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CABINET

THE ECONOMIC PROSPECT AND IMPLICATIONS FOR POLICY

Memorandum by the Chancellor of the Exchequer

INTRODUCTION

1. Last March Cabinet endorsed the Medium Term Financial Strategy (MTFS) for bringing about a permanent reduction in the rate of inflation, and thereby creating the conditions for a sustained growth of output, employment and living standards. Essential to the strategy was a decline over the period in public sector borrowing, so that the monetary deceleration could be achieved while at the same time reducing interest rates.

2. There are some encouraging signs that the strategy is beginning to bring about greater realism in pay and pricing. We must build upon this success by holding to the strategy. This means that we must take the decisions necessary to ensure that public expenditure, borrowing and the growth of money supply - which have all been too high recently - are brought firmly under control. If we fail to do this we will do immense damage to the overriding objectives we have set ourselves of reducing inflation, interest rates and the tax burden.

3. This paper outlines the economic prospect and sets out the policy decisions we need to take to implement our strategy.

THE ECONOMIC BACKGROUND

4. We are clearly in a period of recession for the industrialised countries. World inflation rose and output began to decline from the first quarter of 1980. This decline is likely to continue through the rest of this year, and 1981 could be a year of relatively slow recovery.

5. The prospects for the United Kingdom economy are dominated by the cumulative effects of past and present inflation and low productivity. These can be seen most clearly in the serious loss of competitiveness and the low level of company profitability. The volume of exports has so far held up

well, but the very rapid rise in world trade during 1979 and the early months of 1980 to some extent masked the effects of the loss of competitiveness. With world trade slackening the volume of exports may fall from now on. Lower exports and reductions in stocks are likely to be the main factors reducing output in the short-term.

6. The fall in gross domestic product (GDP) this year seems likely to be close to the $2\frac{1}{2}$ per cent forecast at Budget-time; but the recession may be deeper in 1981 than had been thought earlier. The latest forecasts suggest that output in 1981 may fall by about the same amount as this year, but within the year the pace of decline should slacken and there may be some upturn in the second half leading to resumed growth in subsequent years.

7. On inflation the picture is brighter. There has been a marked reduction in the rate of inflation in the past six months. In the immediate future progress may be slowed by the lagged effects of the rise in wage costs in the 1979-80 pay round and by increases in nationalised industry prices; the 12-month increase in the Retail Price Index is expected to be about 11 per cent by late 1981 (this would also be equivalent to 11 per cent between the financial years, which is relevant for cash limits). A single figure outcome is possible but a number of favourable factors - for example, a continuing rise in the exchange rate, a further substantial squeeze in profit margins, a fall in mortgage rates, continuing weak world prices, and single figure average pay settlements - would generally have to go in the right direction. On balance we must expect some of these factors to go in the wrong direction.

8. Further progress in reducing inflation will depend critically on the course of pay increases. The most effective way in which we can influence the private sector is to convince everyone that we will stick to the financial strategy, whatever the short-term difficulties, and to settle public sector pay at a low figure.

9. So far the reduction in inflation has come about in a way that has permitted a further rise in real personal incomes because it has affected prices before earnings. The burden of adjustment has fallen disproportionately on company profits. This means that the finances of many companies are extremely vulnerable in the immediate future unless wage settlements are low. A fall in real earnings over the next year or so is essential, and indeed this seems now to be widely accepted.

PUBLIC FINANCES AND THE PUBLIC SECTOR BORROWING REQUIREMENT (PSBR)

10. The Treasury's latest forecasts put the PSBR for 1980-81 at over £10 billion. This is £2 billion above the Budget forecast, much of it because of over-runs in expenditure. This over-spending has been a

major reason for the difficulties we have experienced this year in getting to the point when we can look forward to a significant fall in interest rates.

11. For 1981-82 the forecast PSBR is over £11 billion. This assumes that the cuts in programmes proposed by the Chief Secretary in July are fully achieved, but allows the expenditure totals to increase to the full extent of the adjustment in demand-determined programmes (such as social security) and expected expenditure shortfalls caused by the revised economic prospects. It also assumes full inflation adjustment of personal and expenditure taxes in the 1981 Budget and public services pay rises of 9 per cent. A PSBR of the size implied by this forecast would have the most serious implications for interest rates.

