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*From the Private Secretary*

9 February 1987

**PAPER FOR ECONOMIC FORECAST**

The Prime Minister has seen the draft of the Chancellor's paper for Cabinet on Thursday attached to your letter to me of 6 February.

The Prime Minister's only comment was to suggest that the final sentence of paragraph 5 ("There is no reason to risk anything here") is insufficiently strong. Subject to an amendment to meet this point, she is content that the paper should be circulated to Cabinet colleagues today.

(David Norgrove)

Alex Allan, Esq.,  
HM Treasury

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Treasury Chambers, Parliament Street, SW1P 3AG

01 270 3000

*It is very  
light-weight & 65  
specified for my laptop  
but I have to be  
winded*

6 February 1987

David Norgrove Esq  
No 10 Downing Street

Prime Minister

The key paragraphs are  
5 and 6.

Two small amendments  
made.

Dear David,

Content for the Chancellor  
to circulate this on Monday?

## PAPER FOR ECONOMIC FORECAST

... I attach a draft of the Chancellor's paper for the Cabinet discussion of economic strategy next Thursday. The Chancellor would like to know that the Prime Minister is content, before it is circulated to other Cabinet colleagues on Monday.

*JAN*  
6/2

*Yours  
Alex*

ALEX ALLAN  
PRINCIPAL PRIVATE SECRETARY

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DRAFT

ECONOMIC STRATEGY

? We are reaping the benefits of prudent fiscal and monetary policies. The economy is now performing as well as that of any developed nation. Growth has been sustained at near to 3% a year since 1981, one of our longest periods of expansion ever. It is in marked contrast to the record of the 1970s.

2. Yet the most remarkable feature of this expansion is that it has been achieved against a background of falling inflation and with improving competitiveness. Inflation has fallen from 16½% at the end of 1980 to 3¼% at the end of 1986. Manufacturing productivity has grown faster than in any of our major competitors. Provided we guard against a resurgence of inflation, and provided we maintain external and domestic confidence in our policies, the prospects for this year and next are good.

3. But the proviso is important. We have demonstrated convincingly that steady growth comes from pursuing a sound monetary and prudent fiscal policy set in a clear medium-term framework - and from resisting the temptation to inject fiscal stimuli which might provide short term gains but spell long term trouble. The over-riding need in this Budget must be to do nothing which might put the favourable prospects which now lie before us at risk.

Fiscal prospect

4. Last year, the Budget was dominated by the sudden collapse of our oil revenues, which have fallen from £11½ billion in 1985-86 to an estimated £4½ billion in 1986-87. I introduced a cautious Budget which nevertheless contained sufficient by way of tax reduction to show our determination to stick with our policies. The PSBR was expected to be around £7 billion in 1986-87. This still seemed the most likely outcome at the time of the Autumn Statement. Since then, however, the tax gathering season has

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*Too compressed?*  
revealed a marked surge in non-oil revenues. This is not the result of stronger economic growth - the economy has performed in line with our projections. It is the consequence of higher than expected effective tax rates. It means that the PSBR this year will, for the second year in succession, be lower than the Budget estimate.

5. This outturn inevitably affects the appropriate stance for 1987-88. Prudence is judged, rightly, in relation to achievement. The economy is performing well both absolutely and relative to other countries, with a lower than expected PSBR. There is no case for allowing the PSBR to rise again, even though this will mean setting a lower figure than the  $1\frac{3}{4}\%$  of GDP envisaged in the MTFS. There is no reason to risk anything here. *- Not sharp enough*

6. Despite this, I still expect there to be room for further tax reductions, although the substantial public expenditure increases we announced in the autumn have pre-empted the greater part of our fiscal scope. It will, however, be seen as a measure of the soundness of our policies that we shall be able to maintain public borrowing at unequivocally low levels despite the sizeable additions we have made to the level of public expenditure, despite the slashing of our oil revenues, and still be able to make some further reduction in taxation.

Economic prospects

7. During 1986 our economic performance has been influenced by the difficulties the world economy experienced in adjusting to the sharp fall in oil prices. As expected, we have seen a strong growth of demand in all the industrial economies, including the UK. But the oil producers and other developing economies cut back their imports more than expected. As a result the industrialised countries experienced weak export demand in the early months of 1986. UK exports initially reflected this performance but have grown strongly since the middle of the year. By the fourth quarter of 1986 the volume of visible exports (excluding oil and erratics) was  $9\frac{1}{2}\%$  per cent higher than a year earlier. This appears to have been a stronger performance than in any other major economy. As a result, manufacturing output

grew rapidly in the second half of 1986, having been weak in the first half of the year.

