PRIME MINISTER

BUDGET

The Treasury holds most of the cards in discussion about the Budget, and without being able to discuss this with them or having seen any of the papers, the comments below come with a health warning.

Nigel and I have discussed this and agree on the assessment, though he has not seen these words.

First, with some hesitation, some comments on the politics of prudence.

A prudent budget in practice turns on the size of the PSBR and the amount of tax cuts. There is a balance sheet to be struck. On one side, a somewhat more relaxed budget would give the Chancellor and the Government some shorter term popularity, many of the Cabinet colleagues would accept it more readily, and it would give the Chancellor greater scope for progress towards reforming the tax system and restoring incentives. It would be presented as helping to improve the supply side of the economy and no doubt the figures could be shown to be sufficiently consistent with the last MTFS. In the shorter term, a somewhat more relaxed budget would also help output and employment, though the amounts we are discussing are relatively small in terms of the economy as a whole.

On the other side of the balance sheet, a more relaxed budget risks damage to market confidence. It could look like the start of an electoral bribe, and it could risk confirming the view that, particularly with the changes in the composition of the Cabinet and the Westlands affair, you are no longer "the same prudent old Maggie" as Brian Walden described you.

This budget will have an important bearing on the economy in the run up to the election. The Chancellor is keeping discussion very close even within the Treasury. He will not tell Cabinet colleagues much of his thinking at Cabinet on 13 February. We wonder whether on this occasion you should not seek to involve a small group of colleagues (eg, Lord Whitelaw, Mr. Tebbit and Sir Geoffrey Howe). But no doubt this would be resented deeply by the Chancellor.

I suggest you start with the economic scene in your discussion with the Chancellor. What are the prospects for inflation, output, interest rates and unemployment? What are the risks? How does the Chancellor see the prospects for oil prices?

My guess is that the forecast will show a rather better export prospect than the Treasury expected in the autumn, but perhaps rather slower growth of investment and consumption. The inflation prospect may on balance (lower exchange rate versus lower oil prices) be a little worse.

If the Chancellor feels that oil prices are more likely to fall below what has been assumed in the forecast than to rise above the forecast level, that will point still more firmly towards the need for a prudent Budget, partly because of the effect on revenues and partly because a fall in oil prices is much like a cut in indirect taxation.

I think you need not spend too much time on monetary policy. But you will want to emphasise your concern that a measure of broad money needs to be kept in the picture.

Fiscal policy is at present the key. Here there are three areas for discussion:

(i) The size of the PSBR.

(ii) The size of the fiscal adjustment.

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(iii)The assurance the Chancellor needs to give the markets about the action he may take if oil prices fall.

Taking the third point first, Sir Geoffrey Howe gave such an assurance to the markets in both the 1982 and 1983 budgets. This is particularly important because Budget Day seems often to fall around the time when OPEC have a meeting and when also the markets are becoming anxious about falling oil prices as Spring comes. In 1982 Sir Geoffreh Howe said:

> "Obviously, if there was (sic) to be a prolonged fall in the oil price, below the level we currently expect, then both the beneficial effect on activity and domestic prices, and the revenue-loss effect on the PSBR, would be increased. It would be wholly irresponsible for me to rule out the possibility of having to take action to correct the fiscal balance, if that were to happen."

The uncertainties this year may need a repetition of those words.

The <u>size of the PSBR</u> and the size of the fiscal adjustment give <u>separate</u> signals to the markets. Large tax cuts may look irresponsible even if the PSBR is acceptably low.

In the 1985 MTFS, as we discussed last night, the Chancellor indicated a PSBR of £7 billion or 2% of GDP for 1986/87. The Autumn Statement increased asset sales by £2½ billion. On a crude calculation the PSBR should therefore be set at around £5 billion to offset this. Alan Walters recommended £5½ billion.

I mentioned last night that our financial deficit is high by comparison with our savings ratio. We rank with the United States and France. Figures for Japan, Switzerland and Germany are substantially lower. (This calculation - by Phillips and Drew - does not simply look at savings ratios; it also takes

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See the table enclosed.

into account estimates of capital consumption in each country.)

