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15 July 1988

Paul Gray Esq
No.10 Downing Street
London SW1

Dear Paul,

PRIME MINISTER'S SEMINAR ON THE ECONOMY

... I attach a note for discussion at Monday's meeting.

Yours
Alan

A C S ALLAN

ECONOMIC SITUATION

Output and Demand

1. The economy has continued to perform well. We seem to be heading for another year of 4 per cent growth.
2. It is now widely acknowledged that supply performance has improved. The clearest sign is that productivity continues to grow at an exceptional rate. The supply reforms introduced since 1979 have been largely responsible for this improvement.
3. Even so demand growth has outpaced the sustainable rate of output growth. And by even more than we expected at Budget time, despite the maintenance for most of the time of high real interest rates and despite the tightness of fiscal policy. This rapid growth of demand has been accompanied by a sharp deterioration in the current account of the balance of payments. There has also been some worsening of indicators of domestic monetary conditions; and MO growth is currently well above the top of its target range.
4. It is now clear that the stock market crash has not had the adverse effects on spending that many people feared - thanks in large part to the prompt action taken by the authorities of the major nations in reducing interest rates.
5. In addition, the huge inflow of capital into the UK over the past year has increased domestic demand and contributed to the current account deficit. This inflow is a reflection of confidence in UK economic performance, but it has increased the problems of economic management.
6. Some of the domestic demand growth is welcome. Higher profitability and fuller utilisation of capacity have produced a long overdue investment boom which, in time, will enhance supply capacity and further improve economic performance.

7. More worrying has been the continued rapid growth of consumption. Although the strength of personal disposable income has been a major factor, a declining savings ratio has also played an important part.

8. But the recorded growth of investment and consumption falls short of a full explanation of the growth of demand. The situation is complicated by the poor quality of the statistics and consumption, investment, or exports could all be stronger than is being officially recorded.

9. We expect some slowdown of domestic demand and output over the next year, especially in the light of the recent monetary tightening - but inevitably there are major uncertainties.

Inflation

10. Inflation as recorded by the RPI is expected to average 5½ per cent in the fourth quarter of this year. It may peak in mid-1989 at over 6 per cent before resuming its downward trend.

11. The RPI inflation profile is heavily influenced by changes to the mortgage rate: this is a damaging anomaly, since a tightening of monetary policy initially puts up measured inflation. Mortgage rate effects may be adding more than 1 per cent to recorded inflation in mid-1989 - the exact amount depending upon the path of interest rates. Excluding mortgage interest rates, inflation shows a much flatter profile (see table 1).

12. World commodity prices are also having an influence on inflation. They have been rising very rapidly, albeit from a very low level. It is not only in the UK that analysts ^{were by} ~~under~~estimated the effect of the stock market crash.

13. General cyclical pressures are also pointing to higher inflation: it is normal for inflation to shadow the economic cycle but with a lag.

14. The task now is to make doubly sure that we keep downward pressure on the underlying inflation rate.

15. We have wanted to tighten domestic monetary policy for some time now. But this was hampered by the strength of sterling and the dangers of an exchange rate 'bubble' emerging. Since the pressure on sterling has eased it has been possible to increase interest rates by $2\frac{1}{2}$ per cent, and they may well have to go higher. We will need to watch carefully the trend of MO.

16. It is important to dampen the housing boom which has been an important factor in credit creation. Higher mortgage rates are a crucial part of the tightening of monetary policy.

17. Some argue that higher interest rates will do nothing to slow growth of credit. But they have an important effect on monthly mortgage payments which will absorb spending power. And higher interest rates mean a higher return to savers which should act as an incentive to save. Higher interest rates will also restrain the growth of company spending, particularly on stocks.

18. The projections for next year have some clear similarities with the inflation 'blip' in 1985 - some temporary increase in general inflationary pressures combined with the short-term adverse consequences for the RPI of higher mortgage rates.

