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SECRET AND PERSONAL

JDBARH

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cc: BG

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

20 October, 1986.

Dear Alex,

THE ECONOMIC PROSPECTS

The Prime Minister yesterday held a seminar at Chequers to discuss the economic prospects and economic policy. Present were the Chancellor of the Exchequer, the Chief Secretary, Sir Peter Middleton, Sir Terence Burns, and Professor Brian Griffiths. The meeting was discursive, and this record picks up the main threads.

The Prime Minister expressed strong concern about the underlying economic position. The markets were themselves signalling great disquiet, and they might be right. The savings ratio was falling; consumer and retail sales were growing very strongly; the current account had moved into deficit; it was perhaps significant that the effective exchange rate had fallen from 76 after the Budget to 67 now, even though the oil price had risen during that time. There was a whiff of a Barber boom about the economy, and the markets seemed to believe that the Government wanted to cut taxes in the 1987 Budget, come what may.

In discussion, it was pointed out that real interest rates had been negative in 1972. They were now enormously positive. Moreover, during the next few months inflation would be rising, and there were some signs of falling pay settlements. The effect would be to reduce the growth in real incomes which was fuelling consumer spending. It was acknowledged that the forecast of the current balance given in the FSBR had been wrong. But exports had been badly affected this year by the slow-down in UK export markets.

The Prime Minister suggested that fiscal policy could well be contributing to the overheating. The PSBR out-turn in 1985-86 had been only £5¹/₂ billion, with asset sales of around £2¹/₂ billion. The out-turn this year was expected to be at least £7¹/₂ billion, with asset sales of £4³/₄ billion. The Public Sector Financial Deficit was in some ways a better measure than the PSBR, and that showed a very large increase between the two years. A looser fiscal policy and a deteriorating current balance were two very worrying

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developments. Against this, it was argued that the PSBR, even allowing for asset sales, was a lower percentage of GDP than it had been in 1981 after the very tough Budget of that year. The fall in oil revenues might also be a reason for allowing higher borrowing. It was agreed that further study would need to be made in the coming months of the links between public borrowing and interest rates.

The meeting agreed that the prospect for inflation was worrying. But some increase next year was inevitable in view of the sharp fall in mortgage rates and oil prices earlier this year. It was noted that the election in 1983 had been fought with inflation at 4%. It would be a test of the Government's stewardship whether the next election was fought with inflation lower than that. But this could well be difficult to achieve.

On the exchange rate it was noted that depreciation added to inflation and tended to release the pressure on employers to control their costs. It was agreed that the exchange rate could not be allowed to fall much further. Equally, substantial intervention could not be allowed to continue. Some small further movement in the exchange rate might be allowed (a move on the index from 67.3 to 67 was mentioned), but it would then be necessary to raise interest rates quickly. If this proved necessary, the increase would need to be large enough so as to avoid, if possible, a need for a further increase at around the time of the Autumn Statement.

There was a brief discussion of the National Insurance Fund and National Insurance contributions. It was agreed that an increase of $\frac{1}{4}\%$ in both employer and employee contributions would be worth considering as a means to boost market confidence when the Autumn Statement was announced. However, the markets might see this simply as a means of making room for tax cuts in the next Budget. It was further agreed that an increase in the NHS element of NIC should be considered, to bring home to people the ever increasing cost of the National Health Service, and to help the PSBR.

I am recording other points separately.

I am copying this letter to Jill Rutter (Chief Secretary's Office).

Jas,
David.

David Norgrove

A.C.S. Allan, Esq.,
HM Treasury.

LIST OF GUESTS ATTENDING THE SEMINAR AT CHEQUERS AT 9.30 A.M.
FOLLOWED BY LUNCH ON SUNDAY, 19 OCTOBER 1986

The Prime Minister

Rt. Hon. Nigel Lawson, MP

Rt. Hon. John MacGregor, MP

Sir Peter Middleton

Sir Terence Burns

Mr. Nigel Wicks

Mr. David Norgrove

Professor Brian Griffiths