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27 July 1988

Paul Gray Esq
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Prime Minister + MB
Rees
27/7

Dear Paul,

CHANCELLOR'S END-OF-TERM LETTER

As you know, the Chancellor writes an end-of-term letter to Conservative MPs each July. The Prime Minister may like to have ... the attached copy.

Yours ever,

Andrew

A P HUDSON

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27 July 1988

As the House rises for the Summer Recess, I thought it might be helpful if, as in previous years, I took the opportunity to set out how I see the current economic situation and prospects.

The British economy continues to perform remarkably well. We are currently experiencing the longest period of steady, sustained growth, at an average rate of some 3 per cent a year, ever recorded. During the 1980s as a whole, we have transformed ourselves from the slowest growing of all the major European economies - as we were in the 1960s and 1970s - to the fastest.

Industrial profitability is the best it has been for 20 years, and as a result we are now experiencing a massive and welcome upsurge in industry's investment in new plant and machinery, particularly in manufacturing. Meanwhile, for the past two years now, unemployment has been falling fast, in all regions of the country, and more rapidly than in any other major nation.

Despite this rapid growth, inflation has remained low, averaging some 4½ per cent over the past five years: still not good enough, but a dramatic improvement on the legacy we inherited. Indeed, in a single year under Labour, prices rose more than they have done during the whole of the past five years under our stewardship.

Britain's economic renaissance is now widely recognised throughout the world. You may have seen the cover story in the May issue of the leading American business magazine, Fortune, entitled "BRITAIN IS BACK: After Decades of Decline, the World's Oldest Industrial Power Has Recovered Its Prowess".

And the prospect is for more of the same. Yet who would have credited it, only nine months ago, in the wake of the dramatic stock market crash which re-awakened echoes of 1929 and led to predictions on all sides of a return to the slump of the 1930s? The fact that those predictions have been comprehensively falsified is testimony, first, to the fundamental soundness of the world economy, and, second, to the excellent international co-operation which now exists among the Finance Ministers of the major nations, which enabled us to take prompt and effective co-ordinated action. Had that not taken place, the consequences of Black Monday might have been very different. It is all too easy to forget, now, just how fragile confidence then was.

There was, however, another consequence of this co-ordinated relaxation of monetary policy in the wake of the stock market crash: a modest but unacceptable pick-up in inflation in many countries. The UK is particularly vulnerable to any such resurgence, with our exceptionally rapid rate of growth.

I have thus had to take prompt action to tighten monetary conditions, by raising interest rates sharply. This will moderate the expansion of demand and in due course enable inflation to resume its downward trend. But, thanks in large part to the fact that our retail price index, unlike those of most other countries, has the mortgage rate as one of its major components, recorded inflation will go up further before it comes down again.

We have been through this before when inflation edged up in the first half of 1985, before coming down again to the lowest levels for a generation. In the same way, inflation is now likely to edge up in the second half of the year and the first half of next year, before coming back down again. Whatever action is necessary to keep inflation under control, this Government will always take.

The action taken to curb inflation will also, in time, reduce the deficit on the current account of the balance of payments. But it is important to recognise that this deficit is a very different animal from current account deficits we have known in the past, and which the US is experiencing at the present time. For we now have a budget surplus, and this means that the current account deficit is entirely a private sector phenomenon, with the private sector investing more than it is currently saving, and financing the rest by inflows of capital from overseas. That is why the financial markets, quite rightly, are so unruffled. It is something that will in due course reverse itself and which meanwhile is readily financeable.

The balanced budget - indeed a budget surplus - which we now enjoy, and which I believe we can and should sustain over the years ahead, underlines the other important lesson. That is that economic success comes not from the supposed stimulus of a budget deficit, but from constant improvements in the so-called supply side of the economy: that is, the climate within which business and industry operate and the enterprise and efficiency with which they respond to that climate. It is in that context that the reform and reduction of income tax in this year's Budget are of such importance.

We have now fulfilled our Election pledge of a basic rate of 25 pence in the pound at the first opportunity, and have the lowest top rate of income tax in Europe. And with our corporate tax rate already one of the lowest in the world, it is fair to say that, over the past nine years, this Government, under the inspired and dedicated leadership of Margaret Thatcher, has transformed Britain from being a high tax country to a low tax country. The economic benefits of this will be increasingly felt as the years unfold. And meanwhile, we have pledged ourselves to bring the basic rate of tax down further, to 20 pence in the pound, as soon as it is prudent and sensible to do so.

None of this is to deny the need for carefully considered increases in key areas of public expenditure. But it remains as important as ever that we ensure that the overall growth of public spending stays well within the growth of the economy as a whole. Our economic success has depended on maintaining firm control of public expenditure: a budget surplus does not in any way change the nature of what constitutes the sound conduct of economic policy.

In short, the economy is doing well. The difficulties that beset us are difficulties we have successfully dealt with in the past and will do so again; without drama, and without interrupting the steady progress we have already achieved. We will stick to the proven strategy that has brought us unprecedented success, and which will bring further success in the years that lie ahead.

NIGEL LAWSON