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Treasury Chambers, Parliament Street, SW1P 3AG
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10 July 1986

David Norgrove
No 10 Downing Street

Dear David,

ECONOMIC PROSPECTS: CHANCELLOR'S PAPER FOR JULY CABINET

... I attach a draft of the Chancellor's paper on economic prospects for next week's Cabinet. Subject to the Prime Minister's views, (and some last minute polishing) the Chancellor would like to circulate next Monday. There will be an opportunity for discussion at tomorrow's bilateral.

The Prime Minister may also like to see the final draft of the Chief Secretary's Cabinet paper. This has been updated to record the agreement on local authority current expenditure, and the need for the Secretary of State for the Environment's statement to cover local authority capital expenditure. The drafting has also been tightened up in places, as the Prime Minister suggested. The Chancellor will explain the change to paragraph 17(a), to remove any reference to reporting back to Cabinet after the bilaterals.

*Yours ever
Rachel*

RACHEL LOMAX
Principal Private Secretary

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CABINET

ECONOMIC PROSPECTS

Memorandum by the Chancellor of the Exchequer

1. Events this year are turning out rather differently from the prospect foreseen at the time of the Budget. The fall in inflation - both worldwide and in the UK - has gone further than expected. But output has grown more slowly, as the initial unfavourable effect of the oil price fall has been superimposed on a temporary pause in activity worldwide, with inevitable consequences for unemployment.

2. There is still every reason to expect a resumption of growth both abroad and at home later this year, as the benefits to economic activity from lower oil prices begin to make themselves felt. But in the light of our experience so far this year we cannot afford to take chances. And however the prospects of world growth turn out, we face two particular threats at home: the failure of pay settlements to respond to sharply lower inflation, and the pressure for higher public spending, against the background of a fiscal position still vulnerable to the oil price which currently stands at under \$10 a barrel as compared with the \$15 a barrel assumed at the time of the Budget.

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WORLD ECONOMY

3. Activity in the world economy was generally sluggish in the first quarter of 1986. There was a small fall in manufacturing output in Japan and much of Europe, and in the United States growth has been modest. Demand from outside the industrialised countries has also been weak, with a substantial reduction in imports by oil-producing countries.

4. With the collapse in oil prices and the continuing effect of the prudent financial policies pursued by all the major nations in recent years, there has been a further sharp fall in inflation: consumer prices in the major industrialised countries have risen on average by only 2 per cent over the past year. The consequent increases in real incomes, together with lower interest rates, should ensure a resumption of reasonably vigorous growth, perhaps later this year.

THE BRITISH ECONOMY

5. At home, the pattern has been broadly similar. Following its strong performance in the four years up to early 1985, output, adjusted for the coal strike, has since grown more slowly, and is now expected to grow at no more than 2½ per cent in 1986, instead of 3 per cent as forecast at Budget time. The prospect of buoyant consumers' expenditure and better exports reflecting the expected upturn in world trade should mean a somewhat stronger increase in activity in 1987 than was envisaged at the time of the Budget.

6. Inflation has fallen steadily for the past few months: as measured by the RPI it is now down to 2½ per cent. I expect it to remain low throughout the rest of this year and next year, although there will inevitably be some bounce back from the current artificially low level.

7. But this fall in inflation has been matched and often surpassed in other industrialised countries. Germany and Japan

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are now enjoying virtually stable prices. Moreover, there are clear signs in our competitor countries that the slowdown in price increases is being reflected in lower earnings growth; and their unit cost increases are negligible or negative.

8. In the UK, on the other hand, there is as yet no sign of lower actual and expected inflation being reflected in lower wage settlements. Earnings so far are continuing to grow at around $7\frac{1}{2}$ per cent per year (as against an increase in the TPI of little more than $\frac{1}{2}$ per cent) implying a sharp rise in our unit costs and a serious deterioration in our competitiveness.

