

CF-pe.

Note

Passed on PM's couch
to Tom Giese.

PRIME MINISTER

ECONOMIC STRATEGY PAPER FOR CABINET

RCC6 19/2

Next Thursday's Cabinet will include the usual pre-budget discussion. I now attach a draft paper the Chancellor proposes to circulate to Cabinet colleagues on Monday. This follows broadly the shape of earlier years. The point that will attract most attention is the inclusion in paragraphs 2 and 16 of an explicit acknowledgement that the annual RPI figures are likely to move above 8 per cent again during the Spring. For the rest, the paper includes nothing very surprising.

I have marked a couple of minor comments on the first page of the draft. But, assuming you are content for the over 8 per cent forecast to be included, the rest of the drafting seems OK to me.

You will see the Chancellor is planning to add as an Annex to the paper the note you saw earlier in the week, giving a preliminary assessment of the impact of Germany Monetary Union.

i) Content for the Chancellor to circulate his paper on this basis?

Yes

Or

ii) Any further comments you want to pass on?

RCC6.

PAUL GRAY

16 FEBRUARY 1990

① I think he is too optimistic about the current account deficit
not

a:\economic\strategy.mrm

② One is left with an uncomfortable feeling that everyone else knows how to keep down inflation, and we don't. Are their money figures more reliable than ours? Our forecasts have been totally wrong.
not



Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

16 February 1990

P R C Gray Esq
Private Secretary to
Prime Minister
10 Downing Street
LONDON
SW1

Dear Paul

ECONOMIC STRATEGY PAPER FOR CABINET

... I attach a copy of the draft Memorandum by the Chancellor for Cabinet next week. Subject to any comments that the Prime Minister may have, and to the addition of a fourth annex on the Economic Implications of German Monetary Union, the Chancellor would propose to circulate this to colleagues on Monday.

V.S.

J.S.

JOHN GIEVE
Principal Private Secretary

ECONOMIC STRATEGY

Memorandum by the Chancellor of the Exchequer

Introduction

X
Following the exceptional growth in 1987 and 1988, we saw a slowdown last year in both consumer demand and business investment. However, demand proved more resilient than we expected at this time last year. The current account deficit rose in 1989; ^{RPI} inflation remained stuck at 7½ per cent or more (around 6 per cent excluding mortgage interest payments); and in the labour market, earnings growth increased and unemployment continued to fall. As a result we were obliged to raise interest rates by a further 2 per cent.

X
2. Recent figures for retail sales, trade, and both business and consumer confidence provide further evidence that demand is slowing down; and the foreign exchange and money markets have been steady. The tightening of policy is clearly working. Our central forecast is that, provided we keep policy tight, we will see a further slowdown this year with a reduction in the current account deficit and, in due course, an easing in inflation. This is in line with most outside forecasts. But there nevertheless remains considerable uncertainty; growth in the monetary aggregates, for example, remains uncomfortably high and there is always a danger of market turbulence. Moreover, the rate ^{RPI} of inflation is bound to rise in the next few months and remain high until well into the Autumn. The prospect for 1990 is therefore an unappealing combination of low growth, possibly rising unemployment, and little progress on inflation. But as long as we avoid the temptation to relax policy too quickly, we should see inflation coming down at the end of the year and during 1991, and a recovery in output growth.

3. In the circumstances, I am sure that we must maintain a cautious approach in the Budget as well as in monetary policy, while continuing our policies to improve the efficiency and flexibility of the economy. If we do so I have no doubt that our economic performance over the next decade can be at least as successful as in the 1980s, and probably more so.

The world economy

4. The world economy grew rapidly in 1988 and 1989, but GNP and world trade have been slowing during 1989 in response to higher interest rates worldwide. Within the Group of Seven growth has slowed most in North America, while in West Germany and other European economies activity has remained strong throughout 1989. G7 growth is expected to slow a little further in 1990, though the scale of the slowdown is likely to be modest when compared with the downswings of the 1970s and early 1980s - a soft landing. Events in Eastern Europe will tend to boost world trade and output, but are unlikely to have significant effects in the short term.

5. Consumer price inflation has risen in all G7 economies, but remains on average some way below underlying inflation in the UK. Because monetary policy is now tighter worldwide than in 1988, and GNP growth is forecast to ease, consumer price inflation in the G7 should fall gradually over the coming year, from 4½ per cent now to 3½ per cent by the end of the year. Real non-oil commodity prices fell during 1989, and a further small fall may occur this year: in contrast oil prices rose during 1989 and the beginning of this year.

Demand, output, and unemployment

6. In the UK, domestic demand - the sum of consumption, fixed investment and stockbuilding - grew by 5½ per cent on average in the four years to 1989. Over the same period non-oil GDP grew by over 4½ per cent. Growth in both domestic demand and GDP at such

rates is some way above the growth of productive capacity in the economy, and faster than over any four year period since the war.

7. Growth on this scale was in part the result of an investment boom. Business investment grew rapidly from the mid-1980s, and by over 10 per cent in each of the last three years. A higher rate of return on capital, now back to its highest level for over twenty years, and the creation of an environment that encourages enterprise, contributed to this remarkable surge in investment, which is already enhancing the supply potential of the economy. While we expected investment and productivity to benefit from our policies, no-one expected a boom on the scale that actually occurred.

8. Consumer spending has also grown very rapidly - by over 5 per cent per annum on average over the four years to 1989. The confidence generated by rising wealth and incomes since the early 1980s has been reflected in a sharp reduction in the saving ratio, associated with higher borrowing. Consumers are in a better position to arrange their spending and borrowing as they wish, now that the controls on the financial system in place until the 1970s have been lifted.

9. A sharp slowdown in demand was clearly necessary after this period of excessive growth and the inflationary pressures thus generated. Recently there have been some welcome signs that this adjustment is indeed occurring. Consumer spending has slowed, and in the last three months the volume of retail sales was only 1½ per cent higher than a year earlier. It looks as if business investment may have peaked in the middle of 1989. Industrial output has also slowed down, and capacity constraints have eased.

10. Domestic demand may well fall a little in 1990. Consumers' expenditure is forecast to follow the trend of recent months, rising only very slowly as the personal sector adjusts further to high interest rates. The end of the housing boom should be an important restraining influence. Companies are likely to trim

their stocks and cut their capital expenditure by a modest amount. After so powerful an investment boom it is not at all surprising that in the very short term some retrenchment is likely.

11. While domestic demand may fall slightly, net exports should continue to grow strongly, sustaining the growth of output. I have no reason to change the forecast of GDP growth I made in the Autumn Statement - just under 1 per cent. GDP growth at this rate would in normal circumstances lead to a rise in unemployment. But while the monthly path for unemployment could be on a rising trend during much of the year, unemployment may be lower on average in 1990 than in 1989.

12. The precise timing and extent of any rise in unemployment will depend crucially on how companies react to high wage demands. They already face a difficult financial position. With a tight policy stance they will have limited scope for passing on cost increases in higher prices. If they allow wages and unit labour costs to accelerate, many are likely to face a severe squeeze later in the year, which in turn could lead to sharper cutbacks in employment, investment, and stocks.

13. Clearly there is great uncertainty attaching to forecasts for growth and unemployment when the economy is at a turning point. It looks as if GDP growth will moderate without the level of GDP actually falling. But the uncertainties are such that it is not possible to rule out a fall in output over a short period. We must continue to stress the need for pay restraint, and to exercise it ourselves in the public sector.

Inflation and the current account

14. The excessive growth of demand and output until early 1989 caused considerable strain in the economy, with serious capacity constraints emerging in a number of industries and rising inflationary pressure. One symptom was the current account deficit of just over £20 billion in 1989. Another was the most

unwelcome rise in RPI inflation - to over 8 per cent between April and July last year. While the inclusion of mortgage interest payments in the RPI makes it a distorted measure of underlying consumer price inflation, the latter also rose - to just over 6 per cent.

15. We cannot be content with an underlying inflation rate of over 6 per cent. The fact that RPI inflation has consistently been below the levels recorded under the last Labour government is small consolation in either economic or political terms. Our performance is still markedly worse than our major overseas competitors. We remain committed to the further reduction of inflation, and any rise in it, however modest by historical standards, requires a firm policy response.

16. RPI inflation is likely to rise to over 8 per cent in the next month or so and is unlikely to come down very far until well into the autumn. One contributory factor is the recent rise in mortgage rates. And a number of special factors, of which the introduction of the community charge at unjustifiably high rates is the most notable, will also add to inflation over this period. (Conversely as they fall out of the 12 month comparisons these factors will tend to depress the rate of inflation in Spring 1991.) A tight policy stance always takes time to influence underlying price and wage inflation, and there could be an uncomfortable period during 1990 while output growth appears to be very low without any apparent progress on inflation. However, by the end of the year, and during 1991, the tight policy stance should be seen to be having the desired results, and both underlying and recorded RPI inflation should be on a downward trend.

17. Progress is likely to be quicker in reducing the current account deficit. Companies have clearly already switched production to overseas markets as domestic demand and capacity constraints have eased; exports of non-oil goods have risen by 15 per cent over the last year. Because world trade growth is

Challenge
to future

likely to fall a little, export growth may be somewhat slower over the coming year than in recent months; but it should nevertheless remain higher than import growth which has already fallen sharply. As a result the prospect is for a substantial fall in the current account deficit in 1990, broadly in line with the Autumn Statement forecast of £15 billion.

Monetary developments

18. Concern about inflationary pressures and the slow response of the economy to the tightening of policy, together with political uncertainties at the end of 1989 and a strong deutschemark, led to a fall in the sterling index of just over 10 per cent during 1989. Recently sterling has firmed, and returned to the level of last Autumn. But that is still over 8 cent below its level at the beginning of 1989. This has added to upward pressure on costs and prices. Growth of M0 has been above its target range since April 1988; and broad money (M4) and credit have continued to grow rapidly.

19. Against this background, monetary policy was tightened during 1989, with two increases of 1 per cent in the general level of short-term interest rates. Mortgage rates also rose during 1989, and have risen further in the last few days to a level nearer their normal relationship with base rates. (The most recent increase in mortgage rates will not immediately affect those whose monthly payments are fixed under annual schemes and have already been set for 1990.) Unpopular as these rises have been, they are having their desired effect, with an adjustment in the housing market a necessary part of the process of restraining domestic demand. We shall have to keep interest rates high until inflation is clearly back on a downward track; it would be folly to lower them prematurely and then be forced to raise them again.

Public finances

20. It now looks as if the PSDR for 1989-90 will be a good deal lower than the £12½ billion I forecast in the Autumn Statement, which was itself below the £14 billion expected at budget time and the £14½ billion recorded last year. There are a number of factors behind the shortfall: on the expenditure side, the outturn is expected to be over £2 billion higher than planned, with privatisation proceeds lower than expected, and a surge in capital expenditure and borrowing by local authorities seeking to forestall the tighter controls that will apply next year; and on the revenue side, corporate tax payments have been lower, and - as a result of our policy on personal pensions - rebates have been a little under £2 billion higher than expected. These adverse influences have been offset only partially by higher income tax receipts than expected.

21. Looking forward to 1990-91, there are a number of factors which will tend to reduce the PSDR further. Some tax changes announced in earlier Budgets have not yet had their full effect: independent taxation, which was announced in the 1988 Budget, comes into effect in April; and PSDR will reflect the full year effect of the reform of National Insurance Contributions which came into effect last October. At the same time, the cyclical slowdown in the economy will reduce the growth of tax revenue, particularly from companies, and increase the upward pressure on public expenditure. I expect to see a smaller surplus in 1990-91 than this year, and a quicker fall from budget surplus to budget balance than envisaged in last year's MTFS.

Conclusion

22. After two years in which the economy had been growing at an unsustainably rapid rate, there are now clear signs of a slowdown. This is to be expected, and indeed welcomed prior to the resumption of steady growth. Already the current account deficit is showing signs of falling.

23. But progress on inflation will be slower. If we are to succeed in getting inflation down, fiscal policy must support monetary policy. This means a cautious Budget, with little if any scope for reducing tax rates or other reliefs.

24. I have endeavoured to set out all the difficulties before us in this paper. But I see no need for excessive pessimism. By next year I do expect a lower trade gap, lower inflation and rising growth. But that does depend on our policies this year.

25. I would welcome colleagues' views on the Budget in the light of the fiscal and economic prospects which I have outlined.

... 26. As background, I attach the three usual annexes on the economic record and prospect, the direct effects of tax changes, and the public finances and the tax burden. I have added an annex this year on the economic implications of German monetary union.

