the outlook for the economy over the next year the present public expenditure plans seem incompatible with achieving a slower growth of the money supply without even higher interest rates or higher taxes.

9. This conclusion is derived from the recent medium-term work on the economy in the Treasury. But the conflicts are likely to be at their most acute in the next two years. Again, as with the short-term prospect, I should not wish to place too much weight on specific figures. There are very large uncertainties and margins of error. But to allow for these I have had further work done on more optimistic assumptions. This shows that, for example, to get money supply growth down to 7 per cent by 1983 (2 percentage points below the middle of the present target range) and the PSBR to about 2½ per cent of GDP (which should allow interest rates to fall) would, on the expenditure plans approved by the Cabinet, imply increases equivalent to around 5p on the basic rate of income tax by 1981-82. And even on this optimistic view of the economy's performance in later years there would be no prospect of a basic rate of below 30 per cent until 1983.

Conclusions

10. For the reasons outlined above the path to low inflation and resumed and sustainable growth will be harder than we had earlier hoped or foreseen. It would be wrong to exaggerate this; but disastrous not to face up to it. In my view two key conclusions now emerge from recent developments. First, however difficult and unpopular the path in the short-term, the centre piece of our strategy against inflation - progressive reduction in monetary growth - remains the only feasible one. But second, unless we are prepared to scale down our spending plans we shall not be able to adhere to this without serious damage to our taxation objectives and the risk of even higher interest rates than the high rates that have proved necessary so far. I believe that this is also becoming increasingly clear to the financial markets and that unless we reduce our spending plans so that they are consistent with our other objectives we shall be confronted by a series of tensions in the financial markets, of which that earlier this month was only a first example.

11. I should be grateful for my colleagues' views. As a help to discussion the Chief Secretary and I have set out in a separate paper some ideas on the possible timing and method of re-opening the public expenditure plans. Subject to our discussion of these two papers I should like to consider when and on what basis we should consider re-examining the present public expenditure plans with the Cabinet, bearing in mind that the Cabinet noted that there was a case for so doing in their discussion on 15th November.

(G.H.)

H.M. Treasury

26th November 1979