

Prime Minister.



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Duty Clerk
25/6/82.

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25 June 1982

PRIME MINISTER

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ECONOMIC PROSPECTS AND PRIORITIES FOR THE NEXT TWO YEARS

I have been considering the economic prospect and our priorities for the rest of this Parliament.

The prospects

2. Since the Budget the prospects, both here and world-wide, have not changed dramatically, though the outlook for US growth has worsened, perhaps dragging ours down a little, while the prospect for inflation here is probably rather better than it was.

3. Over the next two years the prospects seem to be:

i. GDP and Unemployment. The recovery has shown some hesitation in recent months but should resume soon. Forward indicators point to a modest but appreciable rise in output over the next year. This is unlikely to be fast enough to reverse the rising tide of unemployment, but may be sufficient to arrest it. The prospect therefore is one in which unemployment, on the wide definition, will remain around 3 million.



ii. Prices. Inflation has declined more rapidly than we expected, partly because of weak world commodity prices, rapid increases in productivity and strong competitive pressures. Over the next year there should be a further fall. But it would not be safe to assume - certainly not at this stage - that it will go on getting better into 1984. The prospect becomes bound up with what happens to the recovery of output, particularly if at the same time world activity was recovering fast enough to lead to higher commodity prices. On past experience, some rise in the inflation rate must be on the cards as recovery proceeds, but any reversal of the downward trend is unlikely to be substantial - unless the effective exchange rate falls sharply or the coming pay round goes badly. *unemployment*

But break with the poor not so.

Depends on inflation in on trading partners!

determined by monetary aggregates

*(see 14)
Does not matter about PSBR - i der by US
No room for manoeuvre now*

iii. Interest rates have fallen by about 3½ points since last autumn, and there seems a reasonable chance of some further fall. This, however, will obviously depend crucially upon what happens in the US, where rates, both nominal and real, are well above ours, and on confidence at home.

iv. The Tax Prospect. Even at Budget time this looked tight for 1983 and 1984, with little room for reductions, particularly in the next financial year. Since then we have had major new expenditure bids which, if conceded on any scale, would certainly entail higher taxes.

v. World Trade. The trade prospect has worsened, with growth in the major economies looking less



i ?
buoyant than was earlier expected. While the latest indications are that the fall in US output ceased in the second quarter, and this should permit some resumed world-wide growth in the rest of this year and through 1983, the level of world activity over this period seems likely to be lower than we had earlier hoped.

vi. Oil Prices. Oil prices are higher than we had assumed at Budget time, partly reflecting the ability of OPEC to reduce supply when demand is weak. But, barring a major political upheaval in the Middle East, there seems little risk in the next two years of another major oil price rise of the sort experienced in 1973-74 and 1979-80.

*V. uncertain
upward - potential
downward - actual*

4. In short, if things go as expected we can hope to face the country with an economy which is again growing, (though unspectacularly, and with unemployment still high); with major progress registered on inflation (though whether the figures will go on falling right through to 1984 must be an open question); and with substantial achievements to our credit on productivity and competitiveness: in short, a performance which will stand comparison with experience abroad, and enable us to claim that our attack on the fundamental malaise of the British economy is making progress and deserves to be sustained.

Hazards

5. This scenario is however at risk from three specific areas.



6. First, developments abroad. There remains the threat that US interest rates will remain high - worse still the risk of another upward surge. And there are the possibilities of international financial disorder deriving from e.g. loan defaults (Poland, the Argentine, and Mexico), private banking failures, or exchange rate volatility.

de couple

7. Second, there is the domestic pay scene. We shall be discussing this in E Committee shortly: the key point is that another pay explosion could blow away much that we have achieved, on inflation, productivity and competitiveness. (This underlines, of course, the importance of the current round of disputes.)

