Prime Minister,
To see.

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R Carter.
Duty Clerk

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

MR LANKESTER (OR)
to see NJS

PRIME ~~MINISTER~~

PM has seen NJS

ECONOMIC AND FINANCIAL SITUATION REPORT

I have carried out a general "stock-taking" on the economy at a meeting with my advisers here and with the Governor and I thought that you would find it helpful on your return from Lusaka to have a summary of developments and prospects as I see them at present. There are a number of difficulties ahead - not least the very tight Budgetary prospects for next year - and we shall need to monitor developments very closely. But it is too early to make other than very tentative judgements - we shall have a new forecast in October - and I am satisfied that all the necessary preparatory work that we can reasonably undertake is in hand. We shall, of course, be resuming our discussion in Cabinet of public expenditure on 13th September, and I have sent you a separate minute on the timetable for announcing our decisions.

Output, employment and inflation

2. On the economy generally, GDP in the first half of the year was not too different from forecast. But with the recovery from the winter and a sharp rise in consumers' expenditure being offset by a worse external performance than expected (higher imports and lower exports) the present level of GDP is still only about the same as last summer. In the coming months consumer spending will probably fall back to more normal levels and a cyclical downturn in investment and stockbuilding appears imminent. We must

/also expect

also expect the growth in public expenditure on goods and services to have been halted. The depressed outlook for world trade and our own loss of competitiveness will inevitably limit the prospects for a recovery in exports; but the slowdown in domestic activity should reduce the rise in imports. All this suggests that although unemployment was steady in July, it may begin to rise before long.

3. The underlying rise in average earnings appears to have been about 15 per cent over the past 12 months, and the average level of settlements seems to have been rising. Initial signs for future private sector settlements are therefore not encouraging. In the public sector, the recent Clegg awards will add (on Clegg's own estimate) about 11 per cent on average to the pay bill for the groups affected in a full year before allowing for offsetting economies, and I have more to say on this in paragraph 6 below. The awards did not include nurses and teachers where substantially higher settlements are possible.

4. As you know, retail prices were 11.4 per cent higher in June than a year ago, and the July year-on-year increase - due to be announced on 17th August - seems likely to rise to about 15 per cent mainly as a result of the Budget tax changes.

Pay

5. Initial signs for pay claims in the coming months, as mentioned above, are not encouraging. Early negotiations cover Vauxhall, British Leyland, British Oxygen, Fords and local authority manuals. The miners could also come nearer the head of the queue if they try seriously to advance their settlement date to November. Employers in the private sector are expecting a freer hand than last year, but many may not have fully appreciated the problems in relating pay

/settlements

settlements to what can be afforded, and we must continue (as in the campaign that Keith Joseph, Angus Maude and I are now launching) to make clear the consequences of excessive wage settlements.

6. In the public sector, we are currently costing and evaluating the first batch of Clegg reports. As mentioned above, the increases so far recommended, which cover about half the total number of public service employees referred to Clegg, seem likely on Clegg's estimates to add about 11 per cent on average to the total pay bill of the groups affected in a full year. This is a good deal higher than we had assumed in the post-Budget Forecast for these groups, since in computing the overall average we assumed that the awards to nurses and teachers would be substantially higher. It is too soon to make a confident estimate of the overall implications of Clegg, but even allowing for some success in buying out restrictive practices, the average payments recommended for all groups could be at least 2-3 percentage points higher than the post-Budget forecast assumed. This could obviously represent a considerable threat to our plans and, when the assessment of Clegg has been completed, we shall need to consider whether any further savings are practicable to offset the cost of the awards; whether, and if so, in what form, we should submit Government evidence to Clegg on his approach to outstanding references; and whether we want the Commission to continue in existence once work on this round's references is completed. E Committee will, of course, be considering papers on this in the first half of September.

Company liquidity

7. Our policy of squeezing out inflation through monetary policy inevitably creates a tight liquidity position for companies in the short-term. This is part of the process by which excessive wage increases are discouraged. Our

/concern

concern must be whether the squeeze could cause widespread bankruptcies. The impact on the cash flow of companies is uneven and falls particularly severely on companies closely competing with foreign suppliers. The latest rise in the wholesale price index - up 2 per cent in July - may be evidence that companies are aware of the need to improve their cash flows. The scope for raising prices, however, will tend to be limited by the expected tight demand conditions and the relatively high exchange rate. In general, although the outlook is bleak, it is not disastrous. Although there will be problems, particularly as a result of the exchange rate, which will vary between industries and firms, I do not foresee a serious financial crisis, certainly by the standards of 1974. I shall continue to keep the position under close review and have already considered possible measures to help company liquidity. I fear, however, that none of these is easy; most require legislation; and all would involve a PSBR cost.