9. The consequences of this excessive earnings growth are clear. Unemployment, despite all the measures we have taken, continues to increase at an average of 10,000-15,000 per month. With a faster expansion of employment as output growth picks up, and declining labour force growth, the best guess is still that there will be some improvement in the unemployment position next year. But excessive earnings growth is losing us jobs. Furthermore, the loss of competitiveness on our non-oil trade, superimposed on the deterioration in the oil account, is beginning to make the current account of the balance of payments look vulnerable.

10. Despite this the financial markets have so far been reasonably steady since the Budget. The exchange rate has held firm in the face of a further fall in oil prices and uncertainties about the dollar. Base rates have fallen by $2\frac{1}{2}$ per cent and long-term rates have fallen to their lowest level since the early 1970s.

11. But both nominal and real interest rates remain high compared to those of our competitors. The major changes taking place in financial markets have made the task of interpreting monetary conditions very difficult. This has become something of a problem worldwide, but it is particularly marked in the UK. Although narrow money is towards the bottom of its target range, bank lending is expanding rapidly and broad money and particularly,

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but not exclusively, £M3 - continues to grow well beyond expectations. In these circumstances, with no clear guideline for the markets to look at, our approach to interest rates must inevitably remain cautious.

12. Given these uncertainties on the monetary front, the markets are watching even more closely for any evidence of lack of resolution over the size of Government borrowing; and with the further fall in the oil price the fiscal prospect looks more difficult than at the time of the Budget. As the Chief Secretary's paper shows, the pressures for higher public spending are intense and relentless. It will require great determination to maintain the firm control of public expenditure which is central to our economic strategy and essential if we are to make further progress in reducing interest rates and avoid increases in the tax burden.

13. A summary of the most recent Treasury assessment is shown in the attached table.

CONCLUSION

14. The economy has been experiencing a pause in the steady growth seen since the trough of the recession in 1981. That pause, which is also occurring in the rest of the industrialised world and has coincided with the collapse of oil prices, is affecting short-term employment prospects. But inflation has been lower than expected; and the prospect is still for a resumption of growth at home late on this year, as activity worldwide recovers its momentum.

15. But there are clear dangers. Developments in the world economy are inevitably subject to much uncertainty, and the failure so far of pay to adjust to sharply lower inflation is a threat to competitiveness, jobs and confidence in the financial markets. Against this background, we cannot afford to risk reversing the progress we have made in recent years in reducing

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the burden of taxation (still higher than it was in 1978-79), in reducing borrowing and in holding down inflation. It is vital, therefore, that we maintain, as the Chief Secretary proposes, firm control of public expenditure.

N.L

Treasury Chambers

11 July 1986

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MAJOR ECONOMIC INDICATORS

	1983	1984	United Kingdom		Summit 7 (excl. UK) 1986	
			1985	1986		
A	<u>Demand and activity</u> (per cent change on previous year)					
	GDP	3½	2½	3½	2½	3
	Domestic Demand	4½	2½	2	3	3½
	of which:					
	consumer spending	4	2	3	4	3½
	fixed investment	5	8	1	4	4½
	Exports of goods and services	2½	7	6½	1	1½
	Imports of goods and services	6	9½	3	2	6½
B	<u>Inflation</u> (per cent changes on a year earlier)					
	Retail prices, fourth quarter	5	4½	5½	2½	½
	Average earnings, fourth quarter	8	6½	7½	7½	3½ (2)
C	<u>Other indicators</u> (levels)					
	Current balance (£ billion)	3	1½	4	3	-6
	Unemployment level (per cent, narrow definition)	12	12	12½	13	7½
	Interest rates (3 month inter-bank, per cent)	10	10	12	10 (1)	6½ (1)
	Sterling Index, 1980=100	83	78½	78	75 (1)	-
	Oil prices, \$ North Sea	30	29½	27½	10 (3)	-

(1) Current levels

(2) Manufacturing earnings only

(3) Brent price for delivery in July, as of 3rd July

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1986 PUBLIC EXPENDITURE SURVEY

Memorandum by the Chief Secretary, Treasury

The report on the baseline for the 1986 Survey, covering both expenditure to be incurred and the outputs and performance to be achieved, was circulated on 30 May. Colleagues have also completed an examination of their programmes and where they are seeking additional provision, have put their proposals to me. I have circulated a summary of departmental bids - my minute to the Prime Minister of 10 July. This paper examines the prospects for public expenditure and makes proposals for the next stage of the Survey.

