

PRIME MINISTER

cc. Mr. Alexander

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Defence

At your meeting with the Chancellor last Thursday, he mentioned the £400 million overspend on the defence programme for the first two months of this financial year. He also mentioned that he was considering the possibility of introducing cash rationing on a monthly basis.

I think it would be worth taking him up on this, and also asking him what other possible contingency action may be needed to ensure that the cash limits for the year are adhered to. With this in mind, I propose to write to the Treasury as per the attached letter. Agree? *Yes*

I should perhaps explain what is meant by MOD having overspent by £400 million in the first two months. There is no formal control on a month-by-month basis. But spending Departments are asked, before the financial year, to provide the Treasury with a profile of how they think the cash limit will be spent on a month-by-month basis. The Treasury then monitor actual spending against this profile. But if a Department is overspent compared with the profile, the Treasury cannot say that that Department is "breaking the cash limit". Hence the need to consider the possibility of monthly - or perhaps quarterly - cash control.

Finally, you should see the very worrying letter from the Defence Secretary at Flag A. When the MOD cash limit for 1980/81 was set, it was agreed - after much argument - that it would be "subject to review in the light of economic and international circumstances with a view to aiming for an increase in real terms of in the region of 3 per cent in line with the agreed N.A.T.O. target". This review will be completed in a few weeks' time, and I understand from the Treasury that MOD are likely to be asking for an additional

/ £700 million.

£700 million. Whatever the merits on defence grounds, it would create major problems if it were agreed - coming on top of the almost inevitable overspends on the nationalised industries cash limits and probably local authority spending too. If it begins to look as if Government spending and the borrowing requirement are going to overshoot significantly, then we really will be in trouble with the markets; and we could then find ourselves with another "gilts strike" of the kind we had last October. Put slightly differently, if we are to begin moving interest rates down in the near future, the risk that we will have to go into reverse and put MLR up again will be less, the more robust we are in making sure that the cash limits stick. If we seriously believe we are not going to be able to hold the borrowing requirement to the target level, then we should be all the more cautious in moving interest rates down.

On the other hand, we should not forget that lower interest rates ought to mean some relief for public spending. Not only is there direct spending on debt service; but with lower interest rates, the exchange rate will probably fall, and this will make British Steel and British Leyland more competitive, and thereby reduce the call on public funds. A lower pound would of course also reduce the pressure for spending ~~on~~<sup>or</sup> other reliefs (e.g. reduced national insurance surcharge) in support of private sector industry.

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We just can't afford that extra  
now. It is indisputable

27 June 1980

to give a 16.5% increase for  
wages on this basis. The  
money is there. If it is taken out  
that will be less for equipment. No



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FILE

10 DOWNING STREET

*From the Private Secretary*

27 June 1980

When the Chancellor called on the Prime Minister last Thursday morning, they discussed briefly the reasons for the very large increase in spending in the first two months of this financial year compared with the first two months of last. The Chancellor explained that one of the main contributory factors was defence spending, which was £400 million more than expected.

The Chancellor went on to say that he was considering the possibility of introducing cash rationing on a monthly basis, or at any rate on a shorter timescale than the present 12 months basis. The Prime Minister would be grateful for a note on this when the Chancellor has reached his conclusions, and also on what other measures might be needed to ensure that this year's cash limits are adhered to.

T. P. LANKESTER

John Wiggins, Esq.,  
H.M. Treasury.

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