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No loss in
managing in final 12th

PRIME MINISTER

cc: Mr. Wicks

Professor Griffiths

SEMINAR AT CHEQUERS

Those attending are the Chancellor, Chief Secretary, Peter Middleton, Terry Burns, Brian Griffiths, Nigel Wicks and me. We shall be arriving at 0930, and lunch has been arranged. You might want to break for a quarter of an hour half way through so that people can stretch their legs.

The papers are:-

- A Note by the Policy Unit
- B Note by Terry Burns
- C Short-term economic prospects
- D Note on the current account

Objectives

This is not a meeting for decisions. But it should help towards them.

You will want to get a feeling for:

- (i) where the economy is now. The answer is that it is in fact buoyant, with rapid growth of domestic demand in particular. All the recent indicators, unemployment, the current account, inflation, and manufacturing output, suggest this.
Question: How far is this a function of fiscal policy?

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- (ii) What are the prospects for next year? These can now be influenced only by interest rates, for practical purposes.
- (iii) The prospects beyond next year. This is a matter for the Budget decisions and, in a sense, the Chancellor's frame of mind, the bias towards gambling or prudence.

You will also want to get a feel for the strengths and the weaknesses in the economy.

Strengths

- profits
- productivity
- investment

All better than the historic UK experience

Weaknesses

- high interest rates (? pay and fiscal policy)
- our propensity to import
- public expenditure

These are characteristic weaknesses, as yet unresolved.

Things to keep in mind

A discussion of the economy can easily be a rambling affair. I suggest hang on to four main areas:

- (i) The current account: how far is it a question of oil and how far is it also a weakness in non-oil performance?
- (ii) Pay: a disaster. What can be done, if anything?
- (iii) Monetary Policy: the markets may push us towards another increase in interest rates over the next few

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weeks. Is this justified in terms of the outlook for the economy?

- (iv) Fiscal policy: fiscal policy is easier than it was last year, the PSBR is £7½ billion as against £5½ billion and the difference on other measures which take asset sales into account is more than that (Asset sales this year £4³/₄ billion as against £2½ billion last). Inflation is also lower.

Handling of the meeting

I know that the Chancellor and Terry Burns are both very apprehensive about this meeting. As you know, Terry in particular is concerned about his position on fiscal policy. He will not say anything other than what he believes, but I am sure he would want to be left to make his intervention on this in his own time.

There are real and important issues here which cannot be ducked, but I suggest you lead into them gently.

You might introduce the discussion by pointing to the successes of the past nine months:

- a halving of the oil price with little sense of crisis;
- no other oil producer could claim as much;
- (possibly) weathering the Westlands and Rover problems with so little disturbance;
- a difficult few weeks to come but do not be too gloomy;
- public expenditure likely to continue to decline as a proportion of GDP, with or without asset sales;
- unemployment may be starting to fall in a sustained way.

So there is much to be thankful for. The achievements which you and the Chancellor speak about in public are really

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worthwhile and we should not lose sight of them in private discussions.

Points from the Forecast

I am also enclosing the full forecast. The Chancellor is concerned that this should not be the basis for the discussion. A very few of the figures in it are, for legitimate reasons, different from those in the paper at Flag C and the Chancellor wants that to be the basis of the Seminar. I would ask you please to follow his wishes on this.

The forecast does have a few points which are worth noting:

- (i) the forecast has the growth of potential GDP at $2\frac{3}{4}$ per cent per year leaving oil aside. GDP is forecast to grow by $3\frac{1}{2}$ per cent in 1987 excluding oil which is quite a sharp difference and explains the improving employment picture.
- (ii) The forecasters think our trade performance will be better than in the 1970s or early 1980s, though the non-oil account remains a concern.
- (iii) The forecasters expect very large surpluses in the National Insurance Fund even with the assumption of a sharply reduced Treasury supplement.
- (iv) Real industrial materials prices are now at their lowest post-war level.
- (v) The planning total is projected to fall each year from now on as a percentage of GDP, with or without asset sales.
- (vi) Of the 17 per cent fall in sterling since the second half of last year, 10 per cent is put down to lower oil prices and 7 per cent to other factors.

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(vii) UK net overseas assets are forecast to rise from £80 billion at the end of 1985 to £120 billion at the end of 1988.

(viii) Most G7 economies are experiencing substantial deteriorations in their net trade positions at constant prices this year.

(ix) The RPI in July next year is forecast at 4.7 per cent, August 4.6 per cent, September 4.4 per cent, October 4.1 per cent.

The summary of the forecast which the Treasury have sent rightly concentrates on 1987. The prospects for 1988 are even more uncertain. But the forecast does show a further increase in inflation (to 5 per cent) and a current account deficit of £3 billion. There is a fiscal adjustment of £5½ billion. The Chancellor is, I believe, concerned that the figures for 1988 would be misleading and I agree that they can be given no real weight. It would be best both from the point of view of substance and for relations with the Treasury to ignore 1988 for the moment.

Finally, a note on definitions. The PSBR is of course arrived at by netting asset sales from expenditure. The Public Sector Financial Deficit treats asset sales and certain other transactions as borrowing. The General Government Borrowing Requirement and the General Government Financial Deficit differ from the PSBR and the Public Sector Financial Deficit only by the exclusion from General Government of market and overseas borrowing by public corporations, which is not significant.

Julie Bowers
Duty Clerk

PP DAVID NORRGROVE

17 October 1986