In the other direction, even if asset sales are treated as borrowing (to use our loose description), the PSBR would still be around only 2 3/4% of GDP. It would still be possible, as you did in the autumn, to say that borrowing, excluding asset sales, was lower than in any year since 1971/72. (This assumes that the PSBR for 1985/86 comes out as in the autumn statement.) A table showing this argument is attached.

Market expectations are also important. Some are expecting the Chancellor to announce a higher PSBR than £7½ billion. £6 billion or below would probably come as a very pleasant surprise.

The size of the fiscal adjustment is hard to guess. In present circumstances, my feeling is that tax reductions of as much as £2 billion might be risky - even though that has been the size of the tax reductions for the past few years. But this is very much a matter of judgement.

The fourth major area for discussion is thresholds versus the basic rate. 1% off the basic rate and higher rates would cost £1300 million, roughly the same as increasing all the main personal allowances and higher rate thresholds by 5%. (5% of the married man's allowance is £170.)

A reduction in the basic rate clearly is more regressive than raising the thresholds. £170 on the married man's allowance would be worth £52 a year to someone paying the basic rate of tax, and this is the maximum gain for someone with a taxable income of up to £16,200. In contrast, 1% off the basic rate would be worth £162 to someone with a taxable income of £16,200. There is also a much stronger constituency for raising the thresholds than for reducing the basic rate, though the Institute of Directors favour action on the basic rate. Cabinet colleagues are likely to express views about this aspect at Cabinet on 13 February. There has also been some Press comment that a reduction in the basic rate would be more of an electoral bribe.

You might like to look at the IMF staff appraisal of the UK economy which the Treasury have just received which supports the arguments for a prudent fiscal policy, probably leaving little room for tax cuts.

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31 January, 1986.

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(ix) Historic comparisons of PSBR/Money GDP ratios

Per cent

	Rounded PSBR	PSBR	Unrounded PSBR excluding privatisation proceeds	PSFD*
1971-72	1¾	1.6	1.6	1.1
1972-73	3½	3.6	3.6	3.0
1973-74	5¾	5.8	5.8	4.6
1974-75	9	8.9	8.9	6.7
1975-76	9¼	9.3	9.3	7.4
1976-97	6½	6.4	6.4	5.8
1977-78	3½	3.6	3.9	4.4
1978-79	5¼	5.4	5.4	4.9
1974-75 to 1978-79	6¾	6.7	6.8	5.8
1979-80	4¾	4.8	5.3	3.9
1980-81	5½	5.4	5.5	5.1
1981-82	3¼	3.3	3.3	2.2
1982-83	3	3.1	3.3	3.0
1983-84	3¼	3.2	3.6	3.9
1984-85	3	3.1	3.8	3.8
1979-80 to 1984-85	3¾	3.8	4.1	3.7
1985-86 (projected)	2¼	2.2	2.9	3.1
1986-87	2	2.0	2.7	

* Public sector financial deficit

Positive

(i) Government's strategy to maintain monetary conditions which will bring about further reduction in inflation, supported by lower public sector borrowing, remains on course.

(ii) Steady pursuit of MTFS policies has enabled economy to enter fifth year of sustained growth at average rate, so far, of 3 per cent a year, accompanied by fall in inflation from average of 15 per cent (and rising) under Labour to less than 6 per cent now (and falling).

(iii) Autumn Statement confirms prospect of continued strong growth and falling inflation, with public expenditure as proportion of GDP continuing its downward trend since peak year of 1982-83.

(iv) PSBR in 1985-86 expected to be lowest as percentage of money GDP (2¼) since 1971-72.

size and the timing of the exchange rate adjustment, the response of the monetary and fiscal authorities, and the way the world economy at large reacts to the fall in energy prices.

VIII. Staff Appraisal

The U.K. economy is entering its sixth year of uninterrupted growth. Even including the severe downturn in 1979-81, the average growth rate over the past seven years has been about the same as that of France and Germany while it had been significantly lower in the preceding 20 years. Productivity gains have accelerated, and the profitability of the enterprise sector has improved considerably. The current account of the balance of payments has continued to register surpluses reflecting increased receipts from oil and invisibles. The economy has also undergone rather fundamental transformations: deregulation, privatization, tax reform, and the creation of numerous small- and medium-sized firms will over time improve the efficiency and flexibility of the whole economy.