2. In recent years it has been the practice to consider the prospects for local authority current expenditure separately in E(LA) and for the aggregate objectives for nationalised industry external financing limits to be considered at a separate meeting of E(A). This year I believe it would be helpful, in considering the overall objective for public spending to discuss the position reached on local authority expenditure; and to set the objectives for the nationalised industries as part of the wider picture. The Lord President will be circulating a progress report on the discussions in E(LA). On nationalised industries, departments have already received copies of the Investment and Financing Review (IFR). The position is further discussed in paragraph 12 below.

Expenditure Baseline

For 1987-88 and 1988-89 the baselines for individual programmes have been the figures in the 1986 public expenditure White Paper (Cmnd 9702) plus the changes announced in the Budget for employment measures, together with a few minor technical adjustments. For 1989-90 we agreed to construct the baseline for individual programmes by adding 2½ per cent to the provision for 1988-89, but consideration of the aggregate planning total figure for that year was left until now.

Proposals for expenditure

4. In my minute to the Prime Minister of 6 February I urged departments to "live within their existing baselines with pressures for extra resources met by cutbacks elsewhere and - of particular importance - improvements in efficiency and effectiveness". Although colleagues were asked to scrutinise personally priorities within their programmes, I regret to say that substantial bids have been put forward, full details of which were set out in my minute of 7 July. It is very disappointing that so few offsetting savings were identified and that bids were not in general supported by statements of objectives. In my bilaterals I shall be pressing colleagues further on the setting of targets and the measures on which subsequent evaluation would be based. It is clear that the bids made are far in excess of what can be accommodated and that the problem of establishing priorities in the Survey will therefore be severe.

5. Firm control of public spending is central to our economic policy. It is an essential part of our efforts to improve the performance of the economy, and the prospects for both output and jobs, by limiting the role of the state and enabling us to reduce the burden of public borrowing and taxation. It has played an indispensable part in bringing inflation to the lowest level for 18 years. Moreover these achievements, coupled with the reputation we have established for prudent financial management, are the reason why we succeeded in weathering both the miners' strike and the collapse in oil prices without any financial crisis. Over the past year both long and short term

Interest rates have fallen by 2½ per cent, and are now in single figures, the first time this has been true for both since 1973. But further progress is critically dependent on our retaining the confidence of financial markets.

6. If we are not to put all this at risk, it is essential that in the Survey we once again work within the existing and published planning totals for 1987-88 and 1988-89. For 1989-90 we agreed to set the uplift for individual programmes a little below the rate of inflation of 3 per cent assumed for that year in the MTFS. I propose that we now confirm that the planning total should rise by 3 per cent. This will allow a margin for the adjustment of priorities between programmes. This gives broad planning totals for the three years of £144 billion, £149 billion and £153 billion.

Reserves

7. In the White Paper, Reserves of £4½/6¼/8 billion were set for the three years of the plans, figures which were large compared with those set in previous White Papers. In the current year it is already clear that the Reserve of £4½ billion will be under extreme pressure. I must, therefore, treat all applications for access to the Reserve in the current year most strictly and seek colleagues' co-operation in ensuring that cost increases are absorbed and underspendings surrendered.

8. The precise level of the Reserves required for future years depends in part on the decisions taken on programmes during the course of the Survey. If, for example, provision made in programmes is as realistic as possible, lower Reserves can be set than if, as was the case with local authorities in the last Survey, provision is made on a notional basis. I propose, therefore, to consider the precise level of the Reserves later in the Survey, but we must leave, within the public expenditure totals, enough scope for Reserves which are fully adequate, rising through the period and credible to the financial markets.

