

PRIME MINISTER

SEMINAR WITH THE TREASURY: 18 JULY

The papers are as follows:

Flag A - The Treasury discussion paper.

Flag B - The detailed Treasury June Economic Forecast. This is in two parts; a note on the effect of a faster rise in interest rates ^{than} ~~and~~ assumed in the based forecast (which you have already looked at) and the full forecast document (which I don't think you had time to go through last weekend).

Flag C - Comments by Brian Griffiths.

Flag D - The Morgan Guaranty note on the implications of social security trends for fiscal policy (which you have seen but not yet studied). It focusses on the US position; but I think there is an important read across to the UK.

We have scheduled 1½ hours for the meeting. You will obviously want to focus on the policy prescriptions that emerge from the forecast. But I suggest it would be worth spending the first half hour standing back a bit and considering where the UK economy has now got to. Possible issues include:

(i) How far has supply performance really improved?

How far do go.

(ii) How far have the old rigidities and inflexibilities been removed?

Not enough

(iii) Is the major shift we have seen in the private sector savings and investment balance a cyclical phenomenon or a more fundamental structural change?

Financial savings by interest.

(iv) Can we, as the Treasury discussion paper implies, be relatively relaxed about an external deficit which

reflects private sector flows and allow it in large part to be self-correcting?

This last question provides a good way into the key policy issues. My impression from discussions with Terry Burns is that senior Treasury officials are a good deal less relaxed about the external position than the Chancellor is. But whether that will emerge in the discussion is another matter.

I suggest the conclusions we should be working towards are:

(i) It is right to avoid any panic fiscal action between budgets.

(ii) Decisions on the precise fiscal stance for the 1989 Budget need to be taken much nearer the time. But the structural changes in the economy - particularly lower personal sector savings - point to the need for significantly larger public sector surpluses. Given the private sector behaviour patterns of five years ago a balanced budget looked to be an extremely prudent stance; but if the private sector is moving into a position of structural deficit, we should be considering broadly balancing it by a public sector surplus.

(iii) The immediate priority is monetary policy. There is only the one instrument of interest rates. So far this year we have allowed it to be directed too much towards an exchange rate objective and too little towards countering inflation. That balance must now change, and we should further increase interest rates until we are confident that MO growth is under control. If that can be achieved without putting upward pressure on the exchange rate, all well and good. But if the market decides to take the exchange rate up we should accept that consequence.

Recg.

PAUL GRAY

15 July 1988

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