SECRET

ANNEX 1

	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990 ⁽¹⁾	10 year average
								latest estimate		Forecast	
World GNP, ⁽²⁾ in major 7 economies (per cent change)	1½	-½	3	5	3½	2½	3½	4½	3½	3	3
UK GDP ⁽²⁾ (per cent change)	-1	1¾	3½	1¾	4	3¼	4½	4½	2¾	¾	2½
Domestic demand ⁽²⁾	-1½	2¼	4¾	2½	2¾	4¼	5½	7½	4	-1	3
Retail prices Q4 (per cent change on a year earlier)	12	6	5	5	5½	3½	4	6½	7½	6½	6
Interest rates (average 3-month interbank)	14	12½	10	10	12	11	9½	10½	14	15½ ⁽³⁾	
Unemployment (UK, per cent of working population excluding school leavers)	8½	10	10¾	10¾	11	11¼	10¼	8¼	6½	6¼	
Sterling index	118½	113	104½	100	99½	91½	90	95½	92½	89½ ⁽³⁾	
memorandum items											
Non-Oil GDP	-1½	1	3¼	1½	4	3½	5	5	3¾		
Consumers expenditure	0	1	4¼	1¾	3¾	5½	6	7	4¼		
Business investment	-9	2¾	3	10¼	7½	-½	10¾	17½	10½		

⁽¹⁾ Provisional pre-Budget figures⁽²⁾ At constant prices⁽³⁾ February 12

ANNEX 2 : DIRECT EFFECTS OF TAX CHANGESA. Direct Taxes : Indexation

The RPI increased in the year to December 1989 by 7.7 per cent. With indexation by this amount and statutory rounding, the figures for the main allowances and income tax bands, and their equivalents this year, would be:

	<u>1989-90</u>	<u>1990-91</u>	
Personal allowance	2,785	3,005	220
Married couple's allowance	1,590	1,720	130
<u>Tax rate bands</u>			
25% rate	20,700	22,300	
40% rate	over 20,700	over 22,300	

The total revenue cost of indexation of income tax (included in the forecast) is £1,670 million in 1990-91.

B. Indirect Taxes : Indexation

The effects of 7.7 per cent revalorisation of the excise duties (including VAT effects) are as follows:

<u>VAT inclusive price change</u>	<u>Yield in 1990-91</u> <u>£m</u>	<u>RPI impact</u> <u>% points</u>
Beer 1.7p/pint	160	0.07
Wine 6.8p/75cl light wine	55	0.06
Spirits 41.9p/bottle	80	0.04
Tobacco 7.4p/20 king size	265	0.16
Leaded Petrol 8.2p/gallon	305	0.14
Unleaded Petrol 7.1p/gallon	175	neg
Derv 7.0p/gallon	110	0.01
VED £7.70/car	180	0.06
Overall effect, (including minor duties)	1400	0.55 ⁽¹⁾

⁽¹⁾ Figures do not sum due to rounding.

C. Ready Reckoners : Illustrative Tax Changes

	£ million	
	<u>1990-91</u>	<u>1991-92</u>
INCOME TAX		
<u>Allowances and Thresholds</u>		
1% above indexation on all statutory allowances	180	250
1% above indexation on all statutory allowances and basic rate limit	205	295
<u>Rates</u>		
Change basic rate by 1p	1,500	1,900
Change higher rate by 1p	130	270
CORPORATION TAX		
Change in main rate of 1 percentage point	390	570
Change in small companies' rate of 1 percentage point	35	45
VALUE ADDED TAX		
Change in VAT rate of 1 percentage point ⁽¹⁾	1,515	2,070

(1) A 1% change in the VAT rate would change the RPI by 0.48%.

ANNEX 3 : PUBLIC FINANCES AND THE TAX BURDEN**Taxation, Expenditure and Borrowing**

Since the Government first took office, total taxes and NICs have risen by 3½ percentage points of GDP, though the ratio has fallen from its peak in 1981-82. This has enabled us to make net repayments of government debt in the last three years.

Table 1

Overall Taxation, Expenditure and Borrowing
(percentage of GDP at market prices)

	Non-North Sea Taxes plus NICs (as per cent of non-North Sea GDP)	Total Taxes plus NICs	General Government Expenditure (excluding) privatisation proceeds)	PSBR
1978-79	34.1	33.8	43.2	5.3
1979-80	35.0	35.0	43.4	4.8
1980-81	36.1	36.2	45.9	5.3
1981-82	38.6	39.3	46.5	3.3
1982-83	38.1	38.8	46.7	3.1
1983-84	37.6	38.4	45.8	3.1
1984-85	37.7	39.1	46.1	3.1
1985-86	37.0	38.5	44.4	1.5
1986-87	37.4	37.9	43.5	0.9
1987-88	37.6	37.9	41.3	-0.8
1988-89	37.1	37.3	39.0	-3.0

Personal Taxation

Despite reductions in income tax, total personal taxes (direct and indirect, including employees' NICs and domestic rates) in 1989-90 are over £30 billion higher in real terms (ie 1989-90 prices) than they were in 1978-79. For income tax and national insurance contributions the following table shows how the proportion of gross pay they represent rose up to 1981-82:

Table 2

Income Tax and NICs as a per cent of Gross Earnings*

	<u>½ average earnings</u>	<u>average earnings</u>	<u>2 average earnings</u>
1978-79	16.0	27.8	31.4
1981-82	20.8	29.3	32.2
1982-83	20.8	29.8	32.3
1983-84	20.1	29.6	31.7
1984-85	19.3	29.2	31.5
1985-86	18.9	29.0	31.5
1986-87	18.9	28.5	30.9
1987-88	19.1	27.6	29.9
1988-89	18.6	26.3	28.3
1989-90 (estimate)	17.9	26.0	28.3
1990-91 (indexation)	16.9	25.5	28.1

These figures reflect the rise in the standard employees' NIC rate from 6½ per cent to 9 per cent followed by the cut in the rate on earnings below the LEL to 2 per cent in 1989. The lower rates introduced in the 1985 Finance Act do not affect the cases shown. So far as income tax is concerned, personal allowances have increased by about 24 per cent in real terms since 1978-79, slightly less than earnings. The basic rate has been reduced from 33p to 25p.

Average earnings have of course increased by substantially more than prices since 1978-79. So a married man on average earnings has seen his real take-home pay rise by £54 per week. The increase for a married man on half average earnings has been £26 per week, and on twice average earnings £110 per week.

As the table shows, indexation of allowances in the Budget, with no reduction in the basic rate, would lead to a slight fall in the proportion of incomes taken in tax and NICs. This is because 1990-91 sees the effect of the October 1989 NIC reform throughout the year, whereas the financial year average figure given for 1989-90

*Adult male earnings (all occupations). Married couple, wife not working: the couple are assumed to have no children, to avoid distortion of the figures from the abolition of child tax allowances.

includes half a year of the old system. If the post-October figure were looked at for 1989-90, indexation would lead to a very slight rise in the proportion of incomes taken in tax and NICs. This is because earnings are assumed to rise by more than the increase in tax thresholds, which is indexed to changes in prices.

Business Taxation

Following the sharp rise in corporation tax receipts since 1983-84, as a result of the substantial recovery in company profits, total taxes paid by businesses (outside the North Sea) are now higher as a percentage of GDP than in 1978-79. The rise in total taxes on business as a share of GDP was made up of a large rise in corporation tax and smaller rises in other taxes; employers' NICs and NIS fell.

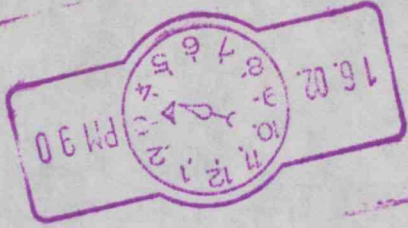
Table 3

Tax paid by Businesses fbn in 1988-89 prices
(figures in brackets are per cent of GDP)

	Corporation Tax ¹	Taxes on self employment incomes	Employers' NICs and NIS	Rates	Other ²	Total
1978-79	8.4	2.8	13.6	5.5	4.3	34.6
	(2.2)	(0.7)	(3.6)	(1.4)	(1.1)	(9.1)
1989-90	18.0	4.6	13.0	8.4	7.5	51.4
(forecast)	(3.7)	(0.9)	(2.7)	(1.7)	(1.5)	(10.5)

¹ Excludes North Sea, but includes ACT

² VED, car tax, road fuel duty, duty on rebated oils, capital taxes



BUDGET - secret

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10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

PRIME MINISTER

INITIAL BUDGET DISCUSSION WITH CHANCELLOR : 8 FEBRUARY

You are seeing the Chancellor for an hour tomorrow evening when he will unveil his present Budget thinking.

He wants to see you privately, but he plans to hand over to you an aide-memoire.

2. I have obtained strictly privately from the Chancellor's office the attached draft of the aide-memoire, so that you have advance warning of what he will say. The Chancellor does not know that either you or I have seen it, so please do not reveal you had any advance warning of its contents.

Overall Stance

3. The summary table at the back of the paper shows this would be a broadly neutral budget, though with a modest net cost (£300m.) in 1991-92.

4. Is that the right stance? I see no case for any looser



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LONDON SW1A 2AA

From the Private Secretary

stance; the main question is should it be tighter?
If late in the year the budget looked to have been too tight - as changes
Income Tax and NICs then looser monetary policy - but not vice versa.

5. Worth considering slight under-indexing of the
main tax allowances, eg 5% rather than see 7 1/2%
implied by indexation?

Company Cars

6. With no major tax give-aways a like wipe of
company cars implies net losses for eg middle - income receivers
with cars. That may be the justification for only a like
20% increase in scale charges; other arguments would point to a
bigger jump. What residual untaxed benefit would be left
after 20%?

Excise Duties

7. The overall package seems to be slightly less than indexation,
and is short allowed for in the latest Treasury forecast.

Several queries:

- should some spirits be more than indexed, as proposed for
petrol and cigarettes?

- why not widen like the unleaded petrol gap (petrol)
(particularly given the absence of many "green" revenues)?



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LONDON SW1A 2AA

From the Private Secretary

VAT

8. The VAT led debt relief etc. package seems quite expensive in 1991-92 (£225m.). Is that justified or necessary?

Corporate Tax

9. Is it worth spending £315m. in 1991-92 for 1% off the main CT rate? Wouldn't it be better to be more generous in raising the small companies rate?
 E.C.C. doesn't allow us to.

Environment

10. If we're going for differentiated car tax, is it worth also looking again at sweeping VED and putting the tax all on petrol?

Savings

11. Abolishing the composite rate arrangements for banks and building societies would be popular for non-taxpayers - particularly the new class of pension wives with unearned tax allowances.
 But: ① it reverses the decision taken on banks in the early 1980s.
 ② What are the long term revenue implications?



10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

12. The new ~~contract~~ ^{tax-free} contracted savings and five-year savings plans look quite useful complements to SAYE and PEPs to cater for regular savers who are not interested in equities.
13. Could higher capital disregard be ~~used~~ social security be brought into effect for 1990-91 community charge payments? But, if so, is this the most sensible way of budgeting extra help?
14. You will see the Chancellor has responded to your doubts about a credit tax.

Sovereign Debt

15. Does the tax relief limit have to be as high as 50% if the Chancellor is worried about the implied tax loss this year. Against that, a higher regime than the current Bank of England notes would undoubtedly be interpreted as the response to your "hiring with fury" over student loans.

Budget - secret

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10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

Charities

16. You asked the Chancellor to consider tax relief for one-off gifts (the Thatcher proposal). A Green Paper this year, rather than his proposals, seems sensible.

Football

17. You will want to consider the balance between carrot and stick.

Other

18. Raising the limit on exempt Friendly Society savings is another idea you asked the Chancellor to look at. Is £1000 high enough?

MTFS

19. The paper is silent on this. If the Chancellor does not raise this you might ask him for his latest thinking in the light of the seminar discussion.

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7/2

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AIDE MEMOIRE ON BUDGET

Income Tax and NICs

No change in income tax rates.

Indexation of personal and married couples allowances, probably some over indexation of age allowances.

No change to NICs.

Company Cars

Car scales (which determine the amount of taxable benefit from company cars) to be increased by 20 per cent, following increases of 100 per cent and 33 per cent in last two years.

Excise Duties

Broad indexation of excise duties. VED and duty on cider, cigars and pipe tobacco frozen; petrol duty and cigarettes duty raised by 10 per cent. Unleaded/leaded differential will widen automatically by $1\frac{1}{2}$ pence a gallon. The impact on the RPI in April will be a little over 0.5 per cent, (which is already in the forecast).

VAT

No change to VAT rate or coverage.

To help business, provide relief from VAT for bad debts, simplify the registration rules for VAT, and raise the registration threshold to the maximum permitted by EC Laws

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Corporation Tax

Reduce Corporation Tax main rate by one per cent to 34 per cent. *How much?*

Increase thresholds for the small companies rate from £150,000 and £750,000 to £200,000 and £1m benefiting 35 per cent of the 50,000 companies currently paying tax at the main CT rate.

Environment

Apart from the rise in the leaded to unleaded petrol differential, considering the scope for differentiating car tax to bear more heavily on less fuel efficient cars. Not attracted to other measures, for example tax incentives for catalytic converters.

Savings

Considering the abolition of Composite Rate Tax from 1 April 1992 thus allowing many married women with incomes below the tax threshold to benefit from independent taxation.

