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PRIME MINISTER

PUBLIC EXPENDITURE 1984-85

Peter Rees is sending you today the paper on public spending he proposes to circulate for the 5 July Cabinet.

2. I also have it in mind to circulate the usual short background paper on the economic prospects. I attach a draft. It is designed to provide a context for the Cabinet's discussion of public spending.

3. My paper does not, because of the risk of leaks, reveal in detail the latest Treasury forecast. Although the forecast suggests a PSBR outturn this year lower than that projected at Budget time, this is due to an expected rise in tax revenue (chiefly from the North Sea). The public expenditure position remains very worrying indeed. When I minuted you last month about this I said that the latest forecast suggested an overspend of £½ billion. That forecast has now hardened up, and - more disturbing still - there are a number of factors which could mean a substantially worse outcome. For example, there are new uncertainties about local authority expenditure, where we have just learned of a very large prospective overspend on capital in addition to the £1.8 billion overspend on current. Moreover, the forecast assumes that the miners' strike will be over at the end of July.

4. I hope that we can discuss later this week what action we need to take. I do not think it would be right to propose an across-the-board cash limits reduction, of the kind we

announced in July last year. But we will need stern decisions on the local authority front; and the case for an early electricity price increase to recoup the additional cost of oil burn is now, in my view, very strong indeed.

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(N.L.)
26 June 1984

CONFIDENTIAL

Draft

Economic Prospects

Memorandum by the Chancellor of the Exchequer

The outlook for United Kingdom growth and inflation over the next two years remains much the same as at the time of the Budget, but the pressures on the world economy from United States policies are a cause for continuing concern. At home, the main danger to an on the whole encouraging prospect lies not in the miners' strike, whose economic consequences have so far been modest, and will in any event be only temporary, but in the relentless pressure for higher public expenditure.

World economy

2. Growth in the world economy is proceeding much as expected, with recovery continuing in the major industrial countries. In the year ahead output may rise at a somewhat slower pace, with some slackening in the recent hectic pace of US growth more than offsetting a steady pick-up in Europe and Japan. This reflects the fact that with the exception of the UK which led the way out of recession, the recovery started rather later outside the US. Overall output in industrial countries may grow by around 4½ per cent this year.

3. Inflation among OECD countries now averages about 5 per cent, with particularly low rates - lower than our own - in the United States, Germany and Japan. It may remain at around that level for a while, with some slight rise in the United States offset by lower inflation in Europe.

4. Better growth, with continuing low inflation, is helping world trade. This is now recovering well and is expected to rise by around 6 per cent this year and next, with particularly rapid growth in imports into North America. The recovery will be especially welcome to the non-oil developing countries, whose rising export revenues should to some extent help to ease their debt problems.

5. But the international prospect remains a source of considerable concern. The heart of the problem is the high level of US interest rates - both nominal and real - resulting from the size and persistence of the US deficit. So long as it remains substantially unchecked, there will be a major question mark over the sustainability of the recovery. US interest rates have risen sharply in recent months, greatly exacerbating the international debt problem. This rise has been reflected, though to a much lesser extent, in many other countries, including our own, with some of the strain showing up in a further increase in the value of the dollar on the foreign exchanges.

UK economy

Actual growth could be ½ per cent less as a result of lower coal output

6. At home, underlying growth in output continues at around 3 per cent - ahead of most of Europe, and so far not greatly affected by the miners' strike.

7. The present recovery will soon have persisted for longer than any recovery since the war. As it continues, so its pattern changes. Personal spending has been growing strongly for two years, helped by lower savings and most recently by strongly rising personal real incomes. It may now slow somewhat, from 4 per cent last year to perhaps 2½ per cent this year, though consumer borrowing is still growing strongly. Companies are now in a better position than for many years as they benefit from improving productivity and only modest increases in unit costs. The ending of NIS in November will also help. Real rates of return

for non-North Sea companies are back to the levels of 1978-79; company liquidity is also at near-record levels; and, with a substantial recovery in profits, companies are now well placed to invest. After allowing for some effect from the Budget measures, fixed investment by industry may increase by some 10 per cent (at constant prices) this year, with another sizeable rise in 1985. On the other hand companies are likely to continue economising on stock levels, so no major restocking seems imminent.

8. The growth of total domestic demand may slow a little from 4½ per cent last year to 3 per cent this year. But, helped by growth in world trade, exports are now recovering strongly: the prospect is for an increase of 6 per cent this year, as against only 1 per cent last year. Overall, therefore, the prospect remains one of growth in UK total output this year of 3 per cent, the same as in 1983, and perhaps a similar increase in 1985.

9. Inflation remains firmly under control, at a shade over 5 per cent in May. At the Budget the increase in retail price inflation was forecast to edge down to 4½ per cent by the fourth quarter of this year, and that remains our best guess. Outside forecasters have tended to be less sanguine, but latterly most of them have been revising their forecasts downwards.

10. Lower inflation is not yet fully reflected in the level of pay settlements. Earnings growth remains obstinately high, probably reflecting a certain amount of pessimism among wage bargainers over the prospects for inflation, but also continued failure to recognise the vital link between pay and jobs. This is the most important single reason why it is proving more difficult to bring down unemployment despite steady expansion and low inflation. But there are some encouraging signs on the employment front. The total number of people in work has been rising for the past year, and is now some 250,000 higher than in early

1983, though the effect on the unemployment register has been masked because some new jobs have been filled by people who were not on the register and others by new entrants to the labour force. Overtime working remains high. But there is still little sign of the labour market producing either the greater flexibility or the lower labour costs needed to produce a significantly better outlook for jobs. The need for greater realism on pay is a message that must continue to be hammered home.

11. The financial markets are going through a difficult patch. This is chiefly because of understandable concern about the international outlook, but there has also been some nervousness about public sector spending and borrowing at home. At least so far as borrowing is concerned these domestic worries should recede as the year unfolds. Despite the recent rise in UK interest rates our short term rates are now more than two points lower than comparable US rates; and if US rates go higher, as in the short run they may do, we ought to be able to avoid following them upward - at least to the full extent. Domestic monetary conditions are satisfactory and, subject to the usual margins of error, the prospects for public sector borrowing this year and (given a satisfactory public expenditure review) next year remain broadly as forecast at Budget time. This year's borrowing profile is more than usually concentrated in the first six months of the year; but there are clear reasons for this and it is now becoming better understood by the markets.

12. Needless to say, the financial picture can change rapidly as we have seen before. But I see no need this year for corrective action of the kind we were obliged to take in July last year. Nevertheless, the public expenditure prospect for the current year is already looking very tight indeed, and it is essential that we maintain the firmest possible control of spending as the year proceeds.

13. Figures from the most recent Treasury forecast are shown in the attached table.

The prospects

14. It is always hazardous to try to look more than a year or two ahead in any detail, since our own progress can always be affected by developments in the rest of the world. But the prospects are unusually promising, provided we can maintain firm control over public spending. The task before us is clearly set out in the paper circulated by the Chief Secretary.

The immediate task

15. I do not underestimate the dificulties in sticking to our published plans. The pressures for higher public spending are intense, as we always knew they would be. If we concede to these pressures now we shall call into question the credibility of our policies in the eyes of nervous financial markets at home and abroad. Our determination to secure a more enterprising and vigorous economy by lowering the burden of taxation will become suspect. We should also make it more difficult to sustain the higher levels of growth needed to bring about more new jobs and a lasting reduction in unemployment. Reducing the tax burden is crucial to the whole thrust of our economic policies - and it is important that we begin the process early in this Parliament.

16. I urge my colleagues to agree to the Chief Secretary's proposals.

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