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CABINET

ECONOMIC PROSPECTS

Memorandum by the Chancellor of the Exchequer

In the past four years we have secured substantial progress on inflation and productivity. The foundations have been laid for sustainable growth and employment, without a resurgence of inflation. Our decisions now and in the coming months will determine the outcome of this Parliament.

2. The broad outlook for activity and inflation over the next two years is little changed from the Budget forecast, though financial developments this year carry a clear warning, as I indicated in our discussion of public expenditure on 7 July.

PROSPECTS

3. World Economy. Since the Budget the prospects for the rest of the world economy have in some respects deteriorated. Although output is growing strongly in the United States the fiscal and monetary position there looks anything but healthy. The very high budget deficit is a cause for particular concern. It would be unwise to count on the United States deficit being reduced much below \$200 billion in the next year or two, even assuming some trimming of tax and expenditure plans. Recovery in Europe and Japan is relatively slow. The overall rate of growth in the major industrial countries, perhaps some 3 per cent next year, seems likely to be weak compared to past cycles. The geographically narrow base of the recovery implies that the upturn in world trade will be relatively modest by past standards, particularly because of the depressed state of markets both in the non-oil developing countries and in the Organisation for Petroleum Exporting Countries. Manufacturing trade, which fell 3 per cent last year, should rise 4 per cent next year. So far recovery is under way without much upward pressure on inflation (inflation in the major seven countries averages below 5 per cent), though some continuing rise in non-oil commodity prices, from generally very low levels, is to be expected. Recovery is being assisted by the general consensus in favour of responsible monetary and fiscal policies. The French demonstration of the perils of trying to spend and borrow one's way out of recession has proved an eloquent warning.

4. Output. Despite the slower growth in world trade our own growth now looks a little higher than the Budget forecast - perhaps 2½ per cent this year, mainly led by buoyant consumer spending and some welcome increased spending by companies on stocks and fixed investment. The rise in consumer spending reflects a significant reduction in the savings

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ratio, helped by falling inflation, lower interest rates and a rapid growth in credit. At the same time company profits have been recovering and are expected to continue to benefit from lower increases in labour costs, with smaller earnings increases and continued rapid productivity growth in manufacturing, as well as the reduction in the National Insurance Surcharge. The balance of payments current account is moving this year from substantial surplus into rough balance (though the figures are, as always, subject to wide margins of error). The change since the Budget reflects firmer non-oil commodity prices this year and a faster growth of demand in the United Kingdom, relative to the rest of the world.

5. In 1984, slower growth of domestic demand may be broadly offset by a faster rise in world demand, producing another year of steady 2-2½ per cent growth. This will be helpful to the prospect for unemployment. I do not expect any major change from current levels for the rest of this year, and the prospects thereafter continue to depend on containing labour costs, improving competitiveness and seeing recovery in the rest of the world.

6. Prices. These are now rising more slowly than at any time since the 1960s; and the prospects for inflation have actually improved a little since March. At the end of 1983, despite the rise in the mortgage rate, the Retail Price Index should still be only some 5½ per cent higher than a year earlier as against 6 per cent forecast at the time of the Budget. This, along with the gradual realisation that there are good prospects for low inflation in 1984, will help the recovery.

7. The figures in the most recent Treasury forecast are shown in the attached table.

RISKS AND UNCERTAINTIES

8. There are, however, still some significant risks and uncertainties.

9. The major overseas uncertainty is United States interest rates and the problem of the enormous United States budget deficit. Continuing high real United States interest rates would be very worrying, and the pressure is undoubtedly for them to rise still further. It is, therefore, all the more important that our policies should aim to establish conditions in which we can distance ourselves somewhat from what happens in the United States. Oil prices, on the other hand, seem to have stabilised and there is a good prospect of a steady reduction in the real oil price in the next two years, the more so if the dollar were to fall. Political disturbances amongst the oil producing countries could always push up oil prices in the short term; but, that apart, there does not at present look to be much risk of a major oil price increase.

10. At home recent financial developments have exhibited worrying features. Money supply in the first four months of the target period has been increasing at an annual rate of around 17 per cent, some way above the 7-11 per cent target. Public expenditure and borrowing have also been well above the levels envisaged at the time of the Budget and threaten our hopes of lower interest rates. With our decisions on 7 July we set about correcting this, but continued vigilance will be needed if we are to keep on track. And, of course, pay in the public sector will require our continuing attention.