Introduce a new contractual savings scheme from January 1991 with a monthly savings limit of £250 allowing people to avoid tax on savings income where they save regularly over five years. Over several years the takeup is likely to increase and the cost will grow to, perhaps, £150m. Unlike SAYE, the schemes will be run by Banks and Building Societies.

Also examining, the possibility of a five year savings plan with an annual limit of £3,000. This would enable capital and interest to build up tax free and encourage people inheriting or otherwise coming into small capital sums to save for a prolonged period. The cost could rise to £150m in due course.

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Exploring also the possibility of exempting interest on small savings accounts (for example exempting up to £100 of interest for each taxpayer). This would be more expensive than the other schemes but could have presentational advantages and also reduce the administrative cost of abolishing CRT.

Abolish Stamp Duty on shares from 1 April 1992. Announcement and legislation needed now to enable the Stock Exchange's new paperless transaction system to be planned and implemented on this basis. Essential to maintain City's competitive position as other countries abolish their duties.

Raise the PEP limits from £4,800 to £6,000 and within that the limit on investments in unit and investment trusts from £2,400 to £3,000. Also change rules to allow inclusion in PEP of investment trusts with 50 per cent of their portfolios in the UK rather than 75 per cent as now.

Provide CGT rollover relief for sales of shares to ESOP trusts.

Raise the capital disregards for certain social security benefits (currently £6,000 for income support and £8,000 for community charge benefit and housing benefit). A number of options still under consideration; one would be to raise the limits of pensioners only (or couples only).

Considered the possibility of imposing a credit tax in order to discourage borrowing but decided against. (This would be necessary in the next Parliament - though unattractive).

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Sovereign Debt Provisions

Limit tax relief on banks doubtful sovereign lending at 50 per cent of total exposure (broadly the figure suggested by the Bank of England's revised matrix). This will bring certainty on the tax due (Inland Revenue are still discussing with the banks the relief for 1987 and 1988) and will detach the tax relief from the Bank's decisions on prudential provisioning. It would allow the Government to phase in the cost of further provision over a period of years. (This year we have a most unwelcome tax loss of around £½ billion).

Charities

Increase the payroll giving limit.

Considering the desirability of issuing a Green Paper on providing tax relief for one-off gifts.

Football

Exploring the possibility of a package of measures to help football grounds meet the recommendations of the Taylor Report:

- (a) clarify eligibility of ground improvements for capital allowances;
- (b) reduce Pool Betting Duty from 42½ per cent to 40 per cent on condition that the 2½ per cent is passed to the Football Trust to be used in ground improvements;
- (c) possibly, introduce a levy on transfer fees.

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Other Proposals

Other proposals include:

- (i) implementation of the second tranche of life assurance reforms (already announced in January);
- (ii) indexing the thresholds for IHT and CGT.
- (iii) increasing the limit on the exempt Friendly Society savings from £100 to £150 (annual premium).

7 February 1990

**BUDGET SECRET
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DIRECT EFFECTS OF BUDGET MEASURES

	<u>£ million</u>		<u>yield (+)/cost (-)</u>
	<u>1990-91</u>		<u>1991-92</u>
	<u>Changes from a non-indexed base</u>	<u>Changes from an indexed base</u>	<u>Changes from an indexed base</u>
1. Index income tax allowances	- 1670	nil	nil
2. 10% on age allowances	- 50	- 50	- 70
3. Increase car scales by 20 per cent	+ 160	+ 160	+ 200
4. Excise duties	+ 1430	+ 30	+ 50
BUSINESS			
5. 1% off main corporation tax rate	- neg	- neg	- 315
6. CT: raise small companies thresholds to £200,000 and £1 million	- neg	- neg	- 25
7. VAT: bad debt relief, simpler registration rules	- 35	- 35	- 225
SAVINGS			
8. Contractual tax-exempt savings scheme	- neg	- neg	- 25
9. Ten year savings plan	- neg	- neg	- 20
10. Abolish stamp duty on shares from introduction of TAURUS (assume 1/1/92)	+ 10	+ 10	- 90
11. PEPs, ESOPs etc	- neg	- neg	- neg
OTHER			
12. Limit relief on banks' sovereign debt provisioning	nil	nil	+ 120
13. Life assurance: already announced	+ 50	+ 50	+ 95
14. Other starters	- 25	+ 5	nil
<hr/>			
15. TOTAL	- 130	+ 170	- 305
<hr/>			
16. Raise capital disregards for community charge benefit etc	- 15	- 15	- 30

7 February 1990

**BUDGET SECRET
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2 The Medium Term Financial Strategy

central

2.01 The objective of the Medium Term Financial Strategy (MTFS) is the defeat of inflation.

2.02 The rise in inflation in the post-war period was put into reverse in the 1980s. This was done by maintaining tight monetary and fiscal policies, complemented by structural policies to improve the responsiveness and flexibility of markets. That remains the right approach to economic policy and the one the Government will follow in the 1990s.

2.03 ~~It will do so because~~ Inflation damages the economy by increasing uncertainty, discouraging investment and reducing profitability. It brings conflict into industrial relations and reduces confidence in the management of the economy, at home and abroad. Action to maintain the soundness of the currency remains a prime duty of government.

2.04 The social effects of inflation are no less destructive. Inflation redistributes income and wealth arbitrarily and capriciously. It discourages saving and is a disincentive to those who wish prudently to provide for their retirement. It bears most heavily on the people least able to protect themselves.

continue to

2.05 The MTFS will remain the centrepiece of the Government's economic policy. It will be accompanied by policies which encourage enterprise, flexibility and efficiency, and thus promote the growth of output and the creation of jobs.

2.06 All major western governments have increasingly followed these policies in recent years, giving primacy to the drive against inflation. And the means of controlling inflation are fundamentally the same in all countries, whatever their institutional structure. They are based on an effective monetary policy supported by a firm fiscal policy. No other methods have been successful.

2.07 These policies do not guarantee a permanent low rate of inflation. Unforeseen events at home or overseas can cause ~~some price rises~~ *pressures* which may lead to a rise in the general price level—as happened with ~~oil prices~~ *the increase in* in 1973 and 1979. At other times a ~~prudent~~ *policy* decision taken for the right reasons on a balance of risks can have unforeseen consequences for inflation. But sound monetary policies will always require corrective action to be taken, to reverse the rise in inflation and set it on a downward trend. *maintenance of*

2.08 This is the course which monetary policy has followed in the United Kingdom over the past decade. It brought inflation down sharply from the high levels of the 1970s, and was set to bring about a further reduction until the renewed resurgence of inflationary pressures in 1987 and 1988. The Government's response to this renewed threat was to tighten monetary policy sharply.

2.09 The Government is determined to bring about a decisive fall in the rate of inflation. But it is not enough simply to state this. It is important for the Government to say clearly how it intends to operate monetary policy, now and in the future, and to set itself realistic objectives which, with determination, will be achieved. In this way the whole economy can work with the grain of the Government's counter-inflation policy.

*note to
para 2.22*

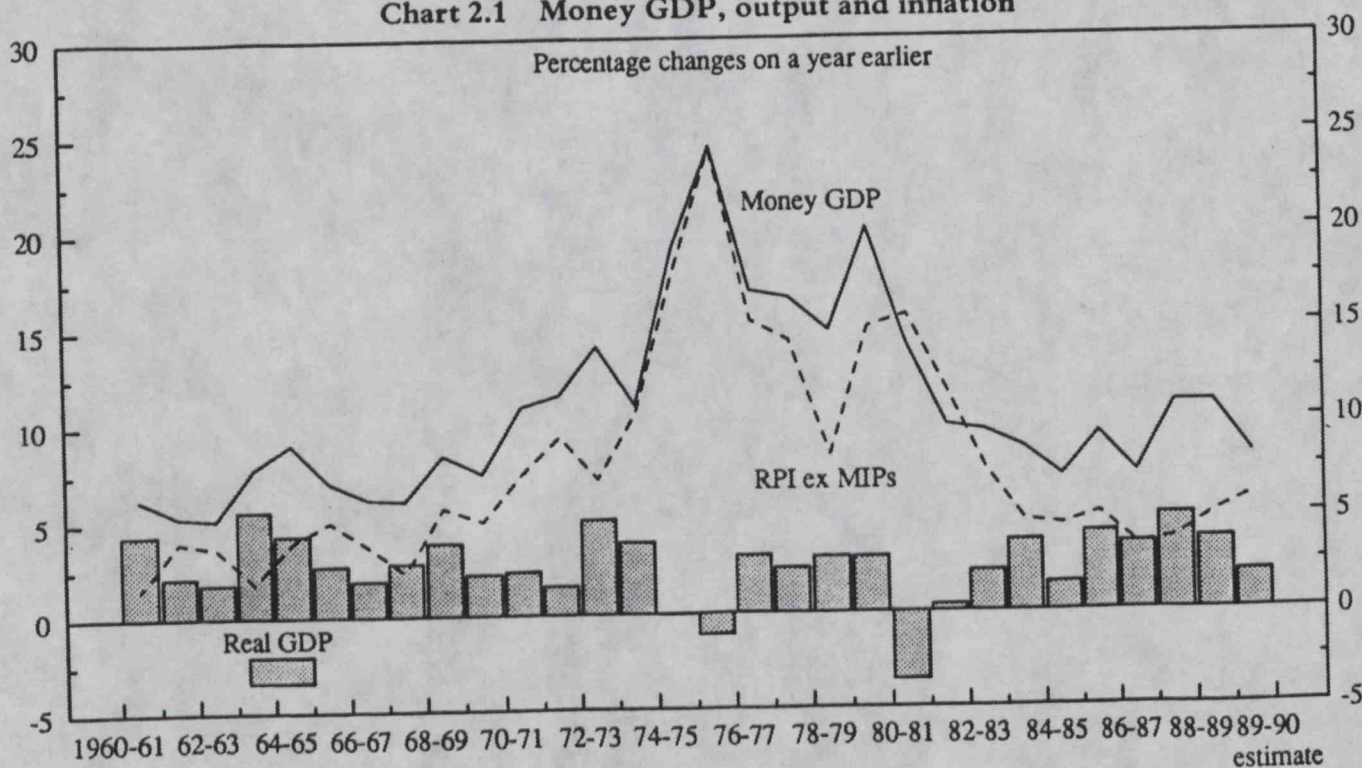
2.10 The Government has committed itself to join the exchange rate mechanism (ERM) of the European Monetary System when the level of UK inflation is significantly lower, there is capital liberalisation in the Community and real progress has been made towards completion of the single market, freedom of financial services and strengthened competition policy. It remains committed to that. But membership is a complement to, and not a substitute for, an effective monetary policy. A medium term financial strategy, which follows the principles set out in this chapter is required both to reduce inflation and to sustain the anti-inflationary stance which ERM membership requires.

2.11 The following sections set out the Government's economic policy in more detail, explain how monetary and fiscal policies have been formulated, and how the Government determines day-to-day decisions about interest rates.

Money GDP and inflation

2.12 The rate of growth of money GDP has averaged some 10 per cent a year over the last three years. This is much too high. The Government's strategy is to keep policy tight enough to secure a much lower rate of growth in money GDP over the next few years. This should bring about a substantial fall in inflation.

Chart 2.1 Money GDP, output and inflation



2.13 Chart 2.1 illustrates the close relationship between growth in money GDP and inflation over the last 30 years. Sharp changes in money GDP growth are often associated in the short term with changes in output. But sustained differences in rates of growth of money GDP are reflected in inflation rather than real growth. The extent of the short-term impact on output depends on how well markets work. The labour market is particularly important in this respect: if labour costs continue to rise fast well after policy has been tightened, that is bound to result in lost output and higher unemployment.

2.14 The period covered by the MTFS is being rolled forward this year to end in 1993–94: Table 2.1 shows the Government's objective for money GDP growth over this period. Real GDP growth is forecast at $\frac{3}{4}$ per cent in 1990–91 (more details are given in chapter 3), but is expected to recover the following year. For 1992–93 and the following year output growth is projected at $2\frac{3}{4}$ per cent, the same trend as assumed in last year's MTFS. The easing of capacity-utilisation that the forecast implies should mean much more moderate inflationary pressures over the medium term.

