

SECRET



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Price Minister
X deficit in other areas.
We are getting hold of the
FSBR draft to check the text.

REC6
11/3

PRIME MINISTER

Now that we have the PSBR figures for the first 11 months of the year - the last figures we shall have before the Budget - I can let you have the further note on the 1988 MTFS I promised in my minute of 4 March.

Fiscal Policy

The PSBR for 1987-88 will clearly turn out much lower than forecast, even at the time of the Autumn Statement. We have a surplus of over £7 billion with one month to go. And though borrowing in the last month is always relatively heavy, we are bound to have a sizeable surplus for the year as a whole. I intend to publish a figure of £3 billion, which is on the cautious side.

I propose to seize the opportunity to make a balanced Budget the norm. It will fluctuate around this in particular years, but balance should be the central aspiration from now on - and this will be the figure which appears in the MTFS for the years 1989-90 to 1991-92. Zero is equivalent to a PSBR of 1% of GDP in the absence of privatisation proceeds.

For next year, 1988-89, a balanced Budget would mean £7 billion of tax cuts. I am sure this would be too much for one year. The £4 billion tax reducing package which we have agreed is, I believe, right for 1988-89. It will leave us in surplus by £3 billion (the same as this year) on deliberately conservative estimates about the future. It also implies, incidentally, no reduction in the tax burden (as measured by taxes etc as a share of GDP). If we succeed in containing pressures on spending, there should be further scope for tax reform and tax reduction in future years.



Monetary policy

The MTFS will emphasise that our central objective is to bring inflation down further. This of course requires firm monetary policy as well as tight budgetary discipline. I therefore intend to reduce the target range for MO in 1988-89 to 1-5% as foreshadowed in last year's MTFS. This compares with the 2-6% range in 1987-88, and current growth of around 5%.

For subsequent years I propose to stick to the pattern of declining monetary growth shown in last year's MTFS. The 0-4% range for the final year of the MTFS (1991-92) is consistent with our objective of moving towards stable prices.

X (The MTFS will make it clear that day to day decisions on interest rates will continue to be taken on a comprehensive assessment of monetary conditions, recognising that exchange rates play a central role in both domestic monetary decisions and international policy co-ordination.

N.L.

N.L.

10 March 1988

BANK BUDGET LETTER

1 The Bank is aware that a substantial reform, and reduction, in personal taxation is under consideration. We would in general terms welcome this for the favourable supply-side response it could help to produce, and we recognise the arguments for making such changes this year. The need for an acceptable reform to generate more gainers than losers no doubt means that the changes would be expensive. From the Bank's perspective therefore a key issue in the Budget judgment is likely to be how far such changes in the structure of personal taxation can be accommodated within the constraints imposed by the conjunctural position.

2 The conjunctural starting point - before the fall in equity prices in October and the more recent falls in both the dollar and oil prices - was, as we now know, one of very strong growth in domestic demand which, notwithstanding an exceptionally vigorous output response, was already spilling over into a worsening balance of payments. Inflation remained in the 4-5% range of the last four to five years, with no sign of underlying decline; at the producer price level, material input costs were relatively subdued and labour costs held down by cyclically strong productivity growth so that price increases reflected higher margins.

3 The recent Bank forecast is similar in its general thrust through 1988/89 to the Treasury's forecast underlying the Autumn Statement. In important relevant respects these forecasts, as well as a number of outside forecasts, suggest a continuation of existing trends. Specifically -

- (i) Domestic spending, particularly consumer demand, remains strong - and stronger than in most other countries.
- (ii) This relative strength of domestic demand is accompanied by a sharply declining private sector financial position and some falling away in the (still strong) output response as pressure on capacity (including shortages of some categories of labour) increases. Coupled with the effects of recent exchange rate movements on competitiveness, these

developments imply a further worsening in the non-oil trade balance (coming on top of further structural decline in the oil balance).

- (iii) Underlying inflation remains - at best - stuck in the 4-5% range, and within that there is likely to be an acceleration in domestic costs, as labour productivity growth moderates with output growth, offset by a weak rise in import prices.

4 While there can be differences of judgment about the strength of these various trends, their general direction seems to be rather clearly established. And the consequences if they turned out stronger rather than weaker than presently foreseen would be a good deal more serious for both the counter-inflationary objective of policy and the sustainability of economic expansion. In the Bank's view therefore the conjunctural outlook requires an overall policy stance that is designed to exert a moderating influence on domestic demand and domestic costs.

5 Within that overall policy stance, monetary policy, including the exchange rate, will need to remain firm, inter alia, to exert a necessary financial discipline on costs in sectors exposed to international competition. But, given the trends identified above, there would be significant risks to the balance of the economy, the current account position, and ultimately the sustainability of domestic demand growth, if the weight carried by monetary and/or exchange rate policy were to become excessive. This concern in turn implies the need for a generally supportive fiscal policy through a restrained approach to the Budget.

6 There is no objective way of translating these general considerations into precise budgetary numbers. But our judgment would be that, in the present strong cyclical position and with the private sector moving towards financial deficit, they imply the need for a significant PSBR surplus of 1/2-1% of gdp, say, £2 1/2-5 bn, in 1988/89. This would mean a public sector financial deficit of £2 1/2 bn to zero. A PSBR surplus of this size probably represents a more cautious fiscal stance than market analysts currently expect; but it seems likely that the market

perception of the strength of the fiscal position in the current year is lagging the outturn as we see it, so that by March the market expectations may well have become more demanding.

7 On our forecasts for the PSBR - which are necessarily less well-informed than those that will be produced in HMT's pre-Budget forecast - a PSBR surplus of 1/2% of gdp next year would still leave room for a fiscal adjustment (either tax reductions or expenditure increases - planned or through allowance for slippage) of as much as £4 bn which should be sufficient to accommodate a substantial package of tax reform. We think that an adjustment of about this size, and still assuming that the larger part of the benefit would accrue directly to the personal sector, is the most that can be prudently undertaken in the present conjunctural position even if HMT's forecast were to suggest scope for rather more within a PSBR surplus of 1/2% of gdp. It is almost certainly more than the markets would expect to be available consistently with a PSBR surplus, and to go further would risk an adverse reaction because of fears of excessive and unbalanced growth of domestic demand and could call into question the credibility of the underlying forecast as a whole.

8 Developments over the two months to the Budget itself could, of course, alter these judgments in either direction. If, contrary to our present expectation, clear signs of a softening of consumer demand, perhaps as a delayed response to the fall in equity prices, were to emerge the scope for fiscal adjustment might be at the higher end of the range. If, on the other hand, there were evidence of a more rapid worsening in the trade balance than presently forecast that would point to the lower end. A substantial further fall in the oil price would also point to a smaller rather than larger fiscal adjustment because in that circumstance monetary/exchange rate policy may need to be somewhat easier than otherwise on balance-of-payments grounds, so that fiscal policy would have to play a larger part in the necessary restraint on domestic demand. And somewhat similar considerations would apply in the case of a further substantial weakening of the dollar if an excessive rise in sterling's effective rate was to be avoided.