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13 July 1990

Barry Potter Esq
Private Secretary to the
Prime Minister
10 Downing Street
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Dear Barry

JULY CABINET

... I enclose a copy of the near final draft of the Chancellor's paper on economic prospects for Cabinet on Thursday, 19 July.

Yours

Kate

MISS K GASELTINE
Assistant Private Secretary

T.K
P.L.
G.H.
K.B.

CABINET

ECONOMIC PROSPECTS

Memorandum by the Chancellor of the Exchequer

The UK economic is still suffering the after-effects of the excessively fast growth in domestic demand that began in 1986 and continued through 1987 and 1988. By tightening monetary policy, and supporting this by a fiscal surplus, we have succeeded in restraining the growth of demand more recently and the current account deficit has begun to fall modestly as British producers have switched sales from domestic to foreign markets. But the adjustment has not been as rapid as we - or others - expected and inflation has continued to rise and has now reached quite unacceptable levels.

2. The large current account deficit and rising inflation have contributed to nervousness in financial markets at various times over the past year. The firming of sterling in recent weeks is welcome; provided it persists, it will help inflation over the next year, offering the prospect in due course of some reduction in interest rates. But confidence is bound to remain fragile for some time, and we must make sure we do nothing that exacerbates anxieties about either the performance of the UK economy or the determination of the Government to achieve its objectives.

3. One important reassurance for markets in the last few years has been the strength of our fiscal position and the emergence of a public sector surplus - coinciding of course with above trend economic growth. But after a number of years when the fiscal position was stronger than expected we may now face a period when it will be difficult to avoid a deterioration and a rapid return either to borrowing or to tax increases.

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World economy

4. The world economy is emerging from a period of exceptionally strong activity. G7 GNP grew in 1989 at 3½ per cent, with US growth easing somewhat in response to the Fed's tight monetary stance while growth in Japan and Germany was very strong.

5. The indicators for the first half of 1990 show these trends continuing. In particular, while there has been a further easing of pressures in the US, a recession there seems unlikely. However, the prospect of relatively sluggish growth in the US should lead to a further fall of G7 GNP growth in 1990 to about 2¾ per cent, close to our estimate of the growth of potential output.

6. With pressure on capacity at a very high level in some economies there is little chance of a significant reduction of inflation in the G7. Indeed there must be a risk that in Japan and Germany underlying inflation will drift up and it is possible that there could be further increases in short term interest rates.

7. The dramatic events in Eastern Europe, and in Germany in particular, will have only a limited impact in the short run perhaps boosting growth of world trade in manufactures, which is crucial for British exports, by ½ per cent in 1990. Overall world trade growth in 1990 is likely to be less than in the previous three years, though faster than in the last 1970s and early 1980s.

The UK economy

8. We have maintained a very tight policy stance for two years now with a budget surplus and real short term interest rates at over 8 per cent. This has had a marked effect on the economy in 1989. The latest figures show that after growing at 7 per cent in 1988 real domestic demand has grown slowly since the end of 1988.

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Pressure upon capacity has eased and unemployment has begun to rise in recent months.

9. Nonetheless the adjustment has proceeded far more slowly than we expected and the indicators for the first half of 1990 give conflicting signals. Some indicators suggest that the necessary slowdown in growth may have halted or even gone into reverse. On the other hand, surveys of company and personal sector intentions, in particular, suggest only weak growth.

10. The indicators present a mixed picture on the outlook for consumer spending. Retail sales growth, which slowed very sharply through 1989, seems to have picked up in the first half of this year, rather against previous expectations.

11. On the other hand, personal sector new car registrations have been on a steep and uninterrupted downward trend since mid-1989, the largest and most sustained fall since 1980. Consumer credit growth has slowed down and, since early 1988, consumer confidence has slumped to historically low levels. Distributors themselves see a weak immediate outlook and their general optimism regarding future prospects has deteriorated noticeably. So, too, has the optimism of manufacturers of consumer goods, as reported by the CBI Industrial Trends Survey.

12. The prospects for companies are also uncertain. The company sector has been running a very large financial deficit in recent years. In the past this would have led to a rapid adjustment with cuts in stocks and investment. As a result of the liberalisation of capital markets and the strength of profitability, companies have been willing on this occasion to live with the deficit. While there have been signs of financial distress in certain sectors and the figures for 1989 suggested that companies were trimming the growth of investment and cutting stocks, initial information for early 1990 was unexpectedly buoyant. Taking 1990 as a whole it looks as if fixed investment will be about the same as last year, and that there will be only modest destocking. This

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would imply a somewhat higher level of company spending than expected at the time of the Budget. Nonetheless we cannot rule out markedly lower company expenditure in the near future if financial distress becomes more widespread and if companies take more aggressive defensive measures to improve their finances.

13. Taking the personal and company sectors together the prospect is for a small rise in domestic demand in 1990, rather than the small fall expected at Budget time. Total GDP is still expected to grow by 1 per cent; but within the total domestic demand looks stronger and net exports weaker than expected. Once again estimates of North Sea production for this year have been significantly reduced and this accounts for some of the weakening.

14. With domestic demand stronger than expected it is not surprising that the current account deficit has been running a little ahead of the Budget expectation. Export growth has been very encouraging particularly in manufacturing, where we have increased our share of world trade, but imports have also continued to grow. Estimates of invisible earnings have recently been revised up, and the expectation is that for the year as a whole the current account deficit will, at £16 billion, be only a little above the FSBR forecast.