Table 2.1 Money GDP growth, output and inflation¹

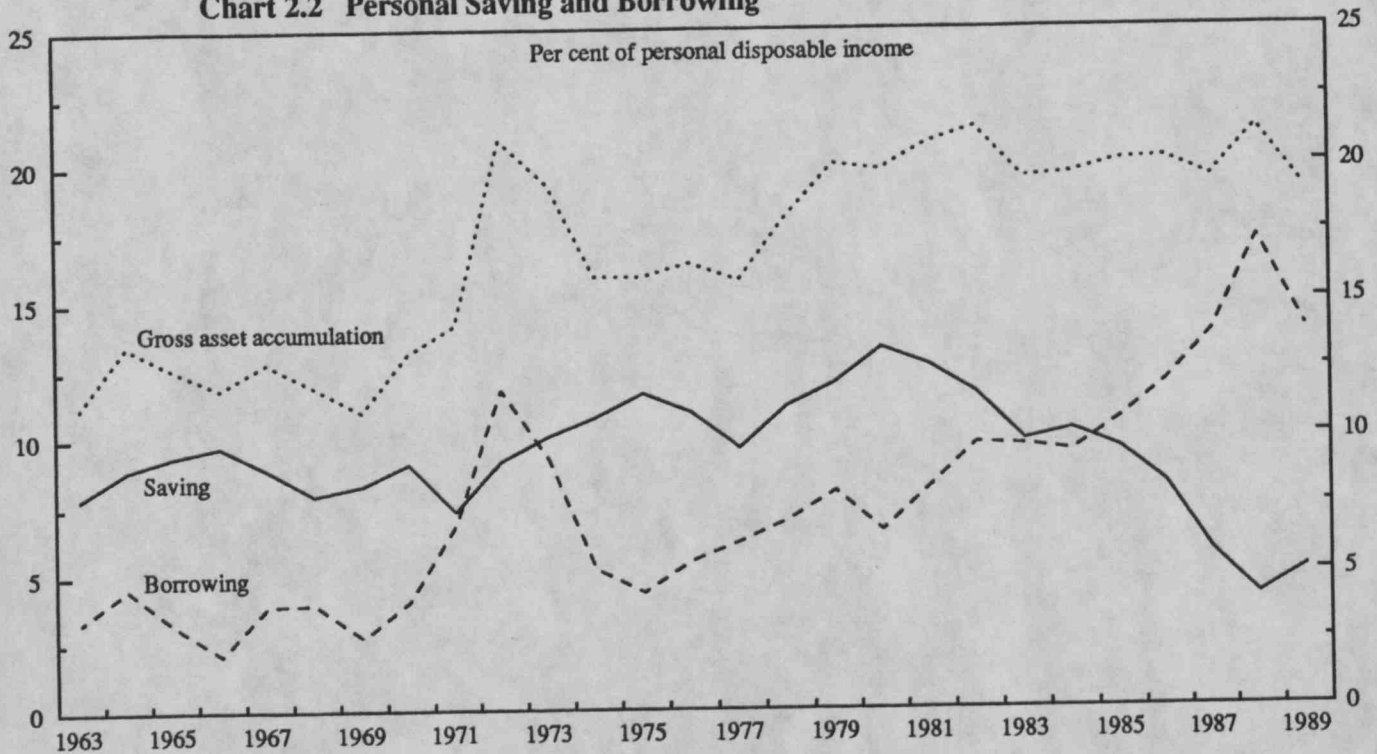
	1989–90 ²	1990–91 ²	1991–92	1992–93	1993–94
Money GDP	$8\frac{1}{4}(8\frac{1}{4})$	5(7)	$6\frac{1}{2}$	$6\frac{1}{4}$	$5\frac{3}{4}$
Real GDP:					
Non-North Sea	$2\frac{1}{2}$	$\frac{3}{4}$	2	$2\frac{3}{4}$	$2\frac{3}{4}$
total	2	$\frac{3}{4}$	2	$2\frac{3}{4}$	$2\frac{3}{4}$
Inflation:					
GDP deflator	$5\frac{3}{4}(6)$	4(6)	$4\frac{1}{2}$	$3\frac{1}{2}$	3

¹ Percentage changes on previous financial year. The figures for 1990–91 are forecasts; the figures for subsequent years show the Government's medium term objectives for money GDP and consistent assumptions for output and inflation.

² The figures in brackets for money GDP growth and the GDP deflator adjust for the distortion arising from the abolition of domestic rates. This is explained in the box on page XX.

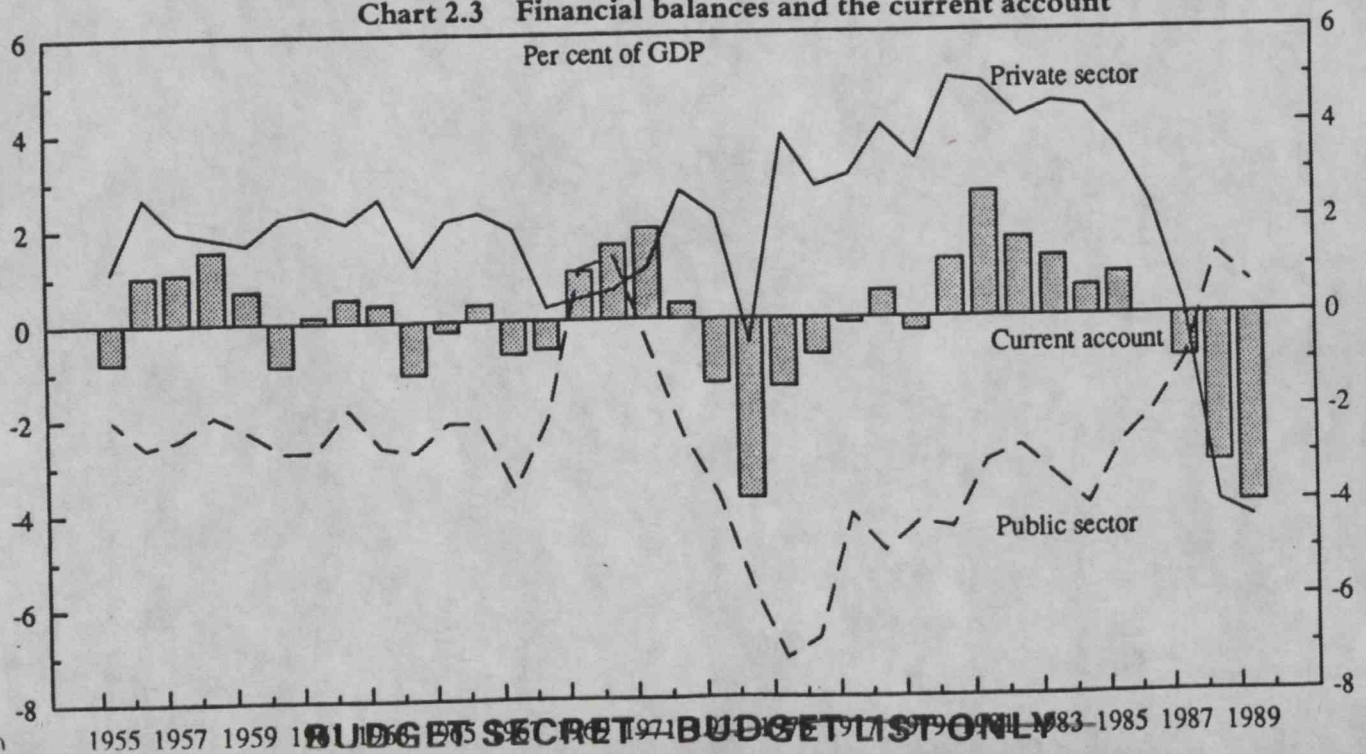
2.15 The main factors in the high demand growth of recent years have been a boom in business investment and buoyant consumers' expenditure. Business investment rose to over 15 per cent of GDP in 1989, the highest proportion ever. The personal saving ratio has fallen sharply since 1985, associated with higher borrowing.

Chart 2.2 Personal Saving and Borrowing



2.16 The private sector as a whole has moved from saving more than it invests (a financial surplus of more than 2 per cent of GDP as recently as 1986) to investing much more than it saves (preliminary estimates suggest a financial deficit of about 4 per cent of GDP in 1989). The extent of this change is without any precedent, at least in the period since the First World War. The recent excess of investment over saving is being financed, in effect, by borrowing from the rest of the world; in other words, it means a large current account deficit on the balance of payments.

Chart 2.3 Financial balances and the current account



2.17 Manufacturing investment reached a new record level in 1989 after growth averaging 8 per cent a year since 1983; total business investment rose by over 40 per cent in the three years to 1989. Published statistics show an unsustainable rate of increase in stocks in 1989. The prospects are for some fall in total domestic investment (including stockbuilding) as a share of GDP over the next few years, while saving should rise as the effects of financial liberalisation and past increases in asset prices become weaker. This means that the private sector financial deficit will contract, perhaps quite sharply, and the balance of payments current account will improve in spite of the public sector moving back towards budget balance.

The policy framework

2.18 The function of macroeconomic policy is to create a non-inflationary climate, and the function of supply side policies is to encourage individuals and companies to make the most of it. The economy is now much more flexible than it was ten years ago, following a series of reforms that have reduced distortions and improved the way markets work.

2.19 Reductions in marginal rates of taxation have increased incentives to work and save, and improved the quality of investment. The extension of owner occupation, the revival of the private rental market, and the introduction of more flexible pension arrangements are helping labour mobility; while employment and trades union law reforms have facilitated more efficient use of the labour force and the creation of new jobs. The deregulation of financial markets (although adding to the problems of monetary control) and the privatisation programme have contributed to improved performance in the industries directly affected and more widely. Youth training has been extended, and major reforms of education are in progress.

2.20 Tight monetary and fiscal policies are both needed to defeat inflation. Inflation is a monetary problem and so monetary policy has to be in the forefront of the battle to conquer it. A firm fiscal policy must complement and support the monetary stance.

2.21 Frequent large changes to fiscal policy instruments are harmful to supply performance and potentially destabilising. So it is best to take a medium term view about the appropriate contribution of fiscal policy, not to use it to offset temporary fluctuations in private demand. These considerations do not apply with the same force to monetary policy, which can therefore be used more flexibly to make shorter term adjustments to the policy stance.

2.22 It is, of course, the Government's firm intention to join the Exchange Rate Mechanism of the European Monetary System. But membership of the ERM is not a substitute for firm monetary policy. They are complements, with the commitment to the one reinforcing the commitment to the other. Most members of the Exchange Rate Mechanism have their own monetary targets. Likewise the British Government will continue to conduct its monetary policy within the MTFS framework.

para 2.12 →

Monetary policy

2.23 The essential instrument of monetary policy is the level of short term interest rates. So it is the authorities' job to set interest rates in such a way that the Government's objectives for inflation are achieved. But, as the following paragraphs explain, monetary policy is complex and the authorities' task is far from mechanical.

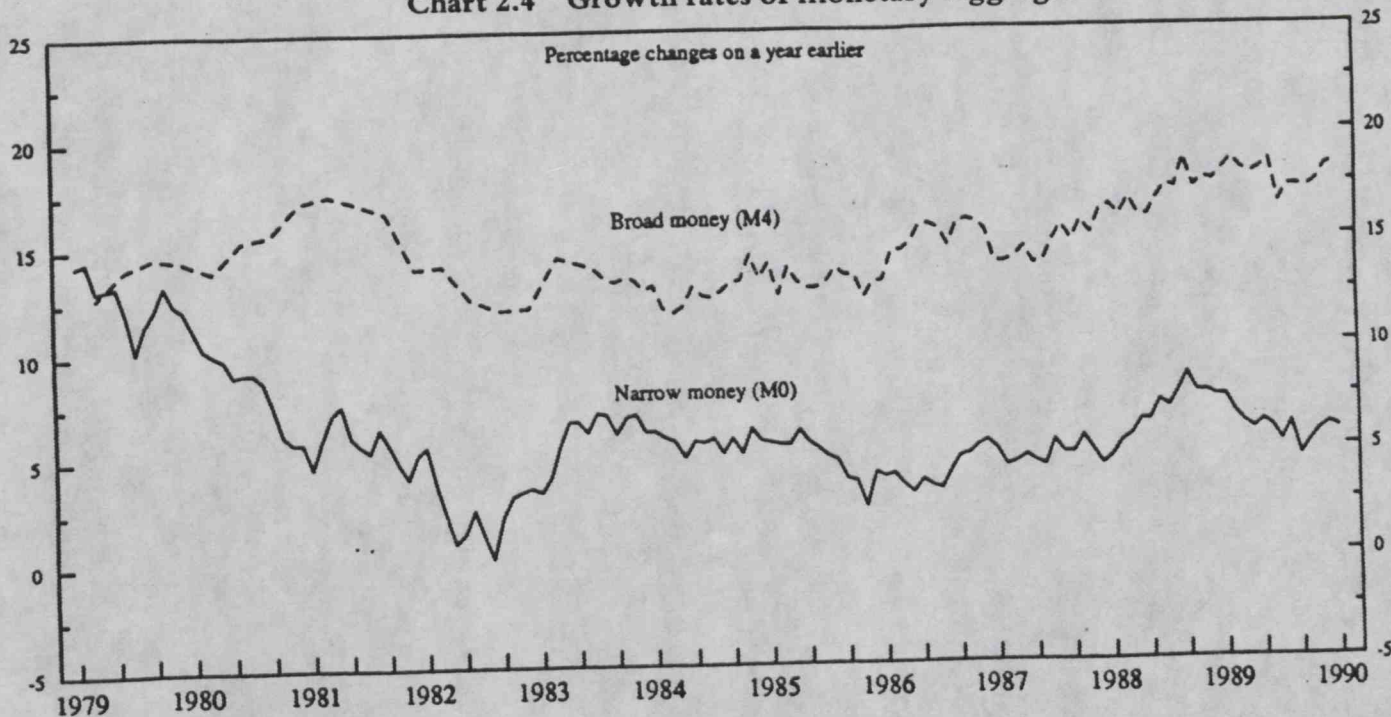
Money and inflation

2.24 ~~Sustained~~ Inflation occurs when monetary growth is excessive: "too much money chasing too few goods" is a traditional and accurate characterisation. That is why the rate at which money is growing is an essential concern of economic policy.