Monetary developments

8. The money supply figures for banking June, the latest available, confirmed that the underlying growth was still 13 per cent or more. The banks' eligible liabilities figures, which are used by the market as an indicator of the £M3 rise, show an increase of some ½ per cent in banking July. £M3, however, seems likely to have risen somewhat more than this, although not as rapidly as in recent months. The figures for £M3 will not be published until 16th August.

9. I see no immediate need to alter our policies. The eligible liabilities figures published on Tuesday seem to have been well received by the markets, perhaps in particular because they suggest a more modest increase in bank lending, and the Bank have been able to sell the balance of the long tap. If the market remains firm we will be announcing a new short tap on Friday. I am also considering other ways

/to help

to help fund the PSBR in the autumn - perhaps by a new National Savings Certificate issue to coincide with the October tax rebates. We intend to allow the already announced recalls of special deposits from the clearing banks to go ahead on 13th August and 10th September, and we shall keep the SSD scheme under review to ensure its general effectiveness. It is still too early to judge whether we have got the money supply under control, and we will need to see some further months' figures before we can be confident about the possibility of interest rates to come down. But I do not share the pessimistic views expressed by some commentators earlier in the week that the next move is likely to be upward rather than downwards.

The exchange rate

10. Sterling's rapid rise against both the dollar and other currencies peaked towards the end of July with the effective rate close to 74.0, an appreciation of almost 10 per cent since the Budget. An adjustment, however, was overdue, and sterling fell sharply on 31st July and again on 6th and 7th August. The effective rate now stands at around 70½ which is nearly 5 per cent higher than on Budget Day.

11. The announcement of the large increase in foreign exchange reserves for July caused some surprise at the apparent extent of the Bank's purchases of dollars from the market but sterling's recent downward adjustment shows that they were justified in order to take some of the speculative froth out of the market. If sterling continued to fall but only gradually, the Bank would give some modest support to the pound but would sell fewer dollars than they bought while the rate was rising. But it is possible that some piece of bad domestic news - possibly concerning

/inflation

inflation or the current account of the balance of payments - could cause the pound to be marked down sharply. If so, we have concluded that it would be advisable for the Bank to make its presence felt in order to avoid giving the impression that the authorities desired a further depreciation of sterling.

PSBR and public expenditure

12. The position on the PSBR this year continues tight. It is imperative, both for the budget arithmetic and for the future control of spending, that we take a very firm line against proposals for additional public expenditure, however modest. Cash limits are exerting a squeeze on expenditure and there are signs that some Departments are finding difficulty in living with this. Having deliberately reduced the contingency reserve in the budget, there is very little margin remaining there for new decisions involving expenditure, however attractive on merits. The threats I can already foresee would preempt virtually all that is available in the reserve.

13. In the meantime, as indicated in paragraph 6 above, the cost of the Clegg awards could be higher than assumed in the post Budget forecast. The Post Office strike, which is delaying telephone bills, will also add significantly to the PSBR at least in the short run.

14. For 1980-81, although it is dangerous to guess too far at the net effect of new developments, the prospect for the PSBR looks increasingly difficult, with very little room for manoeuvre. The Clegg awards are again a factor; and as you know, Cabinet's decisions on the public expenditure programmes came out about £1¼ billion higher than the target. We are looking at all possible revenue raising options, including the North Sea.

/Conclusion

Conclusion

15. I hope this will give you a helpful, if not very cheerful, general picture of the current situation and prospects. We shall need to monitor developments very closely as background to the decisions we shall be taking in the autumn prior to announcing our public expenditure and other plans. But it is clear that room for manoeuvre is likely to be very restricted and we shall need to stick firmly to the monetary and fiscal path on which we are now set. There is no reason - or indeed room - to change course; it must be a case for steady hard pounding. We must also continue to expound our policies at every opportunity and I hope that the campaign that we are now launching (and for which I have already circulated basic briefing) will enable other Ministers increasingly to share this task with us.

16. I am sending a copy of this minute to Sir John Hunt.

AM Battishill

pp. (G.H.)

9 August, 1979

[Approved by the Chancellor of the Exchequer and signed in his absence]

CONFIDENTIAL

DSG

File

10 DOWNING STREET

From the Private Secretary

14 August 1979

NATIONAL SAVINGS CERTIFICATE ISSUE

When the Prime Minister saw the Chancellor's minute to her of 9 August about the economic and financial situation, she commented that she had considerable doubts about the timing of the possible new issue of National Savings Certificates mentioned in paragraph 9. The Prime Minister thought that an issue at the time proposed might have to have a higher interest rate than would be the case a little later.

The Prime Minister intended to mention this point to the Chancellor, but to the best of my knowledge she did not do so. Given the Prime Minister's views, no doubt the Chancellor will wish to put the question of the timing of any new issue of National Savings Certificates to her again before a final decision is taken.

I am sending a copy of this letter to Martin Vile (Cabinet Office).

