

PRIME MINISTER15 July 1988SEMINAR ON THE ECONOMY

The two most significant statistics in the Treasury June forecast are:

- the rise in the forecast rate of inflation (RPI) to 6.4% in July 1989
- the size of the current account deficit for 1988, 1989 and 1990 and the extent of the revision since the Budget earlier this year.

Current Balance Forecast

	FSBR 1988	June 1988
1988	-3.9	-9.3
1989	-4.6	-10.1
1990	-4.3	-9.0

The two interesting issues are: What went wrong? What to do about it.

What Went Wrong?

Demand has outpaced output. Whereas domestic demand (consumption plus investment plus public spending) was expected to grow by 4.2% in 1988 it is now forecast to grow by 5.8%.

What is the source of this extra spending? It is primarily unexpectedly high consumer spending (following a rapid fall in the saving ratio) and high corporate investment. Fiscal policy is in good shape. The unexpected strength of demand is weak monetary policy. The reason for this is that exchange rate stability and not counter inflationary policy has been the major objective of policy. Our experience is the direct consequence of the Plaza and Louvre way of thinking. The result is that MO is outside its target range, interest rates have fallen too rapidly - with the result that inflation is rising and the balance of payments moving into deficit.

What to do about it?

The Chancellor rightly rules out controls and any change in fiscal policy until the next Budget. The emphasis therefore is placed on interest rate policy and the key indicator of success is the reduction in the growth of MO.

The crucial question which needs to be asked is:

Does getting MO within target range take precedence over other aspects of policy? (eg exchange rate stability).

You need to make to very clear that getting inflation down is the priority of policy, that this depends on getting MO to near the middle of the range (1-5%) and that this may require even higher interest rates.

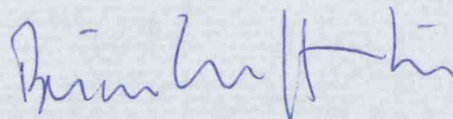
In terms of the current account deficit there is one ominous sentence - paragraph 26 - "But part of the current deficit may reflect medium term trends in savings and investment behaviour and be sustained for some years".

A balance of payments deficit for some years (3, 4, 5 ...?) as a target of policy?

In the seminar you held with the Chancellor before the Budget he argued that it was perfectly feasible to run a smallish balance of payments deficit because private sector investment was greater than private sector saving. The period since the Budget and the June forecast for the current account suggests that it would be very unwise for us to target a balance of payments deficit for some years. Much better to go for a current account.

This is something everyone understands and are prepared to accept. The real danger with planning to run a continuing deficit is that it is difficult to distinguish a private sector market led deficit (the result of investment being greater than saving but with the private market voluntarily financing such a deficit) from one resulting from the creation of excess demand.

The experience of the past year does not augur well.



BRIAN GRIFFITHS