2.25 In contrast to most other economic statistics, accurate data on all of the monetary aggregates are available quite quickly after the period to which they relate. But there is no unique measure of money, and the various aggregates—narrow ones such as M0 and wider ones like M4—rarely grow at the same rate. Nor should they be expected to do so. They have differing relationships with inflation and each has to be assessed, along with other relevant indicators, to build up the picture of what is happening to monetary conditions.

2.26 The underlying point is that growth in the money stock need not be inflationary. It may in part reflect real growth in the economy, and in part long term trends in people's financial behaviour. Moreover, ~~especially in the case of the broad aggregates, growth~~ ~~it~~ growth may be caused by an increase in savings rather than a build up of money likely to be spent and hence of inflationary pressure.

Chart 2.4 Growth rates of monetary Aggregates

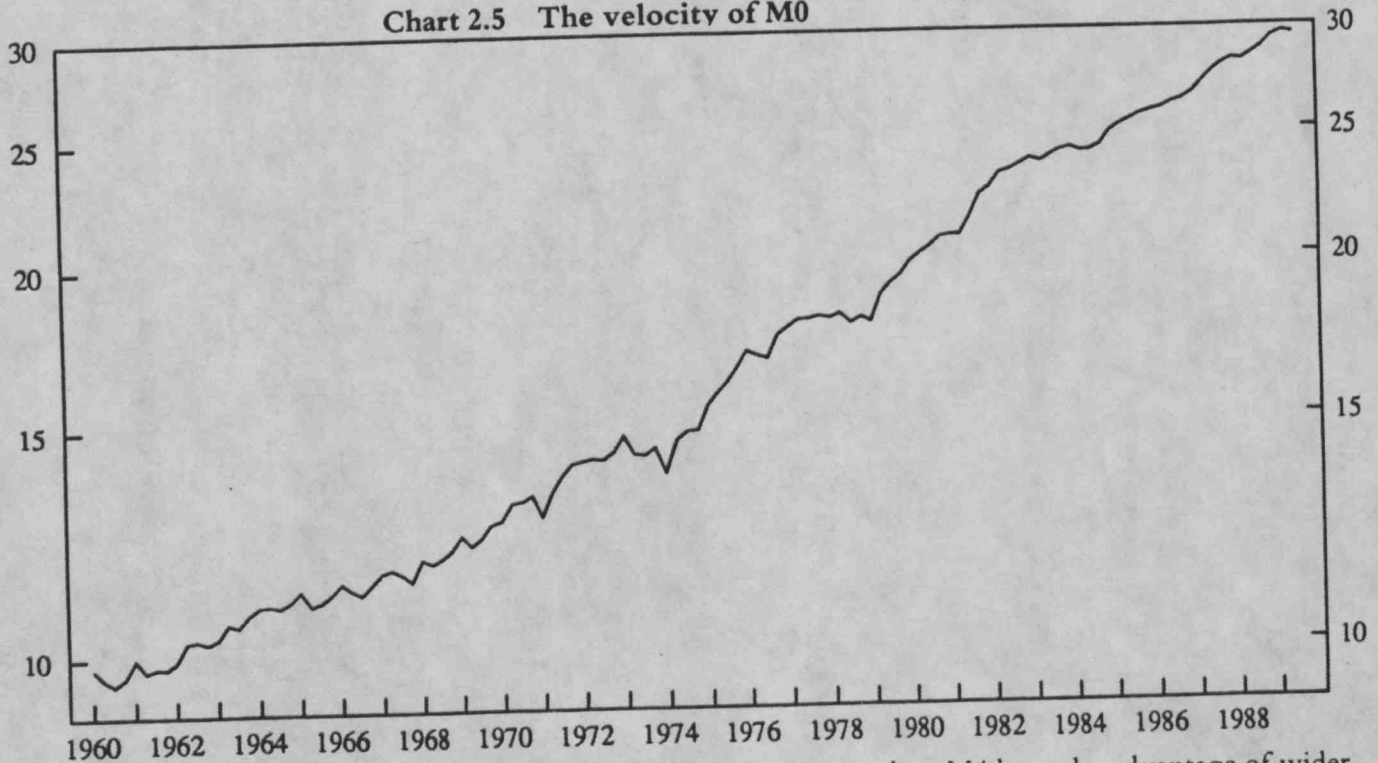


Narrow money 2.27 Narrow money, best measured by M0, has a simpler relationship with money GDP and inflation than have wider aggregates. It tends to be used predominantly for transactions purposes rather than as a home for savings, so that one of the complications associated with interpreting broad money does not arise. M0 cannot claim to be a comprehensive measure of transactions balances. But the pervasive use of notes and coin, which constitute 99 per cent of M0, for making transactions means that M0 has demonstrated a close relationship with money GDP over a period of 40 years or more. Its velocity has grown in a steady and reasonably predictable way, no doubt reflecting a fairly steady rate of change in the way people make payments. M0 has thus proved a timely and generally dependable indicator of current monetary conditions. Because other indicators are available only with a delay and often subject to revision, this is valuable information to have.

x
x

x

Chart 2.5 The velocity of M0



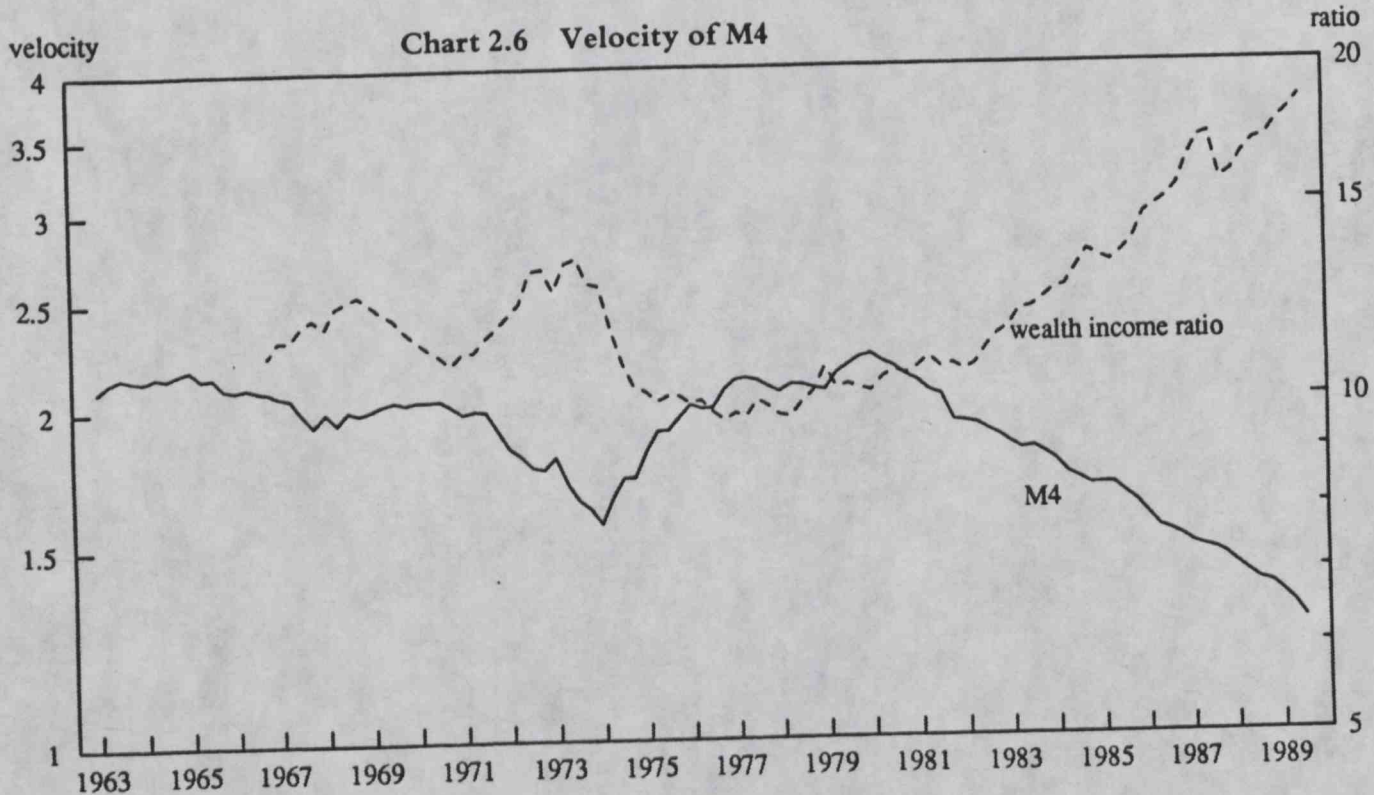
Broad money 2.28 Broader monetary aggregates such as M4 have the advantage of wider coverage. They embrace financial instruments like bank and building society accounts which, while excluded from M0, possess most of the characteristics of money. So the authorities monitor M4 and the other broad aggregates closely. But experience shows that the relationship between broad money growth and inflation is complex and variable.

x

2.29 An observed increase in broad money may, or may not, foreshadow an increase in inflation, depending upon why it occurs. If it reflects only a rise in firmly held savings, there will be no increase in inflationary pressures. On the other hand, if it represents an unstable build up of purchasing power, about to be spent on goods and services in excess of the economy's ability to produce them, that will be clearly inflationary. The important point is that the growth rate of broad money and liquidity alone does not indicate clearly the degree of inflationary pressure: it is necessary to interpret it carefully in the light of other information.

2.30 Experience backs up this analysis. Relatively rapid growth in broad money was consistent throughout the 1980s with much lower levels of inflation. For the most part, the build up of this money has consisted of firmly held savings. Savers have enjoyed a much better return in the 1980s, after the low or negative real interest rates of the 1970s. While the saving ratio has fallen, this reflects a rise in borrowing rather than a fall in gross asset acquisition. Wealth has grown rapidly and it is natural that people should wish to hold a proportion of this as interest bearing money.

2.31 The relationship between inflation and money GDP on the one hand and broad money and liquidity on the other has not been steady or predictable. Taking M4 as the measure of broad money, its velocity—the ratio of money GDP to M4—has changed erratically over time, in a way which mirrors the relationship between wealth and income.



2.32 That said, since the early 1980s the decline in velocity ~~alone~~ has *been* ~~proceeded at a~~ relatively steady ~~pace~~. If it were possible to rely on this trend continuing, there would be a basis for setting a new target range for broad money. It seems likely, however, that the fall in velocity is explained in some measure by the growth of wealth, generally, in the 1980s, at a ~~faster~~ *unusually rapid* ~~pace than incomes have risen~~. In the economy's present position, it is doubtful if ~~this~~ ² upward trend in the ratio of wealth to income will continue. ~~That uncertainty, therefore, applies to the future velocity of broad money as well.~~ *This comes over*

Measuring broad money and liquidity

Broad money and liquidity are among the inputs into the assessment of monetary conditions, and it is important that they are measured in a way which enables all relevant information to be taken fully into account. To date the authorities have tended to concentrate on measures of sterling liquidity held only by residents, added up to form an aggregate—M4 and, before that, M3.

A number of developments have made it necessary to have regard to the behaviour of other forms of liquidity measure. The increasing integration of financial markets across national boundaries, for example, makes it the more important to take account of non-residents' holdings of sterling liquidity, and of residents' holdings both of non-sterling liquidity and of sterling held outside the UK. At the same time, there is increasing interest in the divergence frequently to be seen in the behaviour of the money holdings of the different sectors of the UK economy—households and companies of various kinds.

This all means that coverage and presentation of the monetary statistics must adapt to keep pace with changes in the markets. The Bank of England will, in the next few days, publish a discussion paper dealing with these questions, and inviting comments on the statistical issues to be faced.

There are

Credit 2.33 Similar problems to those with broad money arise in interpreting credit growth. If one individual borrows from another, the borrower has a debt and the lender acquires an asset in the form of the borrower's obligation eventually to repay this. But if the lender is content to regard this asset as a home for his savings, the credit he has extended will not be inflationary. Corresponding to the borrower's spending the money advanced to him, the lender will be abstaining from spending to the same degree. Only if the lender tries to spend his asset, adding to the spending by the borrower, will there be any upward pressure on prices.

