

A02509

PRIME MINISTERThe Economic Prospect

(C(80) 35)

BACKGROUND

The Chancellor of the Exchequer's memorandum offers a general description and analysis of recent developments and the outlook immediately ahead. He suggests that current developments are not substantially different from what had been expected. But he points to two important qualifications to this - both familiar to members of E from recent discussions. First, pay increases have been bigger than expected; second, there are the expected difficulties in containing the PSBR in 1981-82. The PSBR problems are attributable to the problems of controlling borrowing by all three parts of the public sector - Government Departments, the local authorities and the nationalised industries - and to forecasts of North Sea oil output. In addition interest rates are also under pressure because of the continuing high demand for credit from industry.

2. The Chancellor goes on to explain that there are different views among forecasters about the likely depth and duration of the United Kingdom economic recession - a good deal turns on our cost competitiveness at a time of world recession. But he concludes, in his paragraph 9, that the company sector may remain in substantial financial deficit through the period to 1983; that unemployment will rise steeply and beyond the level of 1.8 million previously assumed by Autumn 1981; and that while inflation will decelerate this will not be as quickly as hoped. He nevertheless believes that in the later years of the period there should still be scope for tax reductions.

5. He concludes, in his paragraph 12, that faced with the difficulties of containing the PSBR in 1981-82 and with the high risks and uncertainties which he has set out, it is more than ever imperative to hold to the Government's economic strategy. It is only in this way that we can create the conditions for growth in the medium term.



4. Beyond this general invitation to endorse the present strategy, the Chancellor does not invite specific policy decisions. Proposals on these will be put forward in papers which the Chief Secretary will be circulating for the first discussion of the 1980 Public Expenditure Survey on 10 July, which would probably be followed by a further discussion later in July and again in the Autumn.

HANDLING

5. I suggest you open the discussion yourself by explaining that the aim is a general stock-taking of the economic strategy on the basis of a presentation by the Government's Chief Economic Adviser (Mr Burns) and the Head of the Central Policy Review Staff (Mr Ibbs) and of the Chancellor's paper. This discussion will usefully establish the background to the discussions of the 1980 Public Expenditure Survey which will start on 10 July, on the basis of the papers which the Chief Secretary will be circulating for that meeting in a few days time. It would be as well to emphasise that decisions on specific public expenditure proposals, and the general approach to the exercise, will be reserved until then.

6. You might then invite Mr Burns and then Mr Ibbs to give their presentations. Mr Burns is planning to speak for about 20 minutes and will review the financial aspects of the strategy, rather than supply issues. He will set out the background of current slow growth in world trade; discuss the impact of the monetary strategy on inflation; and discuss the reasons for high interest and exchange rates. Mr Ibbs will supplement this briefly by bringing out a few central issues. The Chancellor of the Exchequer could then be asked to follow to amplify his own paper and Mr Burns's presentation. Each Minister will then no doubt wish to give his own views and to ask questions. You may wish to hold the Chief Secretary to the end of the discussion when he can sweep up and deal in particular with any public expenditure points which might have been raised.

7. It is difficult to say what questions will be raised in a free-ranging discussion of this sort. The main worries are likely to be the debilitation of British industry, rising unemployment and the social strains which follow. The key general question to which they give rise is how quickly can the turn-around come and is the prospect politically sustainable? This in turn may lead



some colleagues to question whether the problems should be met by fundamental reversal of the present strategy or, as the Chancellor proposes, by holding firmly to the strategy. If any colleagues argue for a change of course it will be for them to explain precisely what they mean and their grounds for thinking that their alternatives will work. It is perhaps more likely that some Ministers will argue that, while the broad thrust of the strategy is right, they want to see changes in particular aspects of it. In the discussion of the impact on British industry there are likely to be questions, with which the Chancellor and Mr Burns can deal, on interest rates and the exchange rate, and on whether it is indeed imperative to hold to specific PSBR targets at a time of recession and weak demand. There may well be proposals for relaxation on the public expenditure front by way of, for example, more regional assistance and more expenditure on training measures to assist in redeployment. The Secretary of State for the Environment has given notice, in his minute to you of 27 June on transport investment in the docklands, that he will wish to argue that excessive consumption is destroying capital investment.

CONCLUSIONS

8. In the light of the discussion you will wish to -

- i. establish a consensus that the Government should continue with its existing strategy for managing the economy - ie endorsing the approach in paragraph 12 of the Chancellor's paper, C(80) 35;
- ii. note any public expenditure points and specific proposals but reserve discussion and decision on them until the 1980 Public Expenditure Survey Cabinet next week;
- iii. note any further specific proposals and remit them, where appropriate, for further examination and discussion in due course.

Handwritten signature in black ink, consisting of the letters 'RA' in a stylized, cursive font.

ROBERT ARMSTRONG

2 July 1980