8. The growth of the UK's main overseas markets should be somewhat stronger in 1987 than in 1986. There are, however, risks that the outturn could be less favourable. Prolonged turmoil in foreign exchange markets could lead to reactions that dampen demand and output in the major economies. It is also possible that developing countries and oil producers could import less from the developed economies than we now expect. Nor can we be sure that protection will be held at bay.

9. On the assumption, however, that demand for UK exports in 1987 grows more quickly than in 1986, the prospect is for continued strong export growth. But because non-oil imports have been growing rapidly and the surplus on oil trade has declined by £5 billion there is likely to be a modest current account deficit of around  $\frac{1}{2}$  per cent of GDP in 1987.

10. Domestic demand is expected to continue to grow rapidly in 1987, and combined with vigorous export growth should mean another year of 3 per cent growth. The composition of domestic demand growth is likely to be more balanced than last year, with slower growth of consumers' expenditure and stronger investment.

11. The steady growth performance has contributed to a welcome fall in unemployment. Since August 1986 unemployment (UK seasonally adjusted, excluding school leavers) has fallen by 107,000. With 3 per cent growth in prospect there is every chance of unemployment continuing to fall at a similar rate throughout 1987. But the prospects would be even better if we could see a further slowdown in the rate of pay increase.

12. Since the end of the 1985/86 pause we have seen a further surge in productivity, particularly in manufacturing industry. This builds on the good productivity performance achieved by British industry since 1981. The table below shows how British productivity growth has recovered from the low level of the 1970's. In comparison with other developed economies British productivity

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Growth is much better than in the 1960s and the 1970s. Indeed in terms of output per head in manufacturing industry we have done better since 1979 than any other member of the Summit Seven.

**OUTPUT PER HEAD IN THE MAJOR 7 INDUSTRIALISED COUNTRIES**  
(averaged annual percentage change)

|               | Manufacturing |         |           | Whole economy |         |           |
|---------------|---------------|---------|-----------|---------------|---------|-----------|
|               | 1964-73       | 1973-79 | 1979-86H1 | 1964-73       | 1973-79 | 1979-86H1 |
| United States | 3.4           | 3.5     | 2.3       | 1.6           | 0.2     | 0.7       |
| Japan         | <u>9.8</u>    | 4.0     | 2.7       | <u>7.4</u>    | 2.9     | 2.8       |
| Germany       | 3.9           | 3.3     | 2.3       | <u>4.2</u>    | 2.9     | 1.4       |
| France*       | 5.4           | 3.0     | 2.5       | <u>4.5</u>    | 2.8     | 1.5       |
| Italy         | 5.5           | 2.4     | 2.4       | <u>5.6</u>    | 1.7     | 1.0       |
| Canada        | 4.3           | 2.5     | 3.0       | <u>2.5</u>    | 0.5     | 0.6       |
| UK            | 3.8           | 0.7     | 3.5       | 2.7           | 1.1     | 1.8       |
| G7 Average    | 5.0           | 3.2     | 2.5       | 3.5           | 1.5     | 1.3       |

13. For 1986 as a whole inflation as measured by the RPI averaged 3.4 per cent - the lowest annual figure since 1967. Since the last election most of the short-term swings in the monthly RPI have mirrored changes in the mortgage interest rate. For example, the monthly lows of 3.7 per cent in 1983 and 2.4 per cent in 1986 coincided with falling mortgage rates; the monthly high of 7 per cent in 1985 reflected a rising mortgage rate. With no further change in mortgage rates, the RPI which stood at 3.7 per cent at the end of last year, is likely to edge steadily upwards during the first half of this year before falling back to around 4 per cent by the fourth quarter. This pattern is largely the result of mortgage rate increases at the end of last year coupled with the effect on the 12-month comparison of the temporary dip in petrol prices last summer.

14. The recent and prospective performance on inflation is in historical terms a good one, and one that we can point to with some satisfaction. But it is higher than in most other major industrial countries and it remains important in maintaining

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confidence against an uncertain international background to keep inflation on an unambiguously downward underlying trend.

Summary and Conclusions

15. Output growth last year was close to its average rate since 1981 of 3 per cent a year, and a further 3 per cent growth is expected this year. This compares well with other major countries. Unemployment seems set to fall in 1987. Inflation is rising a bit - though from the untypically low rates recorded in the middle of last year. Markets will be paying close attention to this and perhaps also to the prospects for the current account of the balance of payments. It is in both our short term and medium term interests to play safe with relatively modest tax reductions and a PSBR which takes full account of this year's outturn.

16. I would welcome colleagues' views on the Budget against the background of the fiscal and economic prospects I have outlined.