10 DOWNING STREET

Prime Minister ²

These people are usually quite hostile to the Government.

But there is a good deal in what they say here.

DRN
28/10.

[illegible]

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Phillips & Drew
ECONOMICS UNIT
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STERLING THREAT TO CHANCELLOR'S TAX HOPES

The question now is whether Mr Lawson can get away with a pre-election tax-cutting budget. Our answer is that he can, but only if he now restores financial market confidence in the pound. To achieve that, still higher interest rates will probably be required in the months ahead.

In the run up to the 1987 Budget, Mr Lawson will face three related problems. The first is the state of the budget arithmetic. The second is the state of the economy. The third is the state of the Medium Term Financial Strategy.

As expected, this year's spending discussions, now in final session, are going none too well. They should have been painless. Included within the £144bn public expenditure planning total for 1987/88 is an abnormally large £6¼bn contingency reserve. Yet probably up to £5bn of that reserve has already been absorbed by extra agreed spending, especially for local authorities. The reserve is likely to be too small, even before extra spending in areas like health and education. We expect the planning total to be exceeded by £3bn in 1987/88 - and that could be a conservative estimate. At the same time, the Chancellor wants to cut the basic rate of income tax. In his 1986 Budget, the Chancellor gave away £1bn and he will surely want to do considerably more - say £3bn - in a probable election year. He will be helped to a degree by the buoyancy of non-oil tax receipts. The likelihood is, however, that public borrowing will grow again next year as sizeable tax cuts combine with public spending over-runs. The public sector financial deficit - struck before deduction of privatisation receipts - could well be around £14bn in 1987/88. This is worrying.

It is worrying when there is already mounting evidence that the economy is beginning to overheat. Next year, on-shore growth (GDP less oil) is likely to exceed 3% - well in excess of the economy's productive potential. At the same

time, labour markets will be tightening, pay will fail to moderate significantly, consumer spending will remain robust with the saving ratio falling and the balance of payments on non-oil as well as oil account will get worse. We project a £3bn deficit on current account next year, rising to £4½bn in 1988. It is no use relying on sterling depreciation to correct these current account deficits when domestic demand continues to outstrip supply. The only answer is to cool the economy down. In normal circumstances, this would mean a tighter budget, even November measures. Yet the Government wants the growth in order to produce a vote-pulling reduction in unemployment, even though this means accepting a pick up in inflation. The gameplan therefore will be to leave fiscal policy lax and hope the pound remains reasonably firm to contain inflationary pressure. The distinct danger is that this policy combination will prove untenable with sterling continually under threat. The first task for Mr Lawson, therefore, between now and the Budget is to restore financial markets' confidence in the pound and in his stewardship of the economy.

Yet financial confidence will not return easily while the MTFS continues to disintegrate. In place of the earlier vision stands muddle and uncertainty. To ditch £M3 targets in circumstances when even non-monetarists are beginning to worry about monetary excess smacks of a desire to bundle away dirty washing. More seriously, markets are increasingly in doubt about the Chancellor's intentions on sterling. On our calculations, it continues to be below the bottom end of the Treasury's oil-adjusted target range, probably 70 to 75 on the index. With EMS ruled out, markets have begun to see the MTFS as a policy of Muddling Through with Feeble Sterling.

This is not helpful background. It will take a major effort to convince markets that Mr Lawson is back in charge as a sound money Chancellor. A further sharp rise in interest rates will be required, and is assumed in our forecast. By the end of 1987, this tightening will help produce an inflation rate of 4½% combined with falling unemployment, good growth and sizeable tax cuts. An electorally-attractive package. But if Mr Lawson gambles on the pound and loses, his hopes for a large tax-cutting budget will be undermined and inflation will be over 5% this time next year. The stakes are now very high.

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