Costs and prices decelerated rapidly between 1980 and 1983, but there has been little progress since then. Wages and earnings even showed signs of edging higher in 1985, especially in manufacturing. Both consumer prices and unit labor costs are now rising in the United Kingdom faster than in the other main industrial countries. This is especially disappointing considering that the rate of unemployment is also well above that of the other countries. Although unemployment appears to have stabilized since the summer of 1985, its resistance to decline represents a major challenge for the Government.

The U.K. authorities' overall economic strategy rests on a medium-term framework for financial policies aimed at setting the growth in nominal GDP on a slowly decelerating path, and they have broadly succeeded in meeting that goal (Chart 1). The improvement in the split between price and output and between employment and unemployment is essentially left to supply-side measures, and in particular to those designed to improve the functioning of the labor market. The staff continues to support this strategy. Attempts at pushing up the rate of growth through easier financial policies would run the risk of rekindling inflationary expectations, which as the experience of 1985 demonstrates, remain sensitive to financial developments, and of jeopardizing external equilibrium. If such attempts involved a change in the policy mix based on fiscal expansion, they would result in a disadvantageous shift in the composition of demand. ie less investment, more consumption

The emphasis placed by the authorities on the need to reduce labor market rigidities has led to the adoption of a number of measures designed to curb union power, to eliminate some of the disincentives to employment, to reduce distortions in the tax system affecting the relative cost of labor and capital, and to improve training and increase labor mobility. These measures have not, however, prevented a continuous rise in real wages which, in turn, has impeded a permanent reduction in unemployment. The U.K. authorities have rightly argued that the measures they have introduced will take time for their full effect to be felt, but the staff would also stress the need for further action. There are still a number of obstacles to labor mobility--related in part to housing policies--and disincentives both to firms to increase employment, such as the high costs of separation, and to the unemployed to take low-paying jobs, which could be reduced by Government action. The persistence of high unemployment has led the U.K. authorities to take direct measures to reduce it in the form of work and training schemes and financial incentives for employers to create--and the unemployed to accept--jobs at the low end of the pay scale. The staff supports these measures and their possible extension, inasmuch as they appear to be cost effective and contribute to greater wage flexibility.

. In formulating financial policies, the U.K. authorities should aim at a policy mix which is consistent with long-term objectives. These objectives, as the staff sees them, should be to close the gap between the level of productivity in the United Kingdom and the other main industrial countries, to secure price stability, to create the conditions for sustained employment growth, and to prepare for a decline in foreign exchange receipts from North Sea oil. With respect to the last objective, the staff is less optimistic than the U.K. authorities about prospects for the balance of payments and foresees a current account deficit emerging as early as 1987, even with relatively subdued growth of domestic demand. The staff favors therefore a mix of financial policies that encourages investment, a major determinant of productivity gains and employment creation, and exports.

It is the staff's view that a sufficiently tight fiscal policy would shore up confidence in financial markets and permit a reduction of interest rates at a time when the complete phasing out of tax allowances is likely to be accompanied by a marked weakening of investment activity. Excluding transitory receipts from North Sea oil and asset sales, the PSBR is well above the medium-term target of 1 percent of GDP and the United Kingdom's net public debt as a percentage of GDP, despite its recent decline, remains above that of the other G-5 countries. The staff hopes, therefore, that the decline of the PSBR for the next fiscal year as projected in the last Budget will be achieved and that allowance will be made for the planned increase in asset sales. This will probably leave little room for tax cuts, given the expected shortfall in receipts from oil production, but the reduction in energy prices may be viewed as the equivalent of a tax cut. Some restructuring of taxes may also be possible--even in the absence of a tax cut--to implement the authorities' intended shift from taxation of income to taxation of expenditure. The staff supports the U.K. authorities' emphasis on the need for tax cuts from a supply-side perspective and agrees that the level of tax rates and thresholds acts as a disincentive to work and acquire greater skills. It believes, however, that tax cuts should be predicated on a permanent containment of expenditure. In this respect the staff welcomes the authorities' reaffirmation of their intention to stabilize public expenditure in real terms and to tighten control on outlays. The recently announced reform of the social security system could also contribute in a more distant time horizon to a deceleration of public spending.