2.34 None of this is to deny that broad money and credit growth are important indicators. The growth of liquidity and credit since 1987 has been too fast, as is clear from the rise in inflation. Mortgage lending has been particularly buoyant until recently. But changes in these indicators need to be interpreted carefully alongside other evidence to see what they imply about inflationary pressures, and therefore for decisions on interest rates.

with associated upward pressure on house prices

Monetary targets 2.35 The Government therefore will continue to set a target for M0, as a yardstick for its monetary policy. A target range of 1-5 per cent is being set for M0 in 1990-91, the same as the illustrative range for 1990-91 set out in 1989- last year's MTFPS. Although the 12-month growth rate has fallen from earlier peak levels, it is likely to finish this financial year above the target range. There will be a period before it falls within next year's lower target corridor. it.

and it may be some months

Table 2.2 Growth of M0¹

1989-90	1990-91	1991-92	1992-93	1993-94
[5 $\frac{3}{4}$]	1 0 to 5	0 to 4	0 1 to 4	-1 to 3

¹ 1989-90: forecast percentage change on previous financial year;
1990-91: target range for (seasonally adjusted) 12 month growth rate;
1991-92 onwards: illustrative ranges.

2.36 As to broad money, it would be unwise at present to reintroduce a target range given the uncertainty about its future velocity trend.

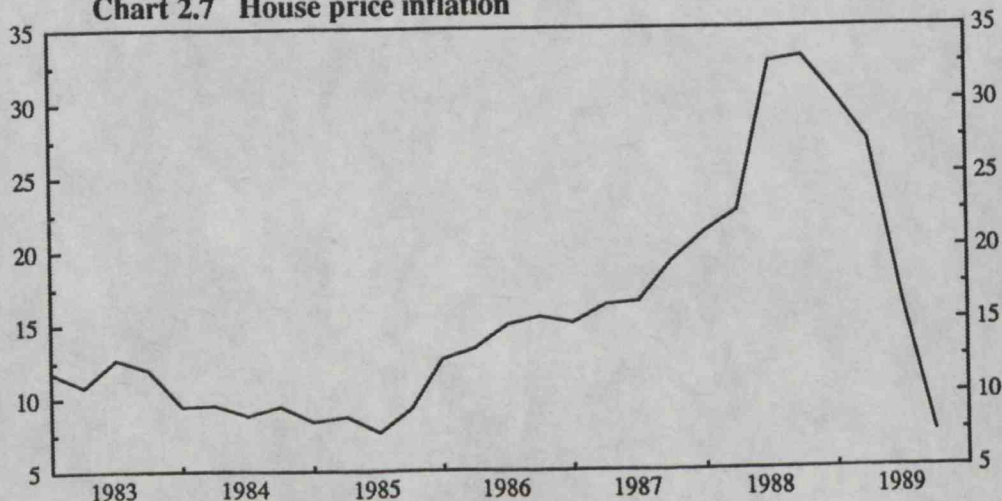
Other factors bearing on the assessment of monetary conditions

show

2.37 A range of other indicators supplement the evidence of the monetary aggregates in the interpretation of monetary conditions. What is happening to the exchange rate is particularly important. If people were to feel that they had too much sterling and tried to reduce their holdings, this would be likely to show up quickly in downward pressure on sterling. More generally, a perceived loosening in the policy stance might slow-up in this way. Other factors, which may have little to do with domestic monetary conditions, also affect its behaviour, so that the exchange rate is not an infallible guide to the tightness of monetary policy. But appraised carefully with other evidence, the exchange rate is a sensitive and timely indicator. Moreover, it can also play a direct part in raising inflation; a lower pound tends to lead to higher import prices in sterling terms as well as giving more headroom for domestic producers to pass on increased costs. A higher pound has the opposite effect. No government can therefore be indifferent to the exchange rate, though in setting interest rates it would be wrong to give undue weight to the minor short-run fluctuations that are inevitable in any financial market.

2.38 Amongst other indicators, the authorities pay close attention to the behaviour of asset prices. Sharp rises in house prices, in particular, and the consequent increase in housing wealth played an important role in the unexpectedly strong demand of recent years. With the increased access to credit that financial liberalisation has brought, people were more easily able to turn their housing "equity" into spending power. The flattening out of house prices over the last year is a welcome development in this respect, following the progressive tightening of monetary policy.

Chart 2.7 House price inflation



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X 2.39 Information relating to the level of economic activity and to the behaviour of inflation itself must also be taken into account, though the indicators are generally available only with a delay. Evidence relating to future behaviour—intensions survey data (for example), or confidence indicators—is monitored closely.

X 2.40 Assessing monetary conditions—deciding whether the monetary stance is appropriately tight or whether a change is required—involves balancing up all of the ~~sets of~~ factors discussed in the previous paragraphs. This cannot be a mechanical process and, inevitably, judgement is required.

Implementing monetary policy

2.41 While assessing monetary conditions is a complex task, implementing changes in the monetary stance is in principle simple. Interest rates are the price of money and credit. Changing the price is the best method of influencing the degree of monetary tightness.

2.42 The level of interest rates affects the economy in a wide variety of ways. Higher interest rates increase the reward for saving while raising the cost of borrowing. There are also cash flow effects; higher interest rates for example reduce the spending power of borrowers after they have paid their interest charges (and increase the incomes of savers). Interest rates also influence asset values and thus the level of wealth. Again, a rise in interest rates will make sterling more attractive than it would otherwise be compared to other currencies, thus raising the exchange rate, leading to downward pressure on domestic costs. Some of these channels are more important than others and not all work in the same direction. Nevertheless, the net effect is that raising interest rates constitutes a powerful way of tightening the monetary stance. Lowering interest rates has the opposite effect.

2.43 Used as a short term instrument, official intervention in the foreign exchanges can also be of value. By buying or selling foreign currency for sterling, as appropriate, the authorities can affect the supply and demand for sterling, and hence the exchange rate, in the short term. Intervention can also on occasion be used to signal the authorities' future intentions, at times dampening or preventing inappropriate and unnecessary movements in sterling. In the longer run intervention is likely to have only modest effects, unless combined with a change in the level of interest rates; but it can be a useful short term tactical weapon. (4 only)

in the 2.44 In principle, an alternative to using interest rates to regulate monetary conditions would be to return to some form of direct credit control. But such controls undermine the free market price mechanism for credit (that the interest rate represents). That would lead to distortions and inefficiencies and poor resource allocation which would be clearly undesirable. They would also be unfair: some would obtain the credit they wanted; others would find themselves rationed. But, more fundamentally, in today's developed and sophisticated financial markets, and without the support of exchange controls, credit controls would be almost impossible to work except in the very short term. For all these reasons, the trend in those major countries that still have credit controls is towards dismantling them. The Government sees no advantage and many disadvantages in swimming against the tide. There is no going back to the relatively controlled and regulated economy of earlier years. (mark)

Reserve Asset Ratios

Because interest rates are the essential instrument of monetary policy, the monetary authorities must be in a position to exercise a high degree of influence over their movements. That means they need to ensure that the financial system is dependent on funds provided by the central bank so that its own lending rate is transmitted more widely into market rates.

To achieve this result, a number of other countries—France or Germany for example—impose minimum reserve asset ratios on their banks. The operation of the ratio increases the banking system's need for funds from the central bank, and thereby helps to ensure that market rates will reflect the rate of interest at which the central bank provides the supply. Only the central bank can meet these needs. It is thus mistaken to see reserve requirements as an alternative monetary instrument to interest rates. In particular, reserve requirements do not serve as a direct credit control. Rather they provide a means whereby official influence on interest rates is made effective.

In the United Kingdom, benefiting from our well developed money markets, the authorities have in recent years been able to exercise this control simply and flexibly by varying the size of market purchases of bills and the weekly Treasury Bill tender. This avoids the distortions that are often inherent in reserve asset ratios.

Funding policy 2.45 Funding policy—the way that the Government finances its own operations—must support monetary policy in attaining the objectives for inflation. The Government will continue to arrange the public sector's financial affairs in accordance with this principle, at the same time financing the public sector so as to minimise any distortion to the financial system. Annex A of this chapter discusses funding policy in more detail.

Fiscal policy

2.46 A budget surplus is expected for 1989–90, the third successive year that the Government has repaid debt. However the PSDR is now estimated at £7 billion, about half what was forecast a year ago. Almost £1 billion of this reduction reflects lower privatisation proceeds. Local authorities' capital spending has increased by about £2 billion more than expected, and an unexpectedly large take-up of personal pensions reduced national insurance contributions by almost £2 billion. These changes taken together account for most of the shortfall in the PSDR compared with last year's forecast.

2.47 The PSDR is set to fall slightly to £6 billion in 1990–91. While there will be a reversal of some of the factors that explain the 1989–90 shortfall, this will be more than offset by the effects of lower growth in 1990–91 ($\frac{3}{4}$ per cent now forecast, some 2 percentage points below trend). The Government has made clear in the past that it sets tax rates on the basis of medium to long-term considerations, and will not normally change them to offset cyclical swings in the PSDR.

2.48 Fiscal policy will remain tight, and so play an important part in bringing inflation down. The PSDR path now projected is shown in table 2.7; the Government's balanced budget objective is expected to be reached in 1992-93. The projections imply that the ratio of net public sector debt to GDP, which has fallen by more than a third in the last five years, will show a further substantial decline over the medium term; so there will be a further fall in the burden of debt interest payments.

Public expenditure

2.49 The Government's objective for public spending is that over time it should take a declining share of national income, while value for money is improved. The ratio of GGE excluding privatisation proceeds to GDP has fallen by almost 8 percentage points since 1982-83; over half the fall took place during the period of fast economic growth between 1986-87 and 1988-89. As economic growth moderates, the ratio may show a temporary rise, even after adjusting for the distortion arising from the abolition of domestic rates which will raise the published ratio by about 3/4 percentage point. Thereafter a continuing decline in the ratio is projected.

Table 2.3 General government expenditure (excluding privatisation proceeds) as a per cent of money GDP^{1, 2}

1964-65	35½	1974-75	48	1984-85	46
1965-66	37½	1975-76	48½	1985-86	44½
1966-67	38½	1976-77	46	1986-87	43½
1967-68	42½	1977-78	42½	1987-88	41½
1968-69	40½	1978-79	43½	1988-89	38½
1969-70	40½	1979-80	43½	1989-90	[39½ (39½)]
1970-71	40½	1980-81	46	1990-91	[40½ (39½)]
1971-72	41	1981-82	46½	1991-92	[39½ (38½)]
1972-73	41	1982-83	46½	1992-93	[39½ (38½)]
1973-74	42½	1983-84	45½	1993-94	[39 (38½)]

¹ 1989-90: latest estimate; 1990-91: forecast; 1991-92 onwards: MTFS projections.

² Ratios in brackets adjust for the distortion arising from the abolition of domestic rates. This is explained in the box on page xx.

Figures

2.50 Projections of government expenditure are shown in table 2.4. For the period to 1992-93, they incorporate the public expenditure plans shown in the public expenditure White Paper (Cm 1001-1021) which have been held unchanged. The projections of local authorities' self-financed expenditure (outside the planning total) have been increased to take account of the sharp real growth in their spending in 1990-91 indicated by recent information about their budgets (see paragraph 5.03). The new projections of gross debt interest payments and accounting adjustments are consistent with the latest economic projections and assumptions. For 1993-94 it is provisionally assumed that general government expenditure will grow by 1½ per cent in real terms; expenditure plans will be settled in future surveys.

which are explained further in chapter 5,

x

Table 2.4 General government expenditure¹

	£ billion, cash					
	1988-89	1989-90	1990-91	1991-92	1992-93	1993-94
Public expenditure planning total	145.5	162	179	192	203	215
Local authorities' self-financed expenditure ²	10.2	13½	13½	13½	14½	14½
Central government debt interest	17.5	18	17	15½	14½	14
Accounting adjustments	4.9	4	3½	3½	4½	5
General government expenditure^{3, 4}	178.1	198	213	224	237	248
Privatisation proceeds	7.1	4	5	5	5	5
General government expenditure excluding privatisation proceeds	185.2	202	218	229	242	253

¹ For 1988-89 to 1992-93, the figures are taken from chapter 5.

² See footnote to table 5.1.

³ General government expenditure, privatisation proceeds and the public expenditure planning total are rounded to the nearest £1 billion from 1989-90 onwards; local authorities' self-financed expenditure, debt interest

and accounting adjustments are rounded to the nearest £½ billion, as in Chapter 5. General government expenditure excluding privatisation proceeds is assumed to grow by 1½ per cent in real terms in 1993-94.

⁴ General government expenditure includes debt interest payments to other sectors as follows (£ billion):

1988-89	18.0	1991-92	16
1989-90	18½	1992-93	15
1990-91	18	1993-94	14½

Revenue

2.51 The Government's objectives for taxation are to reduce tax rates and bring down tax as a percentage of GDP. Much progress has been made in reducing tax rates and reforming the structure of the tax system, and the ratio of tax to GDP has fallen from the peak of 1981-82. In the second half of the 1980s the ratio was broadly unchanged, in spite of substantial cuts in tax rates, reflecting in part cyclical increases in revenue. The rise in the ratio compared with the end of the 1970s reflects the elimination of borrowing: expenditure is now more than covered by taxation and other government receipts.

