FROM: MRS R LOMAX
DATE: 13 March 1986

REF NO: 56 J
COPY NO: 37 OF 51

MR CASSELL

cc: Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Mr F E R Butler
Sir G Littler
Mr Anson
Mr Byatt
Mr Kemp
Mr Monck
Mr A Wilson
Mr Evans
Mr Monger
Mr Odling-Smee
Mr Scholar
Mr Culpin
Miss O'Mara
Mr Pratt
Mr Cropper
Mr Lord
Mr H Davies

Sir L Airey - IR
Mr Battishill - IR
Mr Isaac - IR
Mr McManus - IR
PS/IR

Sir A Fraser - C&E
Mr Knox - C&E
PS/C&E

Mr Norgrove - No.10

Section C only
Mr Peretz
Mr Riley
Mr Kelly
Mr Walsh
Mr Robson
Mr Haache

Section E only
Mr Turnbull
Miss Peirson
Mr Riley

BUDGET SPEECH (FOURTH DRAFT): SECTIONS C AND E

I now attach a redraft of section E, which was missing from the version of the speech circulated last night; there are also one or two small consequential changes to section C, which I am therefore recirculating. The remaining section of the speech - section D on monetary policy - will be circulated shortly.

2. I would be grateful if you would conduct a thorough final check for factual accuracy, and let me have any comments no later than 10.00 am on Friday 14 March.

RL.

RACHEL LOMAX

C. Oil

I presented my Budget last year at the end of a 12-month coal strike.

I observed at the time that it was a remarkable tribute to the underlying strength of the British economy that it had been able to withstand so long and damaging a strike in such good shape.

We now have to face a challenge of a very different kind.

Over the past few months the price of oil has almost halved, and with it our North Sea oil tax revenues and earnings from oil exports.

Not surprisingly, perhaps, this initially caused a fair amount of turmoil in the financial markets, with sterling falling by some 8 per cent.

I decided that it was right to respond with an immediate one per cent rise in short term interest rates in early January, and this helped to prevent the downward movement of the exchange rate from developing an unhealthy momentum of its own.

But equally I thought it right to resist the for a time very strong, but to my mind unjustified, pressure to raise interest rates still further.

That pressure now appears to have subsided.

There has been some speculation that the turbulence in the oil market, which from time to time has fed through into the financial markets, has been deliberately exacerbated by some leading OPEC countries in an attempt to force the United Kingdom to cut back its own oil production and thus become a _de facto_ member of the cartel.

It has even been suggested that the decision to hold a meeting of OPEC Ministers to coincide with today's Budget is part of that same process.

I have to say that, if any such tactics are indeed being employed, those employing them are wasting their time.

There is no question whatever, and never has been any question, of the UK cutting back its oil production in order to secure a higher oil price.

In the first place, the whole outstanding success of the North Sea has been based on the fact that it is the freest oil province in the world, in which decisions on levels of output are a matter for the companies and not for the Government.

And in the second place, we are not only, or even principally, a major oil producer; we are also a major world producer and trader of other

goods and services, and a major oil consumer: there is no overall UK national interest in keeping oil prices high.

I am aware that a Report, recently published in another place, which attracted a certain amount of publicity at the time, predicted that

> "as the oil revenues diminish the country will experience adverse effects which will worsen with time"

- effects of a most alarming nature.

Had the authors of that Report dreamed at the time that half the oil revenues would disappear within a matter of months, their conclusions would no doubt have been even more apocalyptic.

As the House knows, I have always believed their analysis to have been profoundly mistaken.

But certainly it is going to be put to the test sooner than anyone expected.

The United Kingdom is likely to remain an oil producer, of a gradually diminishing volume of oil, for the next 25 years or so.

If we can survive unscathed the loss of half our North Sea oil revenues in less than 25 weeks, then the prospective loss of the other half over the remainder of the next 25 years should not cause us undue concern.

It is, of course, true that in relative terms we do lose from the collapse of the oil price. That is to say, the really big gains will be made by the major non-oil-producing countries such as Germany and Japan, where growth will be boosted and inflation, already low, is likely to fall virtually to zero.

But the oil price fall will be beneficial for the industrialised world as a whole, and even for the United Kingdom what we gain on the swings will more than offset what we lose on the roundabouts.

To be precise, I expect that the levels of economic activity and inflation will if anything be slightly better than what they would have been without the oil price collapse.

And what of the balance of payments?

Thanks to the abolition of exchange control in 1979, we have been able to use a good part of our earnings from North Sea oil since then to build up a massive stock of overseas assets.

Our net overseas assets have in fact risen more than sevenfold from £12 billion at the end of 1979 to some £85 billion at the end of last year.