Turning to monetary policy, the staff agrees that, notwithstanding the rapid expansion of the broad monetary aggregates, the weight of the evidence suggests that monetary policy has not been too loose. At the same time, the high level of liquidity in the economy is cause for caution. Given the additional uncertainties associated with the stance of fiscal policy under the next budget and with developments in the oil market, it would be premature to lower interest rates significantly at present, even though they remain well above those in the main industrial countries. The interpretation of the monetary aggregates remains difficult and, in pursuing their nominal income target, the monetary authorities will need to pay attention to the full range of indicators of monetary conditions and be prepared to react promptly if they perceive that nominal GDP may be moving off its targeted path.

The staff agrees that the exchange rate can provide useful signals on monetary conditions, and that, in view of the fragility of the recent subsidence of inflationary expectations, the authorities cannot be complacent as to the size and speed of a depreciation. However, it believes that some exchange rate flexibility should continue to be allowed in response to developments at home or abroad which affect permanently the external position of the United Kingdom. The authorities do not disagree that the real effective exchange rate of sterling will need to depreciate over time as export receipts from oil decline, a development which may occur rather sooner than expected if the recent sharp fall in oil prices is not reversed. Their preference is to see such a real depreciation achieved through a larger decline in domestic costs and prices than in the main trading partner countries rather than through a nominal depreciation, and they view a firm nominal exchange rate as an effective instrument to keep pressure on enterprises to resist excessive wage claims. Nevertheless, the authorities have been prepared to allow the rate to depreciate when this could be done without undermining progress against inflation or the confidence of financial markets. The staff agrees that a depreciation of the nominal effective exchange rate must not be perceived as an automatic response to a loss of competitiveness resulting from enterprises' inappropriate wage and price decisions, but welcomes the recognition by the U.K. authorities that in certain circumstances, such as a pronounced fall in oil prices, it may be necessary to accept an adjustment of the exchange rate. Financial policies should, however, remain firm enough to dispel any doubt about the authorities' commitment to fight inflation.

The staff welcomes the U.K. authorities' reaffirmation of their commitment to an open trade system and their support for a new GATT round, and a liberalization of the Multi-Fibre Arrangement. It

a way of saying don't join the EMS?

encourages the United Kingdom to use available opportunities to press within the European Communities for the rollback of existing barriers to trade in agricultural and industrial products, as well as in services.

It is recommended that the next Article IV consultation with the United Kingdom be held according to the standard 12-month cycle.

United Kingdom - Basic Data

Area and population	
Area	94,247 square miles (244,100 square kilometers)
Population (mid-1984)	56.5 million
GDP per capita (1984)	£5,653

Composition of GDP in 1984, at current prices	In billions of pounds	Distribution in per cent
Private consumption	194.7	61.0
Public consumption	69.7	21.8
Total investment (including stockbuilding)	55.1	17.3
Total domestic demand	319.5	100.1
Exports of goods and services	91.7	28.7
Imports of goods and services	91.8	28.8
GDP at market prices (expenditure estimate)	319.4	100.0

Selected economic data, annual percentage change (period average)	1983	1984	1985
Real GDP (at market prices, average estimate)	3.2	2.6	3.5 1/
Manufacturing production	2.9	3.8	2.7 2/
Average earnings 3/	9.0	8.8	8.7 2/
Unit wage costs 3/	1.3	3.4	6.2 2/
Retail price index	4.6	5.0	6.1
Rate of unemployment (in percent)	12.3	12.7	13.1
Mo 4/	6.4	6.6	2.2
£M3 4/	10.5	9.5	15.0

Public sector accounts, in billions of pounds	1983/84 Outturn	1984/85 Outturn	1985/86 Estimate 5/
General government receipts	128.4	139.4	149.0
General government expenditure 6/	140.4	157.3	160.5
Financial balance	-12.0	-11.9	-11.5
(In percent of GDP)	(-3.9)	(-3.6)	(-3.2)
Public sector borrowing requirement	9.7	10.2	8.0
(In percent of GDP)	(3.2)	(3.1)	(2.2)