Balance of Payments

19. The forecast shows a current account deficit for this year - and the next two years, although distant-year forecasts are highly uncertain - of close to 2 per cent of GDP. The sharp deterioration this year has a number of aspects: the rundown of oil revenues; the rapid growth of UK domestic demand relative to other countries; and the pressure on relative cost competitiveness stemming from the large capital inflows and the strength of sterling.

20. This outlook for the current account coincides with a progressive tightening of fiscal policy. For this year it now seems we will have a public sector debt repayment of some £7 billion. In other words even excluding privatisation proceeds we look like having a Budget surplus.

Confidence - Saves less spends more? why?
Budget Surplus

*Investment B.O.W.
Increased savings
savings*

21. It follows that any current account deficit is the counterpart of a private sector deficit; in other words the investment being undertaken by the private sector exceeds its own internally generated savings. Part of the investment is being financed by a net inflow of capital from overseas (*).

22. A private sector deficit is unusual in the UK. The private sector has hitherto been in sustained surplus since the early 1950s. (Between 1946 and the early 50s there was a private sector deficit following the exceptionally high liquidity accumulated during the war).

23. But in a world of mobile capital there is no iron law that some countries always run private sector financial surpluses and others always run private sector financial deficits. The pattern can change and depends upon the investment opportunities available as well as savings behaviour.

24. A large part of the move into deficit reflects a rising investment ratio. This can be attributed to higher productivity, higher profitability and higher utilisation of capacity.

25. Part of the deficit also seems to reflect a lower private sector savings ratio, and particularly a sharply declining personal sector savings ratio. We expected low inflation to reduce the savings ratio but have been surprised by the extent of the fall. The buoyant housing and mortgage market has almost certainly played a part. Our view is that there are some temporary factors at work. *What?*
In time we will see some correction although the timing is inevitably highly uncertain.

(* The story is, however, complicated by the residual error in the national accounts. The recorded figures show a private sector surplus. On the assumption that the public sector finances are measured reasonably accurately, either the private sector must be in deficit or the current account in balance.)

26. Part of the strength of investment and the weakness of savings is probably cyclical. The tightening of monetary policy to keep underlying inflation on a downward path should, in time, reduce the current account deficit. But part of the deficit may reflect medium-term trends in savings and investment behaviour and be sustained for some years. But by its nature a private sector deficit is unlikely to become very large. Its scale is limited by the willingness of lenders to finance it and of borrowers to take on increasing debt service obligations.

27. If this is the case, what is the role of government? One theoretical possibility is to run even larger budget surpluses to compensate for the private sector deficit. To some degree this is what we have done with downward revisions to the PSBR path in successive editions of the MTFS. But before deciding to make a change in fiscal policy on these grounds, we must be sure that the private sector deficit will be sustained. Trying to adjust the budget deficit to short-term swings in private sector behaviour would be tantamount to a return to old-style neo-Keynesian demand management. It would also mean foregoing the lasting supply side benefits of lower taxation, and would almost certainly in practice lead to irresistible pressure for increased Public Expenditure.

28. A second possibility is to encourage a lower exchange rate. This would be a serious error; it would be inflationary and it would disrupt the smooth flow of international capital. We must make clear that we reject this route.

29. A third possibility is a return to credit controls in an attempt to increase private sector savings. But this would be impossible given today's flexible and innovative financial markets.

30. The conclusion must be that we should concentrate on keeping our own house in order and in particular making sure that we pursue monetary policy in a manner that will gradually deliver our ultimate objective of stable prices. It may be awkward for us that the private sector runs a current account deficit, but this will correct itself in time and any attempt by us to act to correct it abruptly risks making things a good deal worse.

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Table 1

Inflation

	<u>RPI</u> <u>Total</u>	<u>RPI</u> <u>excluding mortgage payments</u>
1982	8.6	8.5
1983	4.6	5.2
1984	5.0	4.4
1985	6.1	5.2
1986	3.4	3.6
1987	4.1	3.7
1988 F	4.6	4.4

(F: forecast)