



GR
celu.
1. Dph - to see
2. LF - p.c.

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

RCCG
21/7

27 July 1989

Paul Gray Esq
10 Downing Street
LONDON
SW1A 2AA

Prime Minister 2

mb

RCCG
22/7

Dear Paul,

CHANCELLOR'S END-OF-TERM LETTER

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

Yours,

Moira

MOIRA WALLACE

26 July 1989

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

The most welcome development over the past twelve months has been the continuing investment boom, particularly in manufacturing. Manufacturing investment grew by 14½ per cent in 1988, and total business investment by 15½ per cent. And the latest DTI Investment Intentions Survey in June projected a further 15 per cent rise in manufacturing investment in 1989.

As a share of national income, business investment is now higher than at any time since records began. Whereas we were near the bottom of the European investment growth league in the '60s and '70s, in the 1980s we have been at the top. When I announced the reform of business taxation in my 1984 Budget there were fears in some quarters that this might discourage investment. In the event, not only has investment surged ahead, but its quality has improved out of all recognition, as is shown by the dramatic improvement in the return on capital employed.

But, while the investment boom is wholly welcome, and bodes well for the future, total spending in the economy has been growing too fast, and that in turn has led to an increase in inflation. Bringing inflation down is and must remain our top priority. Hence the need for high interest rates.

Our experience over the past year has in fact broadly mirrored that of the rest of the industrial world. The world economy shrugged off the effects of the October 1987 stock market crash with far more resilience than anyone foresaw at the time. The crash led to widespread predictions of a return to the slump of the 1930s. But Governments acted swiftly to cut interest rates and preserve confidence, and in the event the world economy has

continued to forge ahead. This easing of monetary conditions in the aftermath of the crash may have contributed something to the subsequent worldwide pick-up in inflation, but the damage that would have been done if confidence had been lost would have been severe. More recently, other countries, too, have been responding to the pick-up in inflation by raising interest rates.

In the UK, the rise in inflation has been exaggerated by the inclusion, contrary to the general practice overseas, of mortgage interest payments in the Retail Price Index. The RPI excluding mortgage interest payments provides a better guide to the underlying position, and shows that the inflation rate in June was 5.9 per cent: still too high, but less than one per cent higher than it was last July - less than the comparable rise in other major countries over the same period. It is worth recalling too, that under Labour the average underlying rate of inflation was 15.6 per cent, and the lowest rate they ever achieved was 7.7 per cent.

Along with a rise in inflation, the rapid expansion of demand over the past two years has shifted the current account into substantial deficit. But it is important not to confuse our priorities: high inflation is the one real threat to our continued economic success, and the need to get inflation down is both urgent and paramount. By contrast, we have no difficulty financing a current account deficit of the present size, if need be for a considerable period, provided we maintain sound financial policies, as of course we shall. In time, as the economy slows down and as the new capacity which will follow the investment boom comes on stream, the current account deficit will decline. But in the shorter term, the investment boom has itself played a major part in the increase in the current account deficit: fully three quarters of the increase in manufactured imports in 1988 consisted not of consumer goods but of production and investment goods.

The sound financial policies we need encompass both a firm monetary policy and a tight fiscal policy. On the fiscal side, the public finances have been transformed beyond recognition, with decades of borrowing replaced by a substantial budget surplus. For the time being, it is essential that we keep it that way. The Budget surplus is not a pot of gold that we can dissipate at will. In present circumstances it is a necessary buttress against inflation. At the same time it enables us to repay debt, thus benefiting future generations.

We must maintain a firm monetary policy too. That means keeping interest rates as high as is necessary for as long as is necessary. I recognise the difficulties this causes for those with sizeable mortgages, and for many farmers and small businessmen; but the damage that would be done if we were to relax our anti-inflationary stance would be far worse. Given that mortgages account for some 85 per cent of total household borrowing, there is simply no way to curb the growth of credit and bring down inflation without increasing the cost of mortgages. And it is too often overlooked that higher interest rates benefit those with savings, particularly pensioners.

This is not the first time we have faced a rise in inflation and have had to raise interest rates firmly to counter it. In 1985,

too, base rates had to rise to 14 per cent, and this successfully brought inflation back down and laid the foundation for the subsequent four years of strong growth.

There is now clear evidence that high interest rates are again succeeding in damping down the inflationary pressures. Consumer spending has slowed considerably, and the somewhat feverish rise in household prices has been stopped in its tracks. As a result it now looks very much as if inflation may already have peaked. But we need to see a sustained fall, and it is clear that we must persist with tight financial policies until that is achieved.

At the same time, we must press ahead with the policies that have transformed the supply side of the economy - including tax reform, deregulation, privatisation and promoting a wider spread of ownership. Among the measures yet to come into effect are the reform of employees' national insurance contributions and the abolition of the pensioners' earning rule in October.

The policies that have transformed the British economy in the '80s will provide the foundation for further progress in the '90s. In the '80s we have seen Britain go from the bottom of the major European growth league to the top; we have seen manufacturing productivity grow faster than in any other major industrial country, including Japan; we have seen a record number of new businesses starting up; and, more recently, we have seen the benefits coming through in a sharp fall in unemployment to well below the European average. Living standards have risen markedly at all income levels. And the North has participated in this transformation just as much as the South.

So provided we persevere with sound financial policies, the prospects for the rest of this Parliament, and beyond that for the rest of the 1990s, look good. The tough measures we have taken over the past year are our passport to further success in the future.

NIGEL LAWSON