

For Dinner with Chancellor  
24/1/88

PRIME MINISTER

#### THE STANCE OF ECONOMIC POLICY

Following your meeting with the Treasury earlier in the week, and in advance of your dinner with the Chancellor on Sunday, you may like some further reflections.

The key issue is deciding the right mix of monetary and fiscal policy. It is unusually difficult to judge the stance of either at present.

But in considering the balance a crucial point is that it is much easier to make quick changes to monetary policy than to fiscal policy. Moreover fiscal policy is certainly not as tight as it appears at first glance because:

(i) the crude PSBR figures are distorted by privatisation and other asset sales; and in the longer term by oil revenues;

(ii) it is very unusual for the private sector to run a deficit as it is now doing. The Treasury claim to interpret this as a good sign and as evidence of a strong investment performance. There is something in this but I think the main reason for the deficit is low savings rather than high investment. If anything we are still under-investing. So whereas Terry Burns says a private sector deficit matched by a balance of trade deficit equals foreigners financing our investment, an alternative interpretation is that the trade deficit reflects excessive UK demands for foreign consumer goods.

For these reasons the right fiscal stance should certainly be no looser than a broad PSBR balance (or a surplus of £5 billion if privatisation proceeds are counted). And there

is an arguable case for being, say, £2 billion tighter than that.

Given the buoyancy of revenues a PSBR balance could still leave the Chancellor with a fiscal adjustment of around £4 billion. But it is fair to regard a proportion of this as real fiscal drag generated by the system. I have asked the Treasury for their estimates of fiscal drag but they have not yet arrived. However Peter Spencer (ex Treasury, now in the City) published earlier this week an estimate of nearly £2 billion. So fiscal drag could account for around half of the apparent fiscal adjustment. Although it should certainly not be an automatic adjustment, it is fair to regard the act of returning fiscal drag to the taxpayer as a "neutral" policy response.

At present it is also important to maintain a pretty tight monetary stance. If in the event the Budget judgement proved to be overly restrictive it would be possible during the course of the year to ease up on the monetary front. Whereas if the Budget was too loose I doubt if further monetary tightening alone during the year would do the trick. If there is a need before the Budget to tighten the monetary stance you will want to consider linking your agreement to any increase in interest rates to lifting the present DM3 cap.

I attach a further note on some of the details the Chancellor may put to you on Sunday. I shall be at home over the weekend (it is my duty weekend) if you can't decipher my scribbles.

*Recg.*

(PAUL GRAY)

22 January 1988

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