8. Thirdly, there is the risk that, by omission or commission, we lose the confidence of the markets, domestically and overseas. This could happen through a failure to encourage common-sense about pay; through any suggestion that we were relaxing our grip on public expenditure; or through our failing to carry conviction about our ability and determination to maintain non-inflationary monetary conditions. Loss of confidence would affect the recovery through the exchange rate and interest rates and more generally.

Preserving the Foundations

9. Our first priority therefore must be to maintain confidence.

10. This means holding to the monetary and fiscal policies we have followed for three years, and which are



paying off. To change course now, apart from putting the gains e.g. on inflation, at risk, would be welcomed by nobody; our opponents would accuse us of cynicism while our friends would feel let down.

11. It also means, specifically, that we need to be firm about public expenditure. We shall be discussing this in Cabinet on 15 July: if we are to keep open the possibility of the further tax cuts and interest rate reductions which would benefit industry and be electorally helpful it really is crucial that colleagues recognise that the starting presumption in the Survey has to be that the totals published in the White Paper only 3 months ago are to be held.

12. And it means that we must resist pressure to reduce the unemployment figures by throwing money at the problem, or changing macro-economic policy. Today's dole-queue is not the result of our efforts to reduce inflation: it results from others' past reluctance to tackle inflation. To drop our efforts would not work, would store up new problems for the future, and would have a confidence back-lash.

Nature

Building on the Foundations

13. But there are also positive actions which we should take.

14. First, Interest rates represent not only one of industry's biggest perceived costs, but also affect individuals directly, e.g. through their mortgages. We must try to secure further reductions. This means ensuring that



*Opposite of M. Somp
European agreement
No one believed that we could have descended by 5 1/2%*

monetary conditions are not unnecessarily tight; seeking to safeguard our financial markets from the threat of another US interest rates crisis; and - which will support this - doing all we can to ease the problems for business finance and borrowing - especially medium-term finance. You will have seen that I have today announced some modestly helpful changes on this front.

15. We must encourage the restraint of industry's other costs, and in particular the recent welcome real reduction in unit costs. There are other elements beside pay in this. Industry may be further encouraged to improve efficiency, through investment and the necessary changes in working practices. This entails supporting those - e.g. British Rail - whose efforts to secure higher productivity lead to industrial action. And it means that we ourselves must keep up - indeed step up - our efforts to secure the removal of institutional and other obstacles to change, e.g. BR's 1919 wage agreement.

16. We have done less than enough, as yet, to publicise and effectively promote all the changes designed to encourage enterprise which we have made. We have now taken the steps necessary to launch the basic publicity campaign that Michael Heseltine suggested some time ago. But if this is to make a politically significant impact then it needs to be extended and maintained. This will call for major and co-ordinated efforts involving not only Ministers but many others. And, while I doubt whether there is much more that we can do by tax concessions, there are still obstacles to be identified and where possible removed. This, too, is not a job for Ministers alone.



17. Action in these three areas should help quicken economic recovery, while not endangering the key priorities (paras 9-11 above). And on unemployment, a drive to make the most of what is now being spent by the MSC, to get programmes like the Community Work Scheme off the ground, and to overcome - or at least expose - trade union resistance to sensible low-cost means of getting people off the register and into useful work, is politically highly desirable.

Conclusion

18. We always knew we were setting our hand to a two Parliament job. And we knew that there would be a problem in securing our second term without jeopardising the gains we made. The economic prospects in the run-up to the Election are not unpromising, but there are risks. We must maintain our fiscal and monetary policies, so as to be able to bring interest rates down, and this means maintaining our grip on public expenditure. But while this is a necessary condition, we cannot count on it as sufficient. Positive action is required from us in the areas listed in paragraphs 13-17 above.

19. I look forward to discussing with you in due course how the 15 July Cabinet should be handled. Perhaps we might also have a word about how best to pursue with Cabinet colleagues the issues in paras 13-17. And it goes without saying that I would be happy to explain in greater detail the points of timing touched on in para 3 if you think that would be helpful.

(G.H.S.)

25 June 1982