This is a far bigger total than that possessed by any other European country, and bigger than the United States, too.

The earnings from those assets will be of increasing value to our balance of payments in the years ahead.

So, too, should the improvement in our manufacturing trade balance.

For while the British economy may not gain a great deal overall as a result of the oil price collapse, there will be considerable differences within the economy.

The major gainer will be the internationally traded sector of industry in general, and manufacturing in particular, which is already enjoying both lower oil prices and a lower exchange rate against its major competitors.

This provides British industry with an outstanding opportunity both to increase its exports and reduce import penetration in the home market.

It has no excuse for not seizing that unique opportunity.

But it will only be able to do so if it meets two conditions.

First, it must keep firmer control of its labour costs.

Second, it must spend more of its much healthier level of profits on investing for the future in Research and Development and in training.

Both the opportunity, and the responsibility to see that it is not thrown away, rest fairly and squarely on the shoulders of British management.

Meanwhile, despite the massive fall in oil prices, I expect the current account of the balance of payments to remain in sizeable surplus this year, by some £3½ billion.

As I have said, there will be gainers and losers within the economy.

If industry is the main gainer, the main loser, at least in the short term, is the Chancellor of the Exchequer.

Clearly, what is good for the British economy is not always good for the Chancellor.

I can live with that.

But it does mean that North Sea oil revenues, which are likely to amount to not far short of £12 billion for 1985-86, are bound to be very much less in 1986-87.

Indeed, on the assumption of an average North Sea oil price of $15 a barrel, which is close to the average for the past month of $16 a barrel, oil revenues in 1986-87 will be virtually halved at some £6 billion.

This has obvious implications for the Budget.

But the important fact is that, just as we successfully weathered a year long coal strike, we have been able to take the unprecedented collapse in the oil price in our stride.

We have been able to do so, first, because of the underlying strength of the economy in terms of growth, inflation and the external account.

And, second, by virtue of the reputation we have earned over seven years for sound and prudent financial management.

E. Public Sector Borrowing

Monetary policy must always be supported by an appropriate fiscal policy.

That means, in plain English, keeping public sector borrowing low.

The outturn for the public sector borrowing requirement in 1984-85, which had to bear the bulk of the cost of resisting the coal strike, was £10 billion, or just over 3 per cent of GDP.

In my Budget last year I planned to reduce it substantially in 1985-86, to £7 billion, or 2 per cent of GDP.

In the event, despite the loss of £2 billion of North Sea oil revenue, this year's PSBR looks like turning out at a little under £7 billion,

given that the total for the first eleven months comes to under £3 billion.

This successful outcome, which represents the most substantial reduction in the PSBR as a proportion of GDP since 1981-82, is attributable to two factors.

First, public expenditure has been kept under firm control.

Not only is the outturn likely to be well within the planning total, but spending in 1985-86 is expected to be below the previous year's level in real terms, even after allowing for the effects of the coal strike.

And the second factor behind the successful PSBR outturn for 1985-86 is that the £2 billion shortfall in oil revenues has been offset by the increased buoyancy of non-oil revenues, reflecting a healthy economy and an increasingly profitable corporate sector.

Last year's MTFS indicated a PSBR for 1986-87 of £7½ billion, or 2 per cent of GDP.

Some would argue that, in the light of the £2½ billion increase in projected privatisation proceeds, I ought to aim well below that.

Others would claim that, since the sharp drop envisaged in oil revenues is more than double the rise in privatisation proceeds, a higher figure would be appropriate.

As last year, my judgement is that the wisest course is to stick broadly to our pre-announced figure.

But given the uncertainties over the oil price, I have decided, within that framework, to err on the side of caution, and provide for a PSBR of £7 billion, or 1¾ per cent of GDP.

Needless to say, this does not enable me to reduce taxation by anything like the £3½ billion foreshadowed in last year's MTFS.

Indeed, given the assumed loss of more than £5 billion of oil revenues in 1986-87, compared with what was envisaged a year ago, I would have expected to have had to increase taxes in this year's Budget.

However, not only have the tax revenues this year from the 95 per cent of the economy that is not oil proved to be notably buoyant, but there is every sign that this will continue into 1986-87, assisted by a rather higher rate of economic growth than was foreseen in last year's MTFS.

This continued vigour of the non-North Sea economy, which is likely to add more than £3 billion to expected non-North Sea tax revenues, coupled with public spending which remains under firm control, has transformed what might have been a bleak prospect.

As a result, I am able this year to accommodate a relatively modest net reduction in the burden of taxation, of a shade under £1 billion.