IMPLICATIONS FOR POLICY

MONETARY POLICY

12. We must stick to our two main objectives: lower inflation and lower interest rates. This means that there can be no question of departing from our monetary objectives. To do so would have a disastrous effect on inflation, interest rates and the climate for pay bargaining.

13. One consequence of the recent high public sector spending and borrowing is that interest rates will need to remain high for longer than we had hoped. The first requirement now is to secure an out-turn for the money supply in the current financial year that is consistent with the target range set last spring. For this we shall have to rely primarily on monetary instruments, particularly selling more government debt to persons by "granny bonds" and other means.

14. For 1981-82 and later years we must take action to keep monetary growth within the range set out in the MTFS. This will entail fiscal measures to reduce the prospective PSBR.

THE PSBR

15. What size of PSBR in 1981-82 we should aim at cannot be decided now. But it is clear that we must aim at a borrowing requirement substantially below that indicated in the latest forecasts.

16. The illustrative path in the MTFS envisaged a PSBR equivalent to about 3 per cent of GDP in 1981-82: the forecasts imply one of around $4\frac{1}{2}$ per cent. To get back to the MTFS figure would entail a reduction of about £4 billion. To go that far in a year of recession would not be warranted; but if we wish to create conditions in which interest rates can fall we must seek a reduction of at least £$2\frac{1}{2}$ billion from the current forecast figure of over £11 billion.

17. Since that forecast already assumes that the specific reductions in programmes proposed by the Chief Secretary in July are fully achieved this is a formidable objective.

TAXATION

18. On the tax side I am considering a number of options for raising revenues, including the possibility of obtaining additional revenue from the North Sea. But these obviously cannot close more than part of the gap. Even with the cuts in public expenditure proposed in the Chief Secretary's paper (C(80) 58) it will almost certainly be necessary to raise the real weight of personal taxation. The real tax burden was increased in the last Budget; I need hardly stress the difficulties, and disappointments, that any further increase would entail.

PUBLIC EXPENDITURE

19. The credibility of, indeed the chances of achieving, our whole strategy vitally depends on holding public expenditure within our own published planning totals.

20. The changes in the prospects for the economy from those that underlay the White Paper figures mean that there is likely to be higher spending on social security and items such as housing and export credit subsidies. In addition, discussions with the nationalised industries reveal a serious deterioration in their financial prospects.

21. The proposals in the Chief Secretary's paper are addressed to bringing back public expenditure volumes as nearly as possible within our published planning totals. But in itself this would do little to reduce the PSBR below the present forecast. We need to go virtually that far to validate the assumptions already in the forecast.

22. There is thus a strong case that we should seek larger cuts. But I recognise the difficulties of this. Even if we modify the objective of restoring the planning totals by not deducting the full savings from the European Community settlement, keeping within them would require cuts in programmes of about £2 billion (at late 1979 prices) in 1981-82 (and somewhat larger sums in the later years). As the proposals in the Chief Secretary's paper make clear this will entail some very difficult and disagreeable decisions. But unless we face up to this issue there is no prospect of getting back to the path of our medium-term strategy and securing the reductions in monetary growth and interest rates we seek. And in the nearer term there would be very bleak implications for taxation.

23. We must also act on the cost of public expenditure programmes as well as their volume. The PSBR reflects the cash costs of programmes, in relation to our cash receipts from taxes. One way therefore to reduce the PSBR beyond what can be achieved by volume cuts is to reduce the cost of programmes relative to other costs in the economy. In particular, a smaller increase in public services pay, as envisaged in paragraph 5 of my paper on pay and price factors C(80) 60, would be a substantial help.

CONCLUSION

24. The prospects for this financial year and next are extremely difficult. For both years the PSBR on present policies is likely to be much higher than is compatible with easing the pressure on interest rates within the continuing framework of our medium-term financial strategy.

25. For the current year monetary instruments must continue to bear the main strain, though it is vital that cash limits should be held.

26. For next year, although I am considering what extra revenue can be obtained, we must do all we can on public expenditure. Otherwise there is little hope of getting interest rates down.

27. In the later years, the PSBR and interest rate problems may be less acute. But if these are to be years in which, as we all hope, taxes and interest rates are coming down and industrial and economic confidence going up then it is vital that we contain public expenditure within the earlier plans.

G H

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