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From the Private Secretary

20 January 1988

Dear Alex,

The Prime Minister and the Chancellor this morning had a general discussion about economic policy against the background of Sir Terence Burns' note of 18 January. Sir Peter Middleton, Sir Terence Burns and Professor Brian Griffiths were also present.

The Prime Minister said there were a number of features of the economic scene that caused her concern. Inflation remained stubbornly high, particularly in relation to key competitors, and latest figures on earnings and unit labour costs pointed to the dangers of inflation accelerating. Allied to this, the personal savings ratio had fallen to very low levels. The trend of the balance of payments current account was adverse with a significant deficit now emerging; it was essential the UK did not take the place of the United States as a major deficit country. Action to sterilise the large increase in foreign currency reserves had led to large overfunding during 1987. The public finances were at risk if oil prices fell. And the ratio of net public sector debt to GDP remained at very high levels compared with other countries.

In discussion the following points were raised:

- (i) The political difficulties of the trend in the current account should not be underestimated, and would be exacerbated if there were downward adjustments to the figures for invisibles. On the other hand, recent balance of payments figures had been marked by a large positive balancing item which could lead to favourable corrections. In addition the current size of the deficit was only around half a percent of GDP and, unlike the balance of payments crises of the 1960s and early 1970s, it was associated with a strong underlying economic performance.
- (ii) The interpretation of the current account deficit (equivalent to a surplus for the overseas sector) also had to take account of the position in other sectors of the economy. Historically, whenever the public sector had been in the broad balance, there had been no sustained overseas sector surplus. But

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the present position of the private sector was also unusual, with a move into deficit. To the extent that this private sector deficit reflected strong investment growth, a relatively relaxed view could be taken of its being financed from overseas - in effect the current account deficit had been privatised.

- (iii) There had been a small public sector surplus in 1970 but the opportunity that presented had then been wasted by allowing public expenditure to run out of control. It was therefore important to ensure that the present position of broad public sector balance was sustained against a background of rising public expenditure commitments, particularly on the pay front.
- (iv) Interpretation of the present low savings ratio was particularly difficult. The statistics were bedevilled by a large residual error. It had to be remembered that the savings ratio was measured net and that the reduction in recent years in large part reflected the build up of mortgage borrowing. This was associated with heavy consumer expenditure on items such as kitchens and white goods. One view of the prospect for 1988 was for a substantial slowdown in this type of consumer expenditure, a view supported by recent discussions with the Retail Consortium. On this view it was reasonable to expect some increase in the savings ratio during 1988 which would provide an automatic correction of the pressures on inflation and the trade balance. GDP growth during the course of 1988 might slow to say 2 - 2.5 per cent.
- (v) An alternative scenario was one in which consumption-led growth continued at a high rate with no recovery in the savings ratio. On this basis the case for a restrictive fiscal stance was even stronger and would need to be coupled with some tightening of monetary policy.
- (vi) There were indeed substantial grounds for considering an early move to raise interest rates by half a percent to tighten the monetary stance. If the circumstances and timing were right this need not necessarily mean upward pressure on the exchange rate. On the other hand, if the exchange rate was pushed up and unsterilised intervention was carried out to hold sterling below DM 3 that would simply offset the desired monetary effect. In those circumstances a tighter monetary stance could only be achieved by allowing the exchange rate to rise.
- (vii) Table 6 of Sir Terence Burns' paper pointed to the broadly unchanged ratio of taxes and NICs to GDP in recent years. This single aggregate figure was

difficult to interpret as there were different trends for some of the component elements. But a major factor in the continuing strong tax take was the buoyancy of corporation tax as profits rose. In addition, although income tax allowances were indexed for price movements, there was still fiscal drag in the system resulting from real growth. One view of this phenomenon was that 'tax cuts' were no more than returning to taxpayers the additional tax burden generated by growth. There was a related point that, in terms of presentation, the single banner of 'tax cuts' should not be applied to a position in which, although marginal tax rates might be reduced for many taxpayers, the overall tax burden was little changed and was financing a continuing high level of public expenditure.

Summing up the discussion the Prime Minister said it was essential not to take a complacent view of current economic prospects and she felt it was important she should use Question Time and other opportunities to damp down the recent public mood of euphoria about the Budget prospects. She invited the Chancellor to propose some suitable forms of words for this purpose. It would also be helpful if the Treasury could provide a breakdown of the aggregate figures for the ratio of taxes and NICs to GDP.

Yours,
Paul

PAUL GRAY

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