BUDGET SECRET

CHANCELLOR OF THE EXCHEQUER

11/3/86

6

PRIME MINISTER

1986 BUDGET: MTFS

My two previous minutes set out my Budget tax proposals with the exception of those for income tax, which we agreed at our meeting on 5 March.

I have since agreed a package of employment measures with David Young, on which I have minuted you separately.

This leaves the question of the PSBR and monetary targets for 1986-87.

Public Sector Borrowing

The latest indications are that this year's PSBR will come out slightly below the £7 billion forecast in the last Budget (and still more below the figure forecast last Autumn). A substantial shortfall on oil revenues has been more than made up by the buoyancy of other tax revenues and an expected small underspending of the Reserve. We have thus achieved this year a significant step down in the PSBR, the first since 1981-82, reducing the PSBR as a proportion of GDP from over 3 per cent to just 2 per cent.

Last year's MTFS envisaged a PSBR of £7½ billion for 1986-87 (after allowing for a "fiscal adjustment" of £3½ billion). Since then we have added £2½ billion to expected receipts from privatisation, offsetting a similar addition to gross expenditure plans. We have had to revise down our forecast of oil revenues by over £5 billion (on an assumed oil price averaging $15 a barrel for the financial year 1986-87). But other tax receipts are forecast to be significantly higher than was expected a year ago. So the reduction in total government tax revenues is rather less than £3 billion.

At unchanged tax rates, therefore, we would foresee a PSBR of around £6 billion. The Budget package that we have agreed would come to just under £1 billion, raising the PSBR to £7 billion or 1¾ per cent of GDP.

In view of all the uncertainties I think it is wise to err on the side of caution and aim for a borrowing figure below the £7½ billion envisaged a year ago. It is important that the Budget should be seen by the markets as sound and responsible. I think that a PSBR of £7 billion would be so regarded, and indeed should leave us with some room for manoeuvre if, for example, there were a further weakening in oil prices later in the year.

For the remaining years of the MTFS period, I plan to show a path in which the PSBR falls slightly further to 1½ per cent of GDP by 1988-89. (Each ¼ per cent of GDP is approximately £1 billion.)

Monetary Targets

For the monetary targets in 1986-87 I intend to stick to MO and £M3. In view of its past behaviour, a case can be made for dropping £M3 altogether. As you know, £M3 has for some years shown a tendency to grow more rapidly than money GDP, partly in response to financial liberalisation, and partly because high real interest rates have increased the demand for broad money as a medium for saving. £M3 growth has regularly exceeded our expectations, without adverse consequences for inflation. This year has been no exception. A year ago we set a range of 5 to 9 per cent growth for 1985-86; in the 12 months to February the actual growth of £M3 has been nearly 15 per cent. And yet all the indications are that inflation is set to fall further over the coming year.

After careful consideration, however, I have concluded that dropping £M3 would risk giving the wrong signal about our attitude to liquidity. But I cannot risk a repetition of this year's experience.

We must set a range for 1986-87 that is both credible and achievable. I have decided that this should be 11-15 per cent, to allow for a continuation of the recent velocity trend. In view of all the uncertainties about broad money, however, I do not propose to show ranges of £M3 growth for the years beyond 1986-87.

The choice of target range for MO has been much easier. Its growth over the past 12 months has been 3½ per cent, towards the bottom of the 3-7 per cent range set a year ago, and I am reaffirming for 1986-87 the 2-6 per cent range indicated in last year's MTFS. As in the last two years, I shall be publishing illustrative ranges for MO for the whole MTFS period.

The presentation of monetary policy has undoubtedly suffered from the continuing problems with £M3, and the market's reluctance to accept MO as a substitute. I have sought to re-establish the credibility of the MTFS by giving a slightly more prominent role to money GDP in explaining the Government's strategy. This has no real operational significance, but it is a useful way of making the point that, whatever the problems with particular monetary aggregates, the Government remains committed to reducing the growth in money incomes, as a means of achieving a further reduction in inflation.

This approach has been fully discussed with the Bank who support these recommendations.

NL.

N.L.

BUDGET CONFIDENTIAL

File OH

10 DOWNING STREET

From the Private Secretary 13 March 1986

1986 BUDGET

The Prime Minister is entirely content with the proposals set out in the Chancellor's two undated minutes, one about the MTFS for this year's Budget and the other about employment measures.

(David Norgrove)

Mrs. Rachel Lomax,
HM Treasury.

BUDGET CONFIDENTIAL