[It may well be, of course, that the oil price turns out to be different from the $15 a barrel I have assumed for this year's Budget.

If any departure is purely short term, that is most unlikely to have any significance for policy.

But even if it is more than short term, the cautious fiscal stance I have decided to adopt puts us in a sound position to take it in our stride.]

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cc Chief Secretary
Financial Secretary
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Mr McManus - IR
PS/IR
Sir A Fraser - C&E
Mr Knox - C&E
PS/C&E

Mr Norgrove - No.10

BUDGET SPEECH (FOURTH DRAFT): SECTION D

I now attach the remaining section of the Budget Speech - section D on monetary policy.

2. I would be grateful if you would conduct a thorough final check for factual accuracy, and let me have any comments no later than **2pm** on Friday 14 March.

RL

RACHEL LOMAX

D. Monetary Policy

The framework within which that sound and prudent financial management has been pursued, and will continue to be pursued, is the Government's Medium Term Financial Strategy.

As usual, I am extending it forward a year.

At the heart of the MTFS lies the objective of steadily reducing the growth of total spending power in the economy, as measured by GDP in cash terms, at a pace that will gradually squeeze inflation out of the system while at the same time leaving adequate room for sustained growth in real output.

That we have done.

Over the past six years the rate of growth of money GDP has been halved.

And this has brought about a combination of low inflation and steady growth.

We shall continue to maintain steady downward pressure on inflation.

That means above all controlling the growth of money in the economy.

Last year I set target ranges of 3 to 7 per cent for narrow money and 5 to 9 per cent for broad money.

During 1985-86 the targeted measure of narrow money has grown towards the bottom end of its range.

The target range for next year will be 2-6 per cent, as foreshadowed in last year's MTFS.

For broad money, or liquidity, it has been clear since the autumn that the range was set too low.

Throughout the 1980s - and in sharp contrast to the 1970s - broad money has grown far faster than money GDP.

Experience has demonstrated that this has not posed a threat to inflation.

This rapid growth largely reflects the increased attractions of holding interest bearing deposits, at a time of low inflation and high real interest rates, and at a time, too, of innovation and liberalisation in the financial system.

Accordingly, I am setting next year's target range for broad money well above that indicated in the MTFS, at 11-15 per cent.

Given the experience of the past six years, this will be wholly consistent with the further decline in inflation which I expect to achieve.

Short term interest rates are the essential instrument of monetary policy.

So far as the monetary targets are concerned changes in interest rates have the same unambiguous effect on narrow money as they do on the exchange rate.

Their effect on broad money is less certain and much slower acting.

There is thus necessarily some difference in status between the two targets for narrow and broad money.

Needless to say, I shall continue to monitor the evidence of other financial indicators, of which the most important is the exchange rate.

I will say no more about monetary policy today.

Except to repeat what I said at the Mansion House last Autumn: that while financial liberalisation and innovation have inevitably made the process of monetary management more

complicated, there has been no change whatever in the essence of policy.

The Government continues to attach the highest priority to sound money.

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cost structure in general and its wage costs in particular.

In the new and improved climate of industrial relations, and with inflation falling and set to fall further, there can be no excuse for failure to discharge that responsibility.

I have, however, considered whether there is anything further Government can do to assist this over the longer term.

The problem we face in this country is not just the level of pay in relation to productivity, but also the rigidity of the pay system.

If the only element of flexibility is in the numbers of people employed, then redundancies are inevitably more likely to occur. One way out of this might be to move to a system in which a significant proportion of an employee's remuneration depends directly on the company's profitability per person employed.

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This would not only give the workforce a more direct personal interest in their company's success, as existing employee share schemes do.

It would also mean that, when business is slack, companies would be under less pressure to lay men off; and they would in general be keener to take men on than if pay costs were fixed, irrespective of company profitability.

It might, therefore, make sense to offer some measure of tax relief to the employees concerned to help get profit sharing agreements of the right kind off the ground, and to secure the benefits they could eventually bring if they really caught on.

The broad characteristics of such agreements are clear.

But the design of such a relief, and the precise definition of qualifying agreements, is a matter of some complexity.

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I am keenly aware of the practical difficulties.

The Government therefore proposes to discuss with employers and others to see if a workable scheme can be defined which offers the prospect of a worthwhile and broadly-based take up.

If these preliminary discussions are sufficiently encouraging, we would prepare a consultative document setting out a detailed scheme for wider consideration.

The earliest opportunity for legislation would be next year's Finance Bill.

Meanwhile, there is more we can do of an immediate nature to help the unemployed.

In my Budget last year I announced the Government's intention to launch a new two-year Youth Training Scheme, leading to recognised vocational qualifications.

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