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PRIME MINISTER (2) 10/7

10 July 1985

STATE OF THE ECONOMY

Inflation

High interest rates are beginning to have an effect. Sterling has remained very strong; tight money has triumphed over oil prices. World commodity prices are continuing to decline. The strength of the pound is lowering the price of imported materials. The latest wholesale price figures are quite encouraging. There is even some evidence that house price increases are slackening off. Building societies are lending less money now than a year ago in money terms; and their liquidity ratio has fallen from 19.6% in the first quarter of 1984 to 17.1% in May 1985. The narrow money figures remain under good control.

Bank Credit

There is now a nice judgment to be made about inflation. The wider money aggregates continue to show very rapid growth. Bank lending to the energy sector is up 40% on a year ago; to other financial institutions (excluding banks) up 30%; and even manufacturing industry is borrowing 15.5% more. Lending to building societies has been especially buoyant, as their ordinary deposit base has been squeezed and so they have switched to wholesale funds from money markets.

Credit advanced to other financial institutions has risen from £12.2 billion in February 1984 to £16.8 billion in May 1985. Within this, the building societies in May 1985 hit the staggering annual growth rate of 105% in the amount they were borrowing from the banks; insurance companies and pension funds hit a growth rate of 40%; and leasing operations 35%. This reflects the tail end of the investment boom after the Corporation Tax changes. (De Zoete figures)

Money Policy

This credit is not yet having any dramatic impact on price increases. But if left unchecked, it could at any point trigger a major increase in spending power in the economy, which could have inflationary consequences.

The judgment is now, therefore, a nice one. The CBI is desperate to see rates down, and will soon also be complaining about the strength of the pound affecting its export business. But there are risks in going for too early a decline in interest rates.

an early reduction of ½ per cent, presented as caution may still be consistent with this.

The political cycle suggests running a tight money policy for a bit longer. It would be nice to be sure that inflation had been seen off over the next few months as a result of a stronger pound and a sharp correction to inflationary expectations - which were getting out of hand in the early part of this year. There would still be plenty of time to get interest rates down, with a consequential beneficial impact on mortgage rates; and to administer a bigger stimulus to output in the 1986-87 run-up period to the General Election. Too rapid action now through fear of administering too sharp a shock to the economy might leave you in the position where, too close to an Election, you had to administer corrective action yet again - which would be far more damaging.

The Public Sector Accounts

As always, there are problems. The public sector pay bill, and cost inflation in the public sector, were underestimated in the previous White Paper, and so many departments are faced with making real cuts in order to adhere to the guidelines. Revenues will be considerably lower from oil than forecast at Budget time. Each 1% rise in the dollar/sterling rate loses approximately £150 million to the Treasury. On this basis, we are already more than £2 bn. down. The public thinks the Government is deliberately starving the health and education services of cash, and more money will doubtless be needed to do some kind of deal on standards and contracts with teachers, and to finance the Health Service so that it can absorb the ever-increasing number of patients. The road programme, too, is popular and is thought to be under-resourced. These are bids which should be considered favourably.

But there remains much to be done on the other side of the equation. It would be fatal to give way on public spending targets at this juncture of the Parliament. The U-turn rhetoric will grow louder, and economic management will become more difficult. There is no substitute for refusing to sign the cheques for the large nationalised industry overruns. Coal, rail, steel have to be dealt with firmly now. The structural problems - particularly in coal - have to be faced up to. The administrative overhead and public sector assets have to be reduced and pillaged yet again, as the Chancellor is suggesting in his memo.

But it needs good follow-up to make sure that it happens this time. The local authority settlement has to be kept within reasonable bounds. And defence spending - largely through pressure for greater efficiency and better buying - has to be brought down. The asset sales money is being offered in the negotiation very early. Some of it may be needed to cover higher public spending; but some is also needed for tax cuts. Although this will be criticised as a sleight of hand, this Government can claim - with good reason - that asset sales will be a continuing part of its programme, stretching well into the future. Could you make the Chancellor's gift of asset sales conditional on good behaviour from departments? Can't any be used for tax cuts?

Will Growth Continue?

The main hope of growth continuing into 1986 and 1987 is from keeping up the pressure against inflation. It looks as if pay increases are going to remain quite high - 5-6% for settlements, 7-8% for earnings. If inflation is brought down by continuing with the policy you are currently following, then this will leave scope for a considerable increase in real disposable income, and in consumer spending - the dominant part of the economy anyway. You should expect there to be less stimulus to growth from investment as a result of the end of the capital investment boom on the back of tax changes; and some slowing of export growth as a result of the stronger exchange rate policy now being pursued. Growth can continue, but at a more modest rate than will be recorded in 1985, where it will be given a substantial boost by the ending of the miners' dispute.

Unemployment

Whilst most of the outlook is therefore reasonable - on prices, output, consumer spending and real incomes - on this same basis, unemployment still looks unpromising.

It is therefore imperative that a further attack is made on the Why Work? problem. This means taking more people out of tax entirely; examining a tax amnesty to persuade people out of the black economy into the white; and further investigation of benefit claimants. This autumn is the last time to take bold action on unemployment, and your deliberations over the next few weeks should make sure that colleagues are fully aware of the seriousness of the problem.

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