Privatisation proceeds

9. During the course of the last Survey the projections for privatisation proceeds were raised from £2½ billion to

4.4 billion. I indicated in my minute of 6 February that the privatisation programme was now in top gear and that additions to the level of proceeds could not be expected. Although preparations for the BGC sale are proceeding well, and other issues are being worked upon, there is no scope for receipts to be significantly further increased. Moreover, the sums raised by these issues will depend very much on market conditions, which in turn will be strongly influenced by the outcome of the Survey.

Local authority current expenditure

10. The Lord President will be able to report that I have accepted the consensus in E(LA) that provision for LA current expenditure in the RSG settlement for England for 1987-88 should be set at £25.2 billion. This is an increase of some £2.9 billion on our existing plans, which are the same in cash as those for 1986-87, and represents a real terms standstill on local authorities' budgets for 1986-87. It is realistic, in that it goes a long way towards meeting the local authorities' own estimates of the cost in real terms (measured by the GDP deflator) of continuing their existing policies; and yet it indicates to them (and others) that they must contain their expenditure. We must signal to them also the vital need to limit the growth of their pay bills. With the grant percentage held at the 1986-87 level of 46.4 per cent (an increase of £1.1 billion at settlement) rate rises will average perhaps 5 per cent next year for responsible authorities.

11. If the Cabinet endorse this recommendation, the Environment Secretary proposes, I understand, to make a statement about total provision and grant before the House rises in July. There is some risk that an announced increase in provision of this magnitude, before we are ready to set out the rest of our plans, will have an adverse effect on the markets. On the other hand, I accept that there are operational reasons for making a statement in July and failure to do so might itself provoke damaging speculation. We will need, however, to consider the terms of the Environment Secretary's announcement very carefully, which will also need to cover our approach to local authority capital expenditure.

Nationalised Industries

12. I have circulated separately officials' report on the 1986 Investment and Financing Review of the nationalised industries. This shows that the industries' own initial and unamended bids, made in April, are over the baseline by approximately £850 million, £750 million and £575 million in each of the three years respectively. These bids are clearly unrealistic and cannot be accommodated. They now need to be scrutinised rigorously and a number of industries are revising their proposals so that we will have a sounder basis for judging them. In the meantime we cannot take a firm view on the likely overall outcome, but our aim must be to reduce the provision at least to baseline and, where we can, below it. Failure to achieve this will mean greater pressure on departmental programmes.

Running costs and manpower

13. Additional bids for increases in provision for running costs amount to over £550 million in 1987-88 and higher sums for later years. If they were conceded the increase in total running costs expenditure would be more than 6½ per cent on a year earlier, very substantially in excess of the present and expected rate of inflation. Increases of this order would scarcely demonstrate our intention to control expenditure on departmental administration.

14. A significant part of this increase is accounted for by additional bids for pay. But real increases must be matched by growing productivity if the overall rise in departmental costs is to be kept close to the rise in prices in the economy generally. Departments should be planning the measures necessary to achieve this.

15. Another large part of the increase claimed for running costs is accounted for by bids for additional manpower. Colleagues will know from the minute I sent to the Prime Minister of 17 February that we must keep a very tight rein on manpower numbers if we are to hold to our published manpower targets. The position now is that if the additional numbers sought by

Departments were agreed, the target of 590,400 staff at 1.4.88 would be exceeded by 14,000, reversing the downward trend achieved since we took office.

16. I must therefore ask colleagues to re-examine their departmental programmes with a view to reducing the increase in running costs to much more modest levels and to keeping at or below their manpower targets.

Conclusion

17. I invite colleagues to agree:

- (a) that I should now conduct bilateral discussions with colleagues on their individual public expenditure programmes, and on their targets for running costs and manpower;
- (b) that once again we work within the existing and published public expenditure planning totals of £144 billion, £149 billion and £153 billion respectively for the three years 1987-88 to 1989-90;
- (c) that provision and grant for local authority current expenditure be set as recommended in the Lord President's minute and that the Secretary of State for the Environment should announce this before the Recess.
- (d) that we should aim to hold the provision for nationalised industries at least to baseline and where possible below that;
- (e) that we should seek to restrain the growth of running costs and that existing manpower targets should be held.

[JM]