

CONFIDENTIAL

PRIME MINISTER

ECONOMIC POLICY DISCUSSION WITH THE TREASURY

This note draws heavily on comments from Brian Griffiths.
Sir Terry Burns has tabled the paper at Flag A for tomorrow's
meeting. It is more sketchy than we might have hoped. But I
think we can take it as the starting point for discussion.

Objectives for the Meeting

You are dining with the Chancellor next Sunday when he will
reveal his Budget thinking to you. I suggest you keep off
possible Budget details tomorrow but one of the key elements
for discussion must be the appropriate broad fiscal stance.

Additional Material

I attach at Flag B some further tables breaking down the
figures for GDP and inflation for the G7 countries - this
supplements the summary table 1 in the Treasury paper. There
are also two tables showing current account balances for the
same countries both in absolute terms and as percentages of
GDP. You might also like to refer back to the summary
forecast published in the 1987 Autumn Statement (but N.B.
these published figures are not necessarily the same as the
Treasury's internal Autumn forecasts).

I hope the Treasury will also bring with them some figures on
net debt and net debt interest as a percentage of GDP for
other countries to supplement the figures in table 3 of the
Treasury paper.

Background

The starting point is:

- (i) considerable success in UK performance over the
last four years in terms of growth, productivity,
investment, employment and profitability;

CONFIDENTIAL

- (ii) a less good result in terms of inflation and more rapid growth of money GDP than expected;
- (iii) cause for concern over the trend in the balance of payments current account - a surplus of £2.8 billion in 1985 to a prospective deficit in 1987 of £2.5 billion possibly rising from now on;
- (iv) much more rapid than expected growth in tax receipts, leading to a large fiscal adjustment for 1988/89. Recent City estimates if anything understate this; I gather the Treasury's latest figure is for a PSBR surplus of £9 billion if there were no tax cuts (not to be revealed tomorrow).

Where is the economy now and where is it heading?

Before moving to the Treasury's suggested issues for discussion you might press them a lot further for their forecast for the next 18 months. Terry Burns' paper is particularly thin on this. Questions could include:

- (i) prospects for real growth following the stock market collapse. Do the latest business surveys, retail sales figures, etc. suggest a significant impact on growth? N.B. paragraph 6 of Terry's paper says the 1988 year on year growth of GDP could be above 2.5 per cent but with a slow down during the year.
- (ii) What do they expect the current account balance to be in 1988?
- (iii) What is likely to happen to the underlying rate of inflation, eg. after ignoring mortgage effects and bearing in mind the likely slow down in productivity growth?
- (iv) Will the savings ratio recover at all?

Growth 1988-9?

BAF?

Inflation

Savings ratio.

- (v) Is the buoyancy of tax revenue expected to continue?

Wage increases?

Issues for discussion

The order suggested at the end of the Treasury paper seems sensible.

(a) Output growth, market uncertainties and monetary and fiscal policies.

- (i) What are the chances of a recession in the US economy?
- (ii) What are the Treasury's views of the prospects for the dollar (assuming it was allowed to find its own level)
- (iii) How sensitive is UK growth to oil prices and any delayed effects of the stock market crash?
- (iv) What exactly do the Treasury mean by 'a cautious fiscal and monetary policy'?

Oil Prices

(b) Taxes and the fiscal stance.

Table of the Treasury paper shows that total taxes ^{as a proportion of GDP} plus NICs have changed little; and the proposal is to continue this broadly unchanged ratio. But what exactly would that imply for the size of tax cuts/PSBR in the Budget?

(c) Balance of Payments and Exchange Rates

This is probably the most difficult set of questions. The Treasury paper is very relaxed about running a current account deficit (i.e. an overseas sector surplus) of some one per cent of GDP (£4 billion), when the public sector is in broad balance and the private

sector is in deficit (reflecting a strong growth of private investment). You may like to probe this carefully. The danger is that an over-relaxed fiscal stance which allowed consumer spending to continue to grow rapidly could substantially worsen the current account deficit. Might not a tight budget act to curb consumption, help restore the savings ratio and simultaneously both ease inflationary pressures and help the current account deficit?

(d) Inflation and Monetary Policy

(i) what is "adequate downward pressure on inflation"? Does this need to be given higher priority?

(ii) what does avoiding "excessive upward pressure on the exchange rate" mean? If it means holding to something like the DM3 cap this could mean putting the weight of monetary adjustment on interest rates. And if there is still market pressure to push up the exchange rate we will add further to the reserves and loosen the monetary stance. (But NB the comments in paragraph 11 of the Treasury paper that nearly three-quarters of this year's intervention has been sterilised.)

Recd.

(PAUL GRAY)

19 January 1988

Figures Provided BY
TREASURY AT 20/1/88 MEETING

Net Public Debt as a Percentage of GNP/GDP in the Major Countries

	1980	1986(1985)
<u>Net General Government Debt</u>		
(Net General Government Interest payments as a Percentage of GNP/GDP in brackets*)		
- Source OECD		
US	19.5(2.0)	28.8(3.7)
Japan	17.3(1.2)	26.2(1.7)
Germany	14.3(0.9)	22.2(1.7)
France	9.1(1.0)	18.5(2.0)
Italy	61.8(5.4)	99.2(8.7)
Canada	11.5(2.0)	34.0(4.4)
G7 Average	21.8	32.2

*Estimated from OECD National Accounts data. Figures are not entirely consistent between countries but they illustrate the broad pattern of change.

