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PRIME MINISTER

ECONOMIC POLICY OVER THE NEXT YEAR

Perhaps I could leave you some valedictory thoughts on economic management over the next year or so. Some of the points have a bearing on the issues you will be discussing with the Chancellor next week.

The note is in three parts:

A. what went wrong?
B. where are we now?
C. where do we go from here?

A. What Went Wrong?

We have discussed several times the errors over the last two to three years. But it may be helpful, with the benefit of hindsight, to summarise the key issues; because there are morals to be drawn for the future.

Ever since 1985 the Government - and most outside commentators - have under-estimated the impact of three inter-related factors:

a) the effect of financial deregulation on ordinary peoples' ability and willingness to borrow. In the early 1980s it was still quite hard work for people to borrow from banks and building societies; managers made people think they were doing them an enormous favour granting a mortgage or a loan. Financial deregulation has changed all that; potential lenders are now queuing up to lend to anyone with any kind of security to offer.

b) For most people that security is their house. Two-thirds of people now have that asset. And the housing boom meant that most people now have an asset whose value is substantially higher than the existing debt secured on it. This meant lenders were very relaxed about increasing secured loans; and potential borrowers quickly cottoned on to how easy it was to raise extra money. For those with mortgages below £30,000 - still very much the majority in the mid 1980s - there was the added tax incentive.

c) The success of supply side policies and the turnaround in the economy meant that people felt much more confident about spending and borrowing; and less concerned about saving for a rainy day. Indeed by 1987-88 more and more people believed that the economic cycle was a thing of the past and that growth (including rising house prices) would carry on indefinitely.

These three factors combined to make private sector expenditure much more buoyant. And it was just when that effect was at its peak that the main policy errors were made. These arose both in:

(i) Fiscal Policy. Even though we moved into a large fiscal surplus it was probably not big enough. Indeed it was unplanned and arose only because of the cyclical position. The private sector was running such a large deficit that - temporarily - we should have run an even bigger fiscal surplus. That is not to say the supply side reforms in the 1988 Budget were wrong; far from it. But the overall stance of that Budget, eg on excise duties, was too loose. And there was no doubt that people did increase their spending plans in 1988 partly as a result of it. This added to the inflationary pressures and the leakage into imports and a trade deficit.

(ii) Monetary Policy. This was the <u>big</u> problem. The former Chancellor could not have picked a worse time to reduce interest rates. To my mind that was a far bigger mistake than the heavy intervention (although I would not want to defend that either). Interest rates are the touchstone of overall monetary policy. And given the very high "demand

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for money" (excuse the economic jargon) resulting from the factors described above, interest rates (the price of money) should not have been allowed to drop below, say, 12 per cent at any point. But in fact they were lower than that all the way from early 1986 to mid 1988.

B. Where Are We Now?

The present state of the economy is still very hard to read. Demand is surprisingly resilient, but I think it is clearly slowing down. Indeed if it were slowing more than it is, the threat of a recession would be very great. I would guess that the higher community charges to finance greater than planned local authority spending could on balance restrain demand a bit further. And hopefully the stagnation in the housing market will provide a salutary lesson for personal borrowers.

The key problems are the monetary aggregates and retail prices. Broad money will stay difficult to interpret, particularly as some of the new savings measures will increase it. Narrow money needs to decelerate but, with inflation higher than expected, the 1 - 5 per cent target range is pretty tight.

I will not dwell on the RPI, which you are rightly concerned about because of the effect it could have upon wage bargaining etc. But however great the short-term problems, I continue to caution against trying to change the index now. It won't improve people's perceptions of inflation, and you will add to the problems by attracting charges of fiddling the figures. Better, I believe, to explain the oddities of the RPI and take the benefits as they unwind next year.

As to policy adjustments, a key point is that the economic indicators we are seeing now have been influenced by the policy actions in 1988, and possibly 1987. The lags are long. And if the present policy levers are held still until you are sure they are working, changes will have been left too late. If you are to get the timing of changes to interest rates right, at some point you will have to take a bit of a gamble.

C. Where Do We Go From Here?

My present guess is that interest rates ought to be reduced before the end of 1990. I do not think you should move before the summer. That would be too soon and would give very much the wrong signal - both to the markets and to private sector - against the background of a high RPI.

The choice may lie between bringing rates down in late summer/early autumn or leaving it until nearer the year end. But whenever you start the process it will be crucial not to allow rates to fall too fast or too far. In my view you should not be contemplating rates below, say, 12 per cent at any point in the next 12-18 months.

The handling of interest rates will be inextricably linked to the ERM. I share your instinctive worries about fixed exchange rate systems. But the fact is that, since the markets believe that sterling's membership of the ERM would give overall economic policies greater credibility, then it will, at any rate for a period. The Chancellor is right to say that the prospect for achieving some reduction in interest rates over the next year will be considerably enhanced by being in the system rather than outside it. There is a good case for linking the date of entry closely to the point at which you decide it is safe to reduce interest rates.

But the main danger of ERM membership later this year is that, because for a period this will give the markets greater confidence in sterling, there could be strong pressures to reduce interest rates more than is prudent on domestic grounds. You must resist that, and so avoid a repeat of the early 1988 mistake.

That means ensuring that the Chancellor will agree, once we are a member, to insist on a revaluation of sterling if there is strong market pressure to push it up.

To revert to timing. If you judge that it is appropriate before the end of this year both to start to bring interest rates down and to join the ERM there seem to be two main possibilities:

a) late September/early October. There may just be enough of a drop in the RPI by then, and you could seize the initiative in the Party Conference season and before Parliament reassembles.

b) around the time of the Autumn Statement in November. This would come before the IGC, and so strengthen the UK's hand there. And this could be a good time to give policy a greater credibility in market terms because you may be forced in the Autumn Statement to present some uncomfortably high public expenditure numbers.

I make this last point because I believe the Chief Secretary was right the other week to stress just how difficult the public spending round will be.

I know the Treasury always says this. But I judge this year will be by far the most difficult since the early 1980s, both because of the cyclical effects and the strength of the pressures for more spending on politically sensitive programmes. And this will be the more difficult to handle because I do not think that the public sector surplus this year will turn out to be as high as the £7b forecast. We have constantly under-estimated the extent of the swings in the PSBR, and my guess is that, net of the £5b allowed for privatisation proceeds this year, we could well be running a deficit before the end of 1990-91. So you must be cautious on fiscal as well as monetary policy.

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