Balance of payments, in billions of pounds	1983	1984	1985 7/
Exports	60.8	70.4	78.7
Imports	61.6	74.5	81.4
Trade balance	-0.8	-4.1	-2.7
Net invisibles	4.0	5.2	5.6
Current account balance	3.1	1.1	2.9
Investment and other long-term capital	-6.5	-12.0	-14.2
External sterling liabilities	4.2	6.4	7.5
Trade credits and other short-term capital 8/	-1.6	3.2	4.8
Balance for official financing	-0.8	-1.3	0.2
Gross reserves, official basis (billions of SDRs) 9/	17.0	16.0	14.2
Gross reserves, IFS basis (billions of SDRs) 9/	11.5	10.3	12.6 10/
Average effective exchange rate index (1980 = 100) 11/	86.7	81.9	81.5

1/ First half of 1985 over the corresponding period of 1984.
2/ First three quarters of 1985 over the corresponding period of 1984.
3/ Manufacturing sector.
4/ End period; for 1985, mid-December over mid-December.
5/ Revised estimate based on the Autumn Statement, 1985.
6/ Excluding net lending.
7/ First three quarters at annual rate; current transactions are seasonally adjusted while capital transactions are not.
8/ Including balancing item and allocation of SDRs.
9/ As of the end of December, unless indicated otherwise.
10/ November 1985.
11/ Annual average.

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SUMMARY TABLE JANUARY 1986 FORECAST

	MAIN FORECAST	LOWER OIL PRICES	
	$20	$18	$15
1. World GNP (major 7 excluding UK) % change on year earlier			
1986	3	3.2	3½
1987	3	3.2	3½
2. Effective Exchange Rate (1975 = 100)			
1986 Q4	75	74	72
1987 Q4	73	72	70
3. Oil prices, $ Brent spot			
1986 Q4	20	18	15
1987 Q4	21½	19½	16½
4. Nominal GDP (mp) (% change on year earlier)			
1986-87	6.7	6.5	6.2
1987-88	6.8	6.8	6.7
5. GDP Volume (% change on year earlier)			
1986	2.7	2.7	2.8
1987	1.7	1.7	1.8
6. RPI (% change on year earlier)			
1986 Q4	4.1	4.1	4.0
1987 Q4	4.3	4.3	4.2
7. Current Balance (£ billion)			
1986	4¼	4	3¾
1987	1½	1	½
8. Fiscal Adjustment (annual not cumulative) £bn			
1986-87	2¼	1¾	¾
1987-88	4¼	3½	2¼

LOWER OIL PRICE VARIANT

$15 case ($18 case in brackets)

% change from base

Year	Major 7 (excl. UK) GDP	Major 7 (excl. UK) Consumer Price Index	Real GDP	RPI	Nominal GDP	Real National Disposable Income	£ Effective exchange rate
1986-87	+0.6 (+0.2)	-1.1 (-0.4)	+0.1 (0.04)	-0.1 (-0.02)	-0.5 (-0.2)	-0.3 (-0.1)	-3.8 (-1.5)
1987-88	+1.1 (+0.4)	-2.2 (-0.9)	+0.1 (0.04)	-0.1 (-0.04)	-0.6 (-0.2)	-0.4 (-0.2)	-3.1 (-1.4)
1988-89	+1.3 (+0.5)	-2.3 (-0.9)	0 (0)	+0.1 (+0.04)	-0.2(-0.1)	-0.2 (-0.1)	-3.2 (-1.3)
1989-90	+1.2 (+0.5)	-2.0 (-0.8)	0 (0)	-0.1 (+0.04)	0 (0)	-0.2 (-0.1)	-2.8 (-1.1)

	Labour cost competitiveness	Earnings	Employees in employment (000s)	North Sea Revenues (£bn)	Fiscal Adjustment (£bn)	World Trade in manufactures (UK weighted)
1986-87	-3.8 (-1.5)	+0.2 (+0.1)	+10 (+ 4)	-1.6 (-0.6)	-1.4 (-0.6)	+0.7 (+0.3)
1987-88	-2.9 (-1.2)	+0.3 (+0.1)	+70 (+30)	-2.2 (-0.9)	-2.0 (-0.8)	+1.5 (+0.6)
1988-89	-2.9 (-1.2)	+0.6 (+0.2)	+70 (+30)	-2.1 (-0.8)	-1.6 (-0.6)	+1.5 (+0.6)
1989-90	-3.2 (-1.3)	+1.0 (+0.4)	+10 (+ 4)	-1.9 (-0.7)	-1.2 (-0.5)	+1.4 (+0.6)