15. The strength of activity so far this year has coincided with a further rise in inflation. Pay settlements have risen strongly, though their effects on earnings have been offset so far by falls in overtime working and bonuses. CBI evidence shows that the greatest single influence on pay settlements is headline RPI inflation, which has risen strongly in recent months, so that we could well see a further rise in settlements later in the year.

This is odd. Pay settlements should fall on this logic in 1990 Q3+Q4.

16. The acceleration in earnings has coincided with a downturn in productivity growth, which is normal at this stage of the cycle, and as a result there has been a sharp rise in the growth of wage costs. This, together with last year's fall in the exchange rate, has led to a rise in underlying inflation. While there is no

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unique measure of underlying inflation, the evidence is that it currently lies close to the range given by the 6 per cent growth of manufacturers' output prices and the 7 per cent growth of the RPI less mortgage interest payments and the community charge. The latter gives a reasonable estimate of what the UK's consumer price inflation would be if calculated in the ways used by most of our G7 and EC partners.

17. Headline RPI inflation has risen to 9.8 per cent, boosted in particular by mortgage interest rate rises and the very high community charge set by local authorities. Both headline and underlying inflation could rise further in the months ahead, with the former possibly breaching 10 per cent in the next month or two. Thereafter underlying inflation should stop rising and then begin to come down gradually as declining capacity utilisation exerts a sharper squeeze on companies' profit margins. Headline inflation will still be likely to be over 9 per cent during the fourth quarter of this year, despite the effects of last November's mortgage rate rise dropping out of the inflation rate. It will fall further through next year. Achieving a substantial reduction in underlying inflation will require sufficient pressure on companies to force them to curtail the rises in their prices and wage costs.

18. I forecast at Budget time a lower debt repayment for 1990-91 than had previously been projected, and also indicated an earlier return to budget balance, with smaller scope for tax cuts. The PSDR in 1990-91 has so far been lower still, in large part, though not entirely, because of higher borrowing by local authorities. To the extent that local authority borrowing is the result of low payments of the community charge caused by teething troubles with new computer systems, some at least of these shortfalls should be unwound before the end of the financial year. But public expenditure is running ahead strongly and there are other adverse developments to come, such as lower than expected North Sea oil production caused by shutdowns to install safety equipment. Our

current forecast is that the PSDR will be well below the projection we made at the time of the Budget.

19. Some of the underlying weakening in the fiscal position this year may be masked by the effects of higher than expected inflation and also somewhat more resilient domestic demand: both these factors are helping to boost revenues this year, while the main automatic impact of higher inflation on expenditure (through social security upratings) will not be felt until the next financial year. But in the next two years or so the slowdown in the economy is likely to hit payments of company and capital taxes, both of which have grown very rapidly in recent years. As a result of all these factors we could well see what remains of the budget surplus evaporating as rapidly as it appeared.

Conclusion

20. I'm afraid this is a very bleak background against which to assess changes to the existing public expenditure plans. It will not be possible, as in previous years, to add to public expenditure plans in the reasonable expectation that buoyant tax revenues will offset the effect on the PSDR. Indeed it could pose the hard choice between tax increases next year and a damaging relaxation of policy. It is essential, therefore, that we follow the recommendations on public expenditure in the Chief Secretary's paper.

21. Providing that we can restrain overall demand in the economy we have the prospect of stopping the rise in inflation and eventually reducing it. But commentators and markets will be looking closely to see that our resolve does not weaken. It will do immense harm if we are seen to be restraining demand in the private sector while letting it grow strongly in the public sector. In contrast if we keep public finances under strict control we should be able to establish and retain market confidence, and this should lead eventually to some reduction in interest rates.

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MAJOR ECONOMIC INDICATORS

	UK			FORECAST	
				UK	G7 excl UK
	1987	1988	1989	1990	1990
A. Demand & Activity					
GDP †	4½	4¼	2	1	3
Domestic demand of which	5½	7¾	3	½	3
- consumers'expenditure	6	7	3¾	2¼	3
- fixed investment	8¼	13¾	4¼	-	5
Exports of Goods & Services	5	¼	4¼	7¼	4¾**
Imports of goods & Services	7¾	12½	7	4¼	5
B. Inflation					
RPI (Q4 on year earlier)	4	6½	7¾	9¼)	
RPI excluding mortgage interest payments and community charge	3¾	5	6	6¼)	4***
GDP deflator (financial years)	5½	7	6½	7¼	3½
C. Other items (levels)					
Current balance (£bn)	-4¼	-15	-19	-16	
Unemployment (per cent, narrow definition)	10¼	8¼	6½	5¼	6
Average earnings (per cent change: financial years)	7½	8¾	9½	9¾	4½++
3 month interest rate	9¾	10¼	14	15*	9
Sterling index (1985=100)	90	96	93	93.5*	
Oil price (Brent, $barrel)	18	15	18	17¾*	
PSDR (£bn, financial year)	3½	14½	7¾	3¼	

* close July 13

** goods only

*** Of the rest of the G7 only Canada has mortgage interest payments in its consumer price index

† Average measure

†† manufacturing earnings

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