IMPLICATIONS FOR POLICY

11. Over the past four years we have followed a responsible and consistent monetary and fiscal policy within the framework set by the Medium Term Financial Strategy. The results can be seen in low inflation - the lowest for fifteen years - and welcome signs of recovery, ahead of most other countries. The task now is to consolidate and improve on these gains.

12. We will continue to operate economic policy flexibly, as in the past four years. But there remains a firm, overriding requirement to maintain the monetary conditions needed to keep downward pressure on inflation, and to support this by firm control over public spending and borrowing. That is the only way in which we can keep the confidence of financial markets, secure the conditions for better output and jobs, and look forward to reversing the trend in unemployment. We are determined to bring about a smaller public sector. And it is particularly important now the recovery is under way that we do not let the public sector crowd out investment in the private sector.

13. But that will imply some difficult decisions. The steps we have just taken on public expenditure this year have helped with the immediate problem, but the markets are understandably suspending judgment until they see how we tackle the present round of public expenditure decisions, the first of this Parliament.

14. The budgetary prospect for next year is no an easy one. At the time of the Budget we were anticipating a small positive fiscal adjustment of around £½ billion in 1984-85. But since then the scope for tax cuts next year has receded. The hoped for room for manouvre is being squeezed between lower revenue projections (partly because inflation is turning out a little lower than we had expected) and continuing upward pressure on public expenditure. Of course, at this stage, the figures are subject to a wide margin of error. But the immediate tax prospect looks distinctly uncomfortable. The conclusion is clear: the most we can afford is to keep to the expenditure plans in the last White Paper for 1984-85 onwards. Even then there will be a risk that taxes may still have to be put up next year if we are to keep to the Medium Term Financial Strategy.

15. As the Chief Secretary's paper (C(83) 23) illustrates we had no alternative but to allow taxes to rise during the early years of the last Parliament. In this Parliament we must continue the trend towards lower taxation started in the last two Budgets. This is not just a matter of meeting our commitments. We also want a better-structured tax system. Taxation is the key to individual incentive, to risk taking and to securing the kind of change in attitudes needed to bring about a more dynamic, competitive and enterprising economy. Tax reform must have a high priority. And we are agreed that without lower taxes we shall not get higher growth.

16. Securing conditions for lasting growth is also the key to more jobs. It is now generally recognised that there is no quick or easy solution to unemployment and no simple trade-off between inflation and unemployment. The only route to higher employment, on a lasting basis, is through lower inflation, lower costs and higher productivity. Lower taxation is a necessary and vital part of this.

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17. This, in turn, will require firm resolution in keeping public expenditure in check. The Chief Secretary's paper sets the prospective growth of public spending in its longer term context. The decisions that will be needed are individually difficult. But the past four years have shown the wisdom of our policies and the electorate's understanding that they work.

19. I urge my colleagues to agree to the Chief Secretary's proposals.

N L

Treasury Chambers

15 July 1983

4
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MAJOR ECONOMIC INDICATORS

	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u> ⁽¹⁾	OECD ⁽²⁾ (major 6 excluding UK) <u>1983</u>
(% change on previous year)					
A. <u>Demand and activity</u>					
Domestic demand	-3	-1½	3	4	2
including consumer spending	0	½	1	3	2½
Exports of goods and services	½	-2½	½	½	-1
Imports of goods and services	-3½	-½	5	5½	3
GDP	-2½	-2½	1	2½	2
B. <u>Inflation</u>					
Retail prices, Q4	15½	12	6	5½	4½
Average earnings, Q4	18½	10½	8	7	7½
(Levels)	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>OECD 1983</u> (major 6)
C. <u>Other indicators</u>					
Current Balance, £ billion	3	6	4	-1	-12
Unemployment (UK, %, excluding school leavers)	6½	10	11½	12½	8½
Interest rates (3 months), %	16½	14	12	10 ⁽³⁾	9½ ⁽⁴⁾

(1) Figures consistent with Treasury summer forecast (CONFIDENTIAL)

(2) US, Japan, Germany, France, Italy, Canada (weighted averages); Treasury forecast.

(3) Current level of 3-month inter-bank rates.

(4) Average of current 3 month rates (of which US rate is for 3 month Euro-dollars)

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