

Prime Minister '2(a-d)'<sup>a</sup>

8.12 in 1st and  
in April - Grant Vlog  
- Household  
- Food Prices



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

Unpredictable  
X down Rate - 11%

Are you content with  
the Chancellor's proposed  
speaking note? (I  
wondered whether it might  
be better not to  
be specific on the  
RPI - exclude 'x')

BHP  
18/4

PRIME MINISTER

2bn - overruns  
Grant levels

**PUBLIC EXPENDITURE AND THE ECONOMY: SPEAKING NOTE FOR CABINET**

We agreed yesterday that I should give colleagues a very frank assessment of the difficulties we will face if we relax our efforts to control public expenditure. The attached note by officials sets out the gist of what I will wish to say though I will work on it overnight and will no doubt wish to express it differently.

2. Given the pressures we face I am convinced that I will need to take a very tough line indeed. On past form some of this is likely to leak. I therefore also attach a draft line which, if you agree, Bernard Ingham and the Treasury press office could take in that eventuality.

L.A 10% p.c.

Inc. in benefits - on  
basic rate

|| Borrowing requirements ||  
|| Cost expenditure ||

[J.M.]  
18 April 1990



Overseas. LA's Pl. Total. £-3bn  
 Review - none left

£7bn  
 £5bn  
 £5bn

Notes for use in Cabinet public expenditure discussion

I made no secret, either in the Autumn Statement or the Budget, of the difficulties which lay ahead of us in 1990. Developments since the Budget have underlined the seriousness of these difficulties. The assessment - as we look ahead to the next Survey - is, I am afraid, gloomy.

2. Against this background, I am alarmed by the growing pressures on public expenditure, which could - if we do not recognise the need for quite exceptional restraint - call into question our whole economic strategy. At all costs, we must avoid being forced into raising taxes, unnecessarily raising interest rates, or seeing a sharp fall in the value of sterling. Yet if we concede increases in spending, one or more of these will be the result.

3. Demand is, without doubt, slowing down, as it needed to do, and has been slowing down for many months. But the whole process - and, crucially, any let-up in the rise in the underlying rate of inflation - is taking a good deal longer than we earlier might reasonably have expected and hoped that it would do. Colleagues will know that the RPI rose in March to 8.1 per cent. The April figure will rise sharply again [with the Community Charge adding 1.2 per cent to that figure and the non-revalorisation of excise duties in the 1989 Budget adding a further 0.55 per cent.]

4. More seriously, the underlying rate of inflation continues to rise, as it has done since the beginning of 1987. Although monetary policy was tightened in 1988 and 1989, our budget surplus was lower last year than the year before. Although the outturn is marginally better than in the Budget, it still looks set to be lower this year, and still lower next. By then, we will be back to a public sector borrowing requirement if asset sales are deducted. And the ratio of public spending to national income looks set to rise for the first time for many years.



5. The foreign exchange markets have so far just about given us the benefit of the doubt - although sterling is now 11 per cent lower than it was 12 months ago. The markets did not like the overspend of more than £2 billion on the planning total in 1989-90, and they regarded the PSDR as being towards the bottom of the acceptable range and they do not like to see headline inflation where it is and underlying inflation creeping up quarter after quarter.

6. I am acutely aware of the spending pressures we face, on many fronts. The greatest spending pressure comes from the community charge. I can illustrate the point very simply: if the aim were to keep the community charge unchanged in cash terms next year, and if it were assumed that we had the means of achieving that, and that local authority expenditure grows by 10 per cent next year, additional grant of £3½ billion would be needed - which is equivalent to 2½p on income tax.

7. So I must tell colleagues that our room for manoeuvre has disappeared. The markets will be watching closely for any sign of a new relaxation of policy, and I fear that if they once believe that we are embarking on further spending increases they will conclude that an offsetting tightening in monetary policy is inescapable, and very probably in the pipeline. We would then see higher market interest rates or a lower pound or more likely both.

8. That would bring with it a new crop of difficulties for us. To avoid that - or to avoid the other possibility, that I am driven by these market pressures to announcing that I will raise taxes in the next Budget in order to finance the extra spending - we will need to stick to our public spending plans, ruthlessly cutting out extra bids, and finding cuts below baseline where we judge an addition to be inescapable.

9. The Chief Secretary has, I know, some further points to make....



PRESS OFFICE LINE ON CABINET

Q. Is it true that there was some discussion of public expenditure at Cabinet this morning, and that the Chancellor had some stern words for colleagues?

A. Cabinet had a brief discussion of the prospects for the forthcoming Public Expenditure Survey, ~~as spending Ministers are beginning to get down to their Departmental budgets for next year.~~ Chancellor made it clear ~~that in the present economic situation~~ the room for manoeuvre in this year's expenditure Survey was much more limited than in any recent year. The Cabinet ~~recognised this and~~ reaffirmed the importance of tight control of public expenditure, agreeing that its success over the years in keeping a firm grip on spending had been of central importance in maintaining sound economic management. It resolved to take whatever tough decisions are necessary to stick to this course.

Delivery of the Chancellor's <sup>objectives</sup> ~~statements~~.  
- determined to reach the targets.

{  
DFI  
Treasury  
Sc.  
Welsh  
}

700,000 - phone out early  
eg us  
3 man. plus phone ?

722 16th mod<sup>2</sup> line