N. J. SANDERS

M. A. Hall, Esq.,
H.M. Treasury.

CONFIDENTIAL

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If you go ahead with a new savings certificate issue you will be goading the Building Societies to put up their interest charges to home buyers. You can't expect co-operation from them and then be unprepared to co-operate with them yourself also.

PRIME MINISTER

To see. We have asked the Chancellor to come back to you about the proposed Saving Certificate issue as well.

MS 14/8

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

14 August 1979

Dear Nick

NATIONAL SAVINGS BANK INVESTMENT ACCOUNT INTEREST RATE

The Prime Minister raised recently with the Chancellor the decision to increase the National Savings Bank (NSB) Investment Account interest rate, and its possible effects on building societies: I understand that it was also mentioned at Cabinet on Friday. The Chancellor has asked me to let you have a note on the background to the decision. (He is of course on holiday and has not therefore been able to approve this letter; but he did not want the note to be held up until his return.)

As the Treasury paper, "Funding the PSBR and the Gilts Market", for the Prime Minister's Monetary Seminar pointed out, there are good grounds for continuing to seek a significant contribution to the financing of the PSBR from National Savings: the total cost of borrowing will tend to be lower, the wider the range of markets we can tap; and the inflow from National Savings may help to bridge the gap when there is a hiatus in sales in the gilts market. We would hope that it would again be possible to raise some £1,500 million in 1979-80 from this source as a means of achieving the monetary objective without putting too great a strain on the gilts market. The NSB Investment Account has played a critical part in the recovery of National Savings as a means of financing the PSBR in the last 3 years. Its interest rate has been moved in line with market rates and inflows have increased: it contributed some £500 million in 1977 and 1978 taken together, and over £200 million in the first 6 months of this calendar year.

In normal circumstances the NSB Investment Account interest rate would have been moved to 13 per cent with effect from 1 August, following the change in competing rates in mid-June. However, given the Prime Minister's concern about the mortgage rate, the decision on the Investment Account was delayed until it was known what building societies were going to do with their investment rates. After the societies had decided to limit the

/extent

N.J. Sanders, Esq.,

extent of increase, the increase in the Investment Account rate was limited to a ½ per cent, bringing the rate to 12½ per cent. For various technical reasons this investment account rate is effectively somewhat less than the new building society share rate, which grosses up to 12½ per cent.

So long as the NSB Investment Account rate is in line with, or below, competing interest rates, i.e. not leading them upward or holding them up, it will have very little effect on building society inflows. It therefore cannot, of itself, lead to an increase in the mortgage rate. So the increase should not affect the question of whether building societies do in fact raise their mortgage rate on 1 January next. On the other hand, not to have raised the NSB Investment Account rate could well have reduced the inflow into National Savings in the next few months. This would have had an important - perhaps a critical - bearing on our control of the money supply. Furthermore, longer term harm would have been done to the Investment Account, as investors could no longer have presumed with any confidence that the interest rate would be moved when market rates moved.

I hope that you find this explanation helpful.

Yours ever,

MAH

(M. A. HALL)

CONFIDENTIAL

Econ Pol

10 DOWNING STREET

From the Private Secretary 15 August 1979

National Savings Certificates

The Prime Minister has seen your letter to me of 14 August about the National Savings Bank Investment Account interest rate. When she saw it she made a comment about the proposed National Savings Certificate issue - on which I wrote to you yesterday.

The Prime Minister takes the view that going ahead with a new Savings Certificate issue would be goading the Building Societies to put up their interest charges to home buyers. She has added that if we expect co-operation from the Building Societies, we must be prepared to co-operate with them ourselves.

No doubt the Chancellor will take these views into account in coming back to the Prime Minister on the subject of the National Savings Certificate issue.

M.A. Hall, Esq.,
H.M. Treasury.

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PRIME MINISTER

The response to your concerns about possible NSB Investment Account interest rate increase.

MAP 21/viii.

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Treasury Chambers, Parliament Street, SW1P 3AG

21 August 1979

N Sanders Esq
10 Downing Street
LONDON
SW1

Dear Nick,

The Financial Secretary has seen your two letters of 14 and 15 August about National Savings Certificates.

He is sure that the Chancellor would want him to reassure the Prime Minister that he will very much have in mind the points which she has raised. While the potential situation in the gilts market, and tha availability of the tax rebates, would make a new certificate in October helpful for monetary control, he readily accepts that there ia a very strong case for postponing any move in this direction until the New Year, when it may be clearer what level of interest rates generally will be needed in future to maintain monetary control, and when the building societies will have finally decided on what their rate structure is to be after 1 January.

Yours,

Paula

P C DIGGLE
Private Secretary

Econ Pol
TMS

10 DOWNING STREET

From the Private Secretary

24 August 1979

The Prime Minister has seen and noted your letter of 21 August (to Nick Sanders) about National Savings Certificates.

M. A. PATTISON

Mrs. P.C. Diggle,
H.M. Treasury.

VLB