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From the Private Secretary

c: Chancellor

Subject cc Master

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BILATERAL WITH THE CHANCELLOR

The Prime Minister and the Chancellor held their regular weekly bilateral discussion yesterday.

The Chancellor said that the pound had drifted a little lower over the last week and in particular over the weekend. But the Bank of England were convinced that there was no fundamental weakness. The pound had moved above its central rate during the course of the day, following release of the much improved monthly balance of payments figures.

There continued to be some Press criticism of the Government's decision to enter the ERM and to cut interest rates on 5 October. Several newspapers seemed to have forgotten their earlier articles in support of immediate entry and cuts, often larger cuts, in interest rates. The Chancellor had asked his Press Office to contrast and analyse the lines taken by certain newspapers on ERM entry and interest rates before and after 5 October. But he was convinced that the Government had made the right decision on the timing of both entry to ERM and the reduction in base rates to 14 per cent. The latest CBI survey, to be published shortly, would show clear evidence of weakening in economic activity.

Looking forward, it was too early to say when it might be appropriate to make a further reduction in interest rates. There was however no reason to expect that the sterling exchange rate would be an obstacle to further cuts. Experience had rapidly been gained on the working of the ERM: with the Spanish peseta stuck firmly at the top of its ERM band, in practice the UK might have to intervene to keeping sterling within its bands at an exchange rate of DM2.87. Indeed the Germans had had to intervene twice in recent months to keep the DM within its bands, because of the exceptional strength of the peseta.

The Prime Minister and Chancellor then discussed the public expenditure round and its implications for the fiscal stance. The following were the main points made in their discussion.

i) All but the defence programme were now settled - but defence was proving difficult. The Prime Minister said that no significant cut could be achieved in the first year given the present uncertainty in the Gulf. That would send quite the wrong signal. The Chancellor considered however that it was particularly important to keep down the third year settlement and show a declining profile for defence spending to illustrate the gains made from improved international security.

ii) The outturn on public spending was likely to be a planning total for 1991/92 fractionally above £200 billion. This was about the present market expectation. But it nonetheless represented a large increase in resources devoted to public spending.

iii) It would therefore be important to present the PES settlement carefully. The forecast GGE/GDP ratio for next year would remain under 40 per cent, though it would show a small increase on the forecast outturn for 1990/91. In effect the whole increase could be accounted for by non-discretionary bids. The discretionary bids accepted by the Chief Secretary would be fully covered by the reduction in the reserve figure for 1991/92 compared to that published in this year's Public Expenditure White Paper.

iv) The outcome on public spending would be seen as weakening the fiscal position. Tax revenues might also be relatively depressed, particularly because of a lack of buoyancy in asset and profit related taxes. A small PSBR was currently projected for next year - though this might be covered by increased privatisation proceeds.

v) One possible response might be an increase in national insurance contributions (NICs) announced at the time of the Autumn Statement. But the prospects for the National Insurance Fund were much improved relative to a year ago; so there was no particular reason to raise NICs. Moreover an increase on employers' NICs would be difficult given present pressures on the private sector; and an increase on employees' NICs would be unpopular. An increase in NICs at this point could not be justified.

vi) It would be necessary to look again at the revenue side at Budget time. It might well be desirable to raise extra revenue next year: but the options were limited. It could not be done by over-indexing excise duties because of the adverse effect on the RPI. But it might be possible to aim for a freeze or under-indexation of certain tax allowances, for example the married couples allowance. There could be no question of a cut in tax rates next year.

Finally, the Chancellor and the Prime Minister had a brief discussion on the Treasury's latest economic forecast. The following were the main points which emerged.

i) The outturn community charge in England next year was likely to be higher than that forecast by the Department of the Environment. The assumption which local authorities made about rates of collection would be important in determining the likely outcome. The average community charge projection was highly sensitive to variations in that assumption. A further discussion with the Environment Secretary on this matter was planned.

ii) Although only a small PSBR was projected for next year (which might as noted earlier be covered by further privatisation proceeds) the projection for 1992/93 indicated a larger PSBR of around £9 billion. The forecast could change. But it could pose an unappetising policy choice later between generating higher revenue or asset sales and a return to public borrowing.

iii) The projected size of the corporate sector financial deficit was unprecedented. Deregulation would help with more imaginative ways of financing the expected deficits. But it was just as credible that the company sector would take action to reduce deficits, rather than seeking clever ways of financing them. This would lead to lower investment and greater destocking than projected. The forecast already showed growth patterns which implied a technical recession i.e. zero or negative growth for three successive quarters: measures to contract the financial deficit by the corporate sector would deepen the projected downturn.

iv) The projections showed that in 1992/93 the balance of payments deficit would begin to increase again after the expected contraction in 1991/92. If that was to be avoided, it would be necessary to achieve a substantial shift in resources away from domestic consumption and towards higher net exports. If that shift were not realised, there would be a risk of downward pressure on the exchange rate.

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