Table 2.5 Non-oil taxes, national insurance contributions and the community charge as a per cent of non-oil money GDP^{1,2}

1964-65	29½	1974-75	35½	1984-85	37½
1965-66	31½	1975-76	36	1985-86	37
1966-67	32	1976-77	36	1986-87	37½
1967-68	33½	1977-78	35	1987-88	37½
1968-69	35½	1978-79	34	1988-89	37
1969-70	37	1979-80	35	1989-90	37 (37)
1970-71	36½	1980-81	36	1990-91	37½ (37)
1971-72	36½	1981-82	38½	1991-92	36½ (36)
1972-73	32½	1982-83	38	1992-93	36½ (35½)
1973-74	33½	1983-84	37½	1993-94	36½ (36)

¹ 1989-90: latest estimate; 1990-91: forecast; 1991-92 onwards: MTFs projections (after fiscal adjustment).

² Ratios in brackets adjust for the distortion arising from the abolition of domestic rates. This is explained in the box on page xx.

2.52 The growth in government revenues over the medium term will depend on the growth of incomes, spending and prices. It will also depend on policy decisions, including measures announced in this year's Budget and other measures that will be implemented over the period, such as the introduction of independent taxation for husbands and wives. Taking

account of these factors, non-North Sea revenues may rise less fast than money GDP after 1990-91, even before allowing for any tax cuts in future Budgets. North Sea revenues are not expected to change much over the medium term.

Table 2.6 General government receipts

	£ billion, cash					
	1988-89	1989-90	1990-91	1991-92	1992-93	1993-94
Taxes on incomes, expenditure and capital ¹	144.7	158	169	175	185	195
National insurance and other contributions	33.0	33	36	38	40	43
Interest and dividends	6.5	7	6	7	7	6
Other receipts	5.5	6	7	7	7	7
General government receipts²	189.7	204	218	227	239	251
of which						
North Sea revenues	3.2	3	3	3	3	3

¹ Includes the community charge from 1989-90 onwards.

² General government receipts, and its components, are rounded to the nearest £1 billion from 1989-90 onwards.

Public sector debt repayment

2.53 The projections of government expenditure receipts are brought together in Table 2.7 to provide projections of the general government debt repayment (GGDR), the PSDR and the fiscal adjustment.

2.54 Changes since the 1989 MTFS are discussed in annex B of this chapter.

Chart 2.8 Public sector borrowing requirement¹

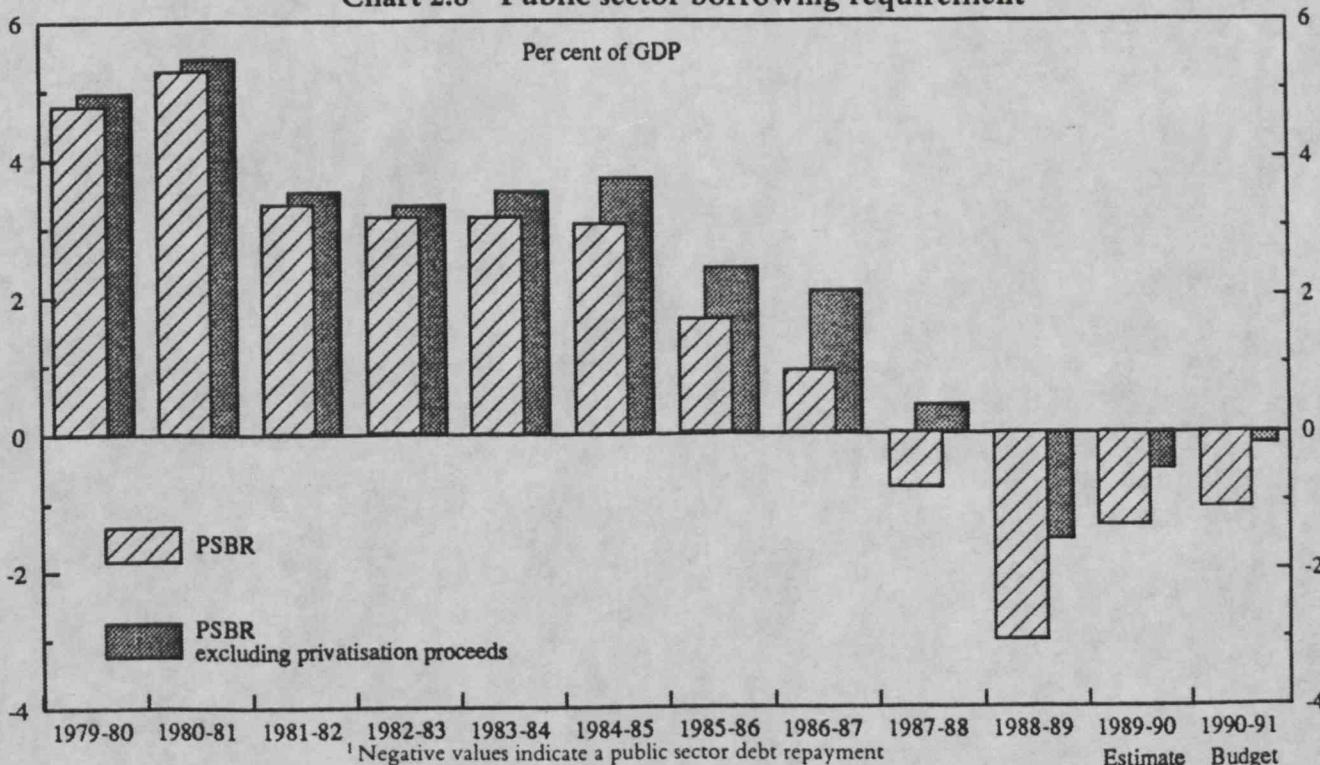


Table 2.7 Public sector debt repayment

	£ billion, cash					
	1988-89	1989-90	1990-91	1991-92	1992-93	1993-94
General government receipts	189.7	204	218	227	239	251
General government expenditure	178.1	198	213	224	237	248
Fiscal adjustment from previous years ¹	—	—	—	—	1	2
Annual fiscal adjustment ²	—	—	—	1	1	1
GGDR	11.5	6	5	2	0	0
Public corporations' market and overseas debt repayment	3.0	1	1	0	0	0
PSDR	14.5	7	6	2	0	0
Money GDP at market prices ³	476.7	515 (516)	544 (555)	580 (592)	616 (628)	652 (665)
PSDR as per cent of GDP	3	1½	1	½	0	0

¹ Rounded to the nearest £1 billion from 1989-90 onwards. Further details for 1990-91 are provided in Tables 1.2 and 6.9

² Means lower taxes or higher expenditure than assumed in lines 1 and 2.

³ Figures in brackets adjust for the distortion arising from the abolition of domestic rates. This is explained in the box on page xx.

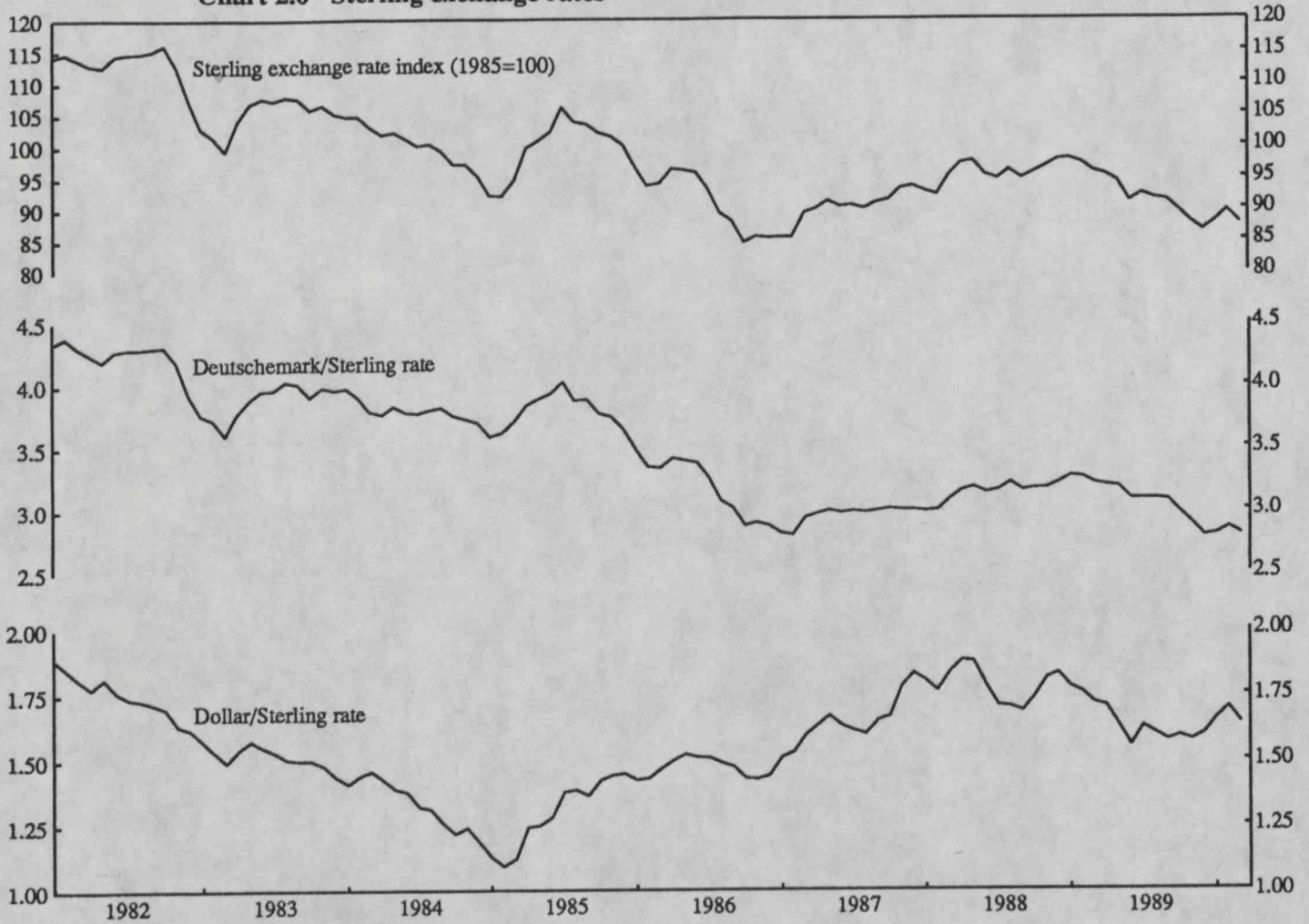
Summary

2.55 This chapter has discussed the Government's economic policy intentions and reaffirmed the Government's determination to bring inflation down.

2.56 There have been clear signs in recent months that the economy has been slowing down under the influence of tight monetary and fiscal policies, and it is likely to grow at well below its sustainable rate over the next year. Against this background inflation should fall sharply. The period of slow growth is also likely to see a contraction of the recent large budget surplus. Tight monetary and fiscal policies will be maintained over the period covered by the MTFS so as to achieve the deceleration in money GDP set out in table 2.1.

2.57 The Government will continue to set a target for M0. It is not setting a target for broad money, but as in the past will take a range of indicators, including the exchange rate, into account in assessing monetary conditions. The Government sees membership of the Exchange Rate Mechanism of the EMS, once its conditions have been met, as complementary to the MTFS policy framework.

