PRIME MINISTER

CABINET: 1990 PUBLIC EXPENDITURE SURVEY

In addition to the Cabinet Office briefing it might be helpful to glance through the following additional papers.

First at **FLAG A** is the Chancellor's speaking note for Cabinet which sets out the main features of the economic forecast.

Attention will focus on the figures for 1991. These are broadly as the Chancellor mentioned to you at last week's bilateral.

- Inflation should fall to 5½ per cent by 1991 Q4.

- Output will manage just positive year on year growth at half per cent.

- The current account deficit will narrow to £11 bmillion.

As you are also aware, the RPI forecast understates the progress in bringing down inflation which the Chancellor believes achievable. But both the output and trade balance figures are more optimistic than justified by the Treasury central forecast.

Second at **FLAG B** is a speaking note which the Treasury suggested you might like to draw on in summing up at the end of the Autumn Statement Cabinet discussion.

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BARRY H. POTTER
7 November 1990
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CHANCELLOR'S SPEAKING NOTE FOR CABINET

First congratulate Chief Secretary on skilful and successful conduct of this year's Survey. Have succeeded in drawing up plans which do not accommodate higher inflation as Cabinet agreed. As a result, should be able to keep ratio of public spending to GDP broadly stable at its present level over the next two years, and show some decline by end of Survey period. Considerable achievement in present circumstances. Thank colleagues for constructive approach to the Survey, and difficult decisions which have had to be made.

Public expenditure

2. Chief Secretary has reported total additions to programmes. To set new planning totals, need to fix privatisation proceeds and Reserves.

3. Essential that plans are credible. In view of uncertainties - on Gulf as well as economy - believe only prudent to set Reserves at higher level than last year. Propose £3½ billion for next year, and £7 billion and £10½ billion for the two later years. Propose £5½ billion for privatisation proceeds, in line with actual receipts in recent years.

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4. Result is planning totals of £200 billion, £215 billion and £226 billion. Increases on previous plans for 1991-92 and 1992-93 of £8 billion and £11.6 billion respectively. Cash increases are substantial and cannot be sure how market will react. But should not come as a great surprise. Largely unavoidable in the light of decisions already announced especially about local government finance, and social security.

5. Important point is that after taking account of higher inflation, new planning totals will be about 1 per cent lower in real terms than those we set a year ago. [That is: they do not compensate fully for the higher level of prices now expected for next year.] Same is true of the plans for central government spending.

6. Taking central and local government together - general government spending is set to grow at under 2 per cent a year in real terms - the same as projected last year. And the ratio of spending to GDP will remain unchanged at 39½ per cent until 1992-93. It should resume its downward trend in 1993-94

7. So a tight settlement. But a necessary one, given the overriding importance of reducing inflation, though I know it means many colleagues have had to drop or postpone

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politically attractive proposals for more spending. Grateful for that.

The economy

8. Survey conducted against exceptionally difficult economic background. Since the July Cabinet events in the Gulf have led to a sharp rise in oil prices, adding to inflationary pressures throughout the world economy and adversely affecting activity. Recent indicators have shown clearly that the tight policies we have been pursuing in the UK have succeeded in slowing down the economy, which is essential if we are to get inflation down. But we are now in an uncomfortable position where the signs of weaker activity are clearly evident but the fall in inflation has yet to happen.

9. This is shown clearly in the latest forecast. (See tables.) For the current year (1990):

- Growth of GDP looks like being 1 per cent, the same as expected at Budget time. But the pattern within the year is different, with output somewhat higher than expected in the first half year, and a decline in the second half.

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- RPI inflation will probably peak close to its current level of 11 per cent.

(see separate note)

- The trade account has improved substantially, and I expect a current account deficit of £15½ billion, virtually unchanged since Budget time and the forecast I circulated in July.

10. As I foreshadowed in July, the public finances are turning out somewhat weaker than we forecast in the Budget. Our latest forecast of the PSDR in 1990-91 is £3 billion, compared with £7 billion in the Budget forecast. The main factors behind this deterioration are:

- Higher local authority borrowing, reflecting problems with collection of the community charge and non-domestic rates.

- Weaker public corporations' finances following the slowdown in economic activity.

- Somewhat higher central government spending.

11. But the tight policies we have been pursuing have ensured that inflationary pressures are now firmly under control. This is shown clearly in the monetary indicators,

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with MO growing well within its target range, and the growth of broad money and lending down sharply. Our membership of the ERM contributes a further discipline which will help to bring inflation down. And lower inflation next year will create the conditions for a resumption of growth.

12. Thus although the present economic situation is a difficult one, I foresee a significant improvement in many respects next year (1991):

- Although output may continue to weaken into the New Year, growth should then resume. GDP is forecast to grow by over 2 per cent through the year, though year on year growth may be only ½ per cent.

- The headline rate of RPI inflation should come down sharply. I am now forecasting RPI inflation of 5½ per cent in the fourth quarter of 1991.

- With domestic demand remaining weak, the current account deficit should improve further, and I am forecasting £11 billion for the year as a whole.

13. The position on unemployment is less promising in the immediate future. It has been rising since March, and is likely to continue rising in the months ahead. Job prospects

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will improve with the resumption of growth next year, but we must continue to press employers to take responsibility for their own costs and to stop bleating about the unions and a going rate.

14. Our membership of the ERM will help us to get inflation down, and requires that we do so. The discipline will be felt keenly in the private sector, with those involved in foreign trade especially having to keep a very tight control over their costs. And it also requires very strong discipline in the public sector. It is essential that we do not relax policy too quickly when inflation starts to fall if we are to maintain credibility with the financial markets. And we must stick firmly to our medium term aim of balancing the budget, which will not be easy with the economy weakening in the months ahead.

15. In view of this, the outcome of the Survey is especially welcome.

Presentation

16. Although this is a satisfactory outcome, it will need presenting with care. In particular as I said last week we must get the balance right between the additions to programmes we have been able to afford and the overall

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tightness of the settlement. There must be a risk that commentators and markets will focus on the big cash additions and see this as a sign of pre-election slackness. That could do great damage in the exchange markets and reduce our ability to bring interest rates down.

17. It is vital therefore that we bring out the truth that this settlement has required some very unwelcome decisions and that we are now planning for a lower real level of expenditure than we did last year.

18. Subject to colleagues agreement, propose to follow broadly same procedures as last year. Make oral statement this afternoon. Accompanied by Treasury press notices on economic forecast and Survey outcome. Arrangements have been made to co-ordinate these with the releases of Departmental press notices. Printed document will be published next Tuesday, 13 November.