B

Real GDP/GNPpercentage growth rates

	1983	1984	1985	1986	1987	Average 1983-1987
UK	3.3	2.4	3.6	3.0	4	3.3
US	3.6	6.8	3.0	2.9	2 $\frac{3}{4}$	3.8
Japan	3.3	5.0	4.8	2.5	3 $\frac{1}{2}$	3.8
Germany	1.9	3.3	2.0	2.5	1 $\frac{1}{2}$	2.2
France	0.7	1.4	1.7	2.0	1 $\frac{1}{2}$	1.5
Italy	0.5	3.5	2.7	2.7	2 $\frac{3}{4}$	2.4
Canada	3.2	6.3	4.3	3.3	3 $\frac{3}{4}$	4.2
Major 7	2.8	4.9	3.1	2.7	2 $\frac{3}{4}$	3.2

Source: OECD, CSO, Autumn Statement

Consumer Price InflationAnnual percentage changes

	1983	1984	1985	1986	1987*	Average 1983-1987
UK	4.6	5.0	6.1	3.4	4.2	4.7
US	3.2	4.2	3.6	1.9	3.6	3.3
Japan	1.8	2.3	2.0	0.4	0.2	1.3
Germany	3.3	2.4	2.2	0.2	0.2	1.6
France	9.4	7.7	5.8	2.5	3.3	5.7
Italy	14.6	10.8	9.2	5.8	4.7	9.0
Canada	5.8	4.3	3.9	4.2	4.4	4.5
Major 7	4.6	4.5	3.9	1.9	2.7	3.5

Source: OECD, CSO

* US, UK, Germany and Italy: January to November
Japan, France and Canada: January to October

Current Account Balances\$ billion

	1983	1984	1985	1986	1987	Average 1983-1987
UK	5	2	4	- 1	- 4*	1
US	- 46	- 107	- 116	- 141	- 156	- 113
Japan	21	35	49	86	86	55
Germany	4	8	15	37	44	22
France	- 5	- 1	0	3	- 3	- 1
Italy	2	- 2	- 4	4	- 2	0
Canada	2	3	- 1	- 7	- 7	- 2
Major 7	- 17	- 62	- 53	- 20	- 42	- 39

* Autumn Statement forecast

Source: OECD

Current Account BalancesPercentage of GNP/GDP

	1983	1984	1985	1986	1987	1983-1987 Average
UK	1.1	0.5	0.8	- 0.3	- 0.6*	0.5
US	- 1.4	- 2.8	- 2.9	- 3.4	- 3.5	- 2.8
Japan	1.8	2.8	3.7	4.4	3.6	3.3
Germany	0.6	1.3	2.4	4.1	3.9	2.5
France	- 0.9	- 0.2	0.0	0.4	- 0.3	- 0.2
Italy	0.4	- 0.5	- 0.8	0.7	- 0.3	- 0.1
Canada	0.8	0.8	- 0.3	- 1.9	- 1.7	- 0.5
G7 total	- 0.2	- 0.8	- 0.7	- 0.2	- 0.4	- 0.5

* Autumn Statement forecast

Source: OECD

1987 Autumn Statement

Table 1.12 Economic prospects: summary

	Forecast		Average errors from past forecasts ¹
	1986 to 1987	1987 to 1988	
	per cent changes		percentage points
Output and expenditure at constant 1980 prices			
Domestic demand	4	3½	1
of which:			
Consumers' expenditure	5	4	1½
General government consumption	½	½	1
Fixed investment	5½	4½	2¼
Change in stockbuilding (as per cent of level of GDP)	0	0	½
Exports of goods and services	5½	2	2½
Imports of goods and services	6½	5	2¾
Gross domestic product: total	4	2½	¾
manufacturing	5	3½	2¼
Inflation			
Retail prices index	per cent changes		
1986 Q4 to 1987 Q4	4		¼
1987 Q4 to 1988 Q4	4½		2
Deflator for GDP at market prices	per cent changes on a year earlier		
Financial year 1987-88	4¼		1
Financial year 1988-89	4½		2
Money GDP at market prices	£ billion ²		
Financial year 1987-88	418 (8½)		1
Financial year 1988-89	448 (7¼)		1½
Balance of payments on current account			
1987	-2½		1½
1988	-3½		3

¹ The errors relate to the average differences (on either side of the central figure) between forecast and outturn; the errors given for constant price output and expenditure are relevant to the forecast for next calendar or financial year. The method of calculating these errors has been explained in earlier publications and Government forecasts (see Economic Progress Report

June 1981). The calculations of average errors are based on forecasts made between 1975 and 1985.

² Per cent change on previous financial year in brackets; average error shown relates to the forecast of the percentage change.