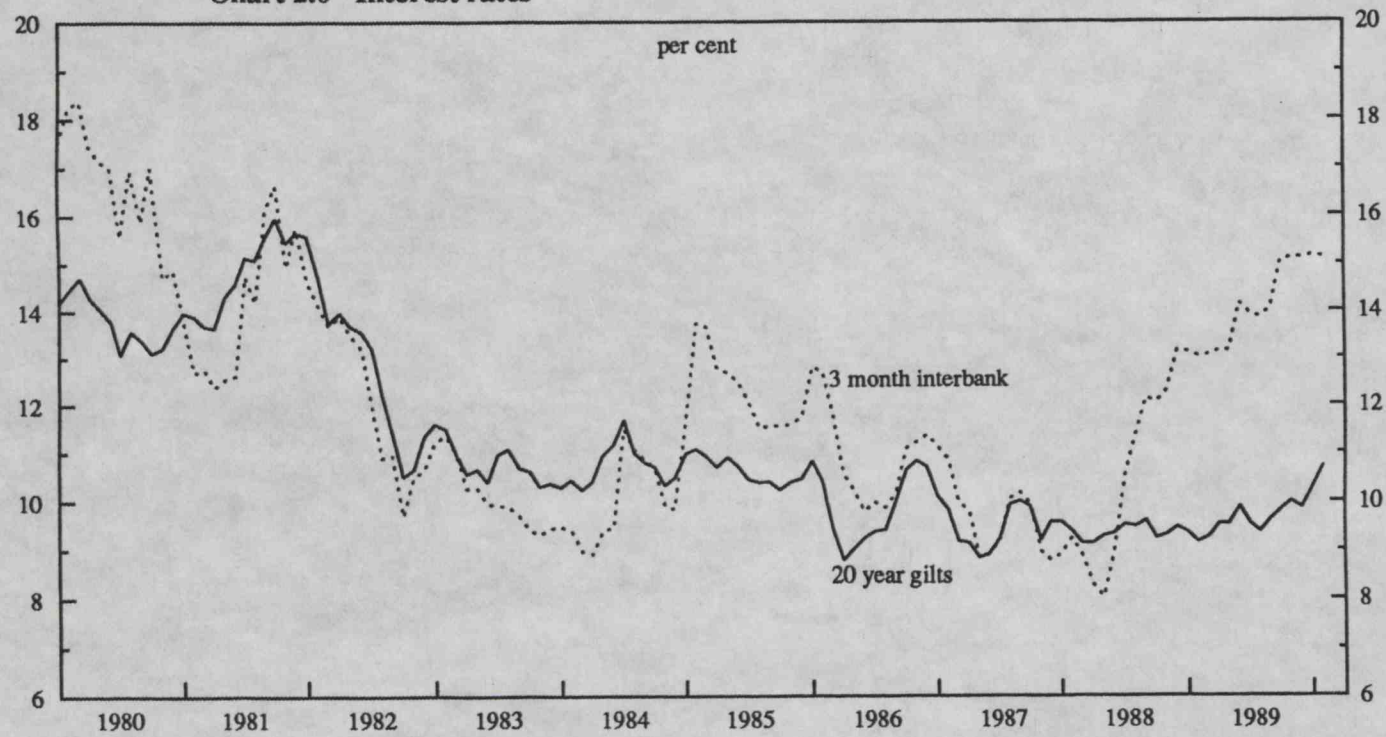
Chart 2.0 Sterling exchange rates



(for possible insertion after para. 2.37)

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Chart 2.0 Interest rates



(for possible insertion after para 2.42)

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Annex B to Chapter 2

Changes since the 1989 MTFS

Money GDP 2B.1 After adjusting for the distortion arising from the abolition of domestic rates, the growth rate of money GDP is expected to be a little higher in both 1989–90 and 1990–91 than envisaged in last year's MTFS, with growth in the GDP deflator $\frac{3}{4}$ percentage point higher in 1989–90 and 2 points higher in 1990–91. Inflation is projected to remain above last year's path but with the difference from last year falling to 1 percentage point by 1992–93. The projected trend in output growth over the medium term in the whole economy is the same as in last year's MTFS.

Table 2B.1 Money GDP growth

Differences from 1989 MTFS projections, percentage points			
1989–90 ¹	1990–91 ¹	1991–92	1992–93
+ $\frac{1}{2}$ (+ $\frac{1}{2}$)	– $\frac{1}{2}$ (+1 $\frac{1}{2}$)	+ $\frac{1}{2}$	+ $\frac{1}{2}$

¹ Figures in brackets show the comparison after adjusting for the distortion arising from the abolition of domestic rates (see the box on page xx).

in 1989-90, 1 percentage point higher than

Monetary aggregates 2B.2 M0 growth has from earlier peak levels declined but has remained above its target range. The target range for 1990–91 is the same as the illustrative range given last year. *The illustrative ranges for subsequent years are also the same. Illustrative target ranges for future years have also been adjusted.*

Table 2B.2 Growth of M0

	Percentage changes on a year earlier			
	1989–90	1990–91	1991–92	1992–93
1990 MTFS	5 $\frac{1}{2}$	0 to 4	0 to 4	–1 to 3
1989 MTFS	1 to 5	1 to 5	0 to 4	0 to 4

Fiscal projections 2B.3 Table 2B.3 shows changes in the fiscal projections since the 1989 FSBR. Additional information on 1989–90 is given in Chapter 6.

Expenditure 2B.4 The planning total outturn in 1989–90 is discussed in Chapter 5. The planning totals for 1990–91 onwards are as in the public expenditure White Paper (Cm 1001–1021); this year's MTFS is the first to show the planning total on its new definition. The cash general government expenditure figures for the future have been revised up since last year.

Receipts 2B.5 Revenues in 1989–90 have in total been somewhat lower than forecast. Income tax receipts were higher, but corporation tax receipts were lower, as were National Insurance contributions, reflecting about £2 billion more personal pension rebates than forecast. Revenues over the next two years or so will be affected by growth in the economy falling below the rate assumed in the 1989 MTFS. The revenue projections this year for the first time reflect the introduction of the Community Charge.

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Table 2B.3 Revenue and expenditure¹

	Changes from 1989 MTFS projections, £ billion				
	1988-89	1989-90	1990-91	1991-92	1992-93
1 General government expenditure	-1	+4	+7½	+8	+13
<i>Receipts²</i>					
2 North Sea taxes	0	0	0	0	0
3 Other taxes and contributions	+½	0	+5½	+4	+7
4 Other ³	-1½	-2½	-2	-1	-½
5 General government receipts	-1	-2½	+4	+2½	+6½
6 Implied cumulative fiscal adjustment ⁴	—	—	-½	-1½	-3½
7 Public corporations' market and overseas debt repayment	+1	-½	-1	0	0
8 PSDR	+½	-7	-4	-4	-3

¹ Rounded to the nearest £½ billion. There have been no significant classification changes made since the 1989 FSBR.

² The allocation of tax receipts between North Sea and other is affected by the treatment of advance corporation tax set off.

³ Includes changes in debt interest and other items.

⁴ Line 6 = lines 7-8-1+5.

Annex A to Chapter 2

Funding policy

2A.1 Funding policy determines how the public sector manages its debt. When there is a PSDR, decisions have to be made about how to use the surplus: what debts to repay, or what financial assets to buy. When there is a PSBR decisions have to be made about how the deficit is to be financed. Despite the substantial debt repayment of recent years, and the consequent fall in the ratio of debt to GDP (see chapter 6 for more details), gross public sector debt still amounts to around £190 billion. Public debt thus remains of significant size in relation to financial flows in the economy, and its management is clearly of considerable importance.

Underlying principles **2A.2** Three principles underlie the Government's funding policy:

- (a) it must support and complement monetary policy in pursuit of the Government's objectives for inflation;
- (b) subject to (a) it should operate in a way which avoids distorting to financial markets.
- (c) subject to (a) and (b) it should be conducted at least cost and risk.

The funding rule **2A.3** In recent years, the implementation of the first two of these principles has been embodied in the "full fund" rule that:

"The authorities will seek to fund the net total of maturing debt, the PSBR and any underlying increase in the foreign exchange reserves by sales of debt outside the banking and building society sectors."

2A.4 The monetary policy rationale for the rule is as follows. If the public sector spends more than it receives, so that it has a borrowing requirement, then funding policy should ensure that this is not financed by an addition to private sector money holdings. In particular the rule ensures that the PSBR is financed by means other than any increase in issue of notes and coin. It also means that the direct effect of a PSBR on broad money is neutralised, with none of it financed by net borrowing from banks and building societies.

2A.5 These same considerations apply, exactly in reverse when, as now, the public sector is in surplus. "Unfunding" in that case offsets the effect the surplus would otherwise have on narrow and broad money.

2A.6 Policy as it has been operated in recent years has therefore been designed to ensure that over time the potential effect of public sector borrowing or debt repayment on broad and narrow money has been offset. Operation of the full fund rule has also helped meet the second objective in paragraph 2A.2, limiting any distortions caused to the capital markets. If net sales of debt were greater than needed to fund the public sector's net borrowing needs—as they were for a period in the early 1980s—then the excess borrowing has to be recycled into a build up in the public sector's holdings of financial assets, such as commercial bills.

Redrafted paragraphs attached.

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2A.7 The operation of such a rule gives guidance to the markets as to how much debt the authorities can be expected to issue, or redeem, in relation to the development of the public finances generally. That increases the degree of market certainty, to the benefit both of investors in Government debt and of the Government.

Application of the rule in practice

2A.8 The funding rule cannot be applied rigidly. The aim has always been to achieve full funding over each financial year as a whole. Within the financial year, temporary under- or over-funding has occurred, depending on conditions at the time. The authorities have not regarded it as sensible to offset the effect on sterling liquidity of foreign exchange intervention operations by funding that intervention immediately or necessarily even within the financial year in which it occurs.

Money market position

2A.9 The authorities must also ensure that funding operations do not lead to money market conditions that complicate the arrangements for setting short-term interest rates—the essential instrument of monetary policy. In 1985 these arrangements were beginning to be undermined by the size of the authorities' holdings of bills, the "bill mountain" which reached a peak of over £17 billion. At that time market holdings of Treasury bills were only just above £1 billion. Since then, official holdings of commercial bills have fallen to [£5 billion] and market holdings of Treasury bills increased to [£10 billion].

2A.10 The main reason for this change in the money market position has been a swing in the position of the local authorities. Over the period since 1985, local authorities as a group have borrowed large amounts from the central government, through the Public Works Loans Board (PWLB), while at the same time putting capital receipts and other funds into the money market by repaying bank loans, and increasing their deposits with banks and building societies. A second factor tending to ease the money market position, and hence requiring an increase in the Treasury bill issue, has been the scale of net gilt sales in recent years by banks and building societies.

2A.11 The change in the local authority position may have related in part to measures taken in the early 1980s to ease the terms and conditions of borrowing from the PWLB, partly with the aim of reducing the scale of money market shortages at the time. The money market position is now very different. The Chancellor therefore announced on 15 February a range of measures intended to limit borrowing from the PWLB, particularly where authorities have investments available with which to finance their capital expenditure.

2A.12 This change should in due course allow a reduction in the size of the Treasury bill issue. But if necessary in the meantime the Government will adjust its funding operations, increasing gilt sales or reducing gilts purchases, so as to prevent an excessive increase in the Treasury bill issue. This would involve a departure from the funding rule.

Other considerations bearing on funding decisions

2A.13 The general point is that no funding policy rule could provide a comprehensive guide to a sensible funding policy. Just as monetary policy itself cannot be a mechanical process, so the authorities must bear in mind a number of considerations in their funding strategy. The factors mentioned in paragraphs 2A.8–12 above may require temporary or longer-term departures from the funding policy rule followed in recent years. There are other considerations that affect the way public debt is managed, but which do not imply any departure from the overall guideline. In particular:

- (i) because the underlying intention is that the public sector does not finance itself by creating money, the authorities need to ensure that funding is not concentrated in very short term debt, where the public liabilities concerned have

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b some of the attributes of money and liquidity, even where these liabilities are not sold to banks and building societies. Treasury bills, which have such characteristics, no longer count as funding, even when sold to others than banks or building societies.

(ii) due regard must also be given to expected servicing costs. If the Government's medium and long term view of interest and inflation rates differs from that of the market as a whole, there will be implications for the type and maturity of debt that the Government wishes to issue or purchase;

(iii) but, equally, reducing risk is important both for the Government and investors. The existence of a range of maturities for debt issued in the past is helpful in this respect. Indexed debt also has the advantage of reducing uncertainty, for both the borrower and investor, about future real yields, and the proportion of gilts in indexed form has risen steadily since 1981;

(iv) because over the longer term the Government will have continuing borrowing or refinancing needs, it is in the general interest that the gilts market retains adequate capacity and liquidity. The series of conversion operations designed to enhance market liquidity have proceeded well and they will be continued.

~~2A.14 Such considerations do not always point in the same direction and some must be given heavier weight than others in determining funding decisions.~~

~~Conclusion 2A.15 Funding operations will continue to be guided by the full fund rule, as they have been over the past few years. But the authorities will be prepared to depart from what the rule formally would require when circumstances warrant it. That will require, as it has in the past, the exercise of judgement by the authorities—a judgement that will be based on the underlying principles set out in paragraph 2.~~

2A.5. In the early 1980s, the authorities went beyond this policy of full funding. They deliberately "overfunded", that is issued more debt than the Government needed to fund its borrowing requirement, in an attempt to reduce the growth of broad money. But experience showed the shortcomings of this policy. With sales of debt greater than the public sector's net borrowing needs, the excess had to be re-cycled into a build up in the public sector's holdings of financial assets, such as commercial bills. Rather than proving of practical benefit, sustained overfunding made monetary policy increasingly difficult to operate. It also created undesirable distortions in the financial markets, discriminating in particular against long term private sector borrowing for investment.

2A.6. So, in summary, policy as it has been operated in recent years has been designed to ensure that over time the potential effect of public sector borrowing or debt repayment on broad and narrow money has been offset. Operation of the full fund rule has also helped meet the second objective in paragraph 2A.2, limiting any distortions to the capital markets. This applies whether the public sector is in deficit or surplus. When there is a surplus, as now, the rule requires the public sector to repay debt - "unfunding". The alternative of using the surplus to acquire assets would amount to overfunding which, if sustained, would have the same adverse effects as in the early 1980s.