

Working Record

SECRET AND PERSONAL



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SUBJECT MASTER

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

18 July 1988

Dear Alex,

The Prime Minister held a meeting this afternoon with the Chancellor to discuss the economic situation in the light of the June Treasury forecast. Others present were Sir Peter Middleton, Sir Terence Burns and Professor Brian Griffiths.

I should be grateful if you would ensure that this record of the discussion is seen only by those with a direct operational interest.

The Chancellor opened the discussion by introducing the paper attached to your letter to me dated 15 July. The development of the economy was generally satisfactory, but the paper focussed on the two problem areas, namely the rate of inflation and the balance of payments current account deficit. Inflation was the main concern, and once the necessary action had been completed on that front other aspects would come right. The fiscal position was very strong, with the public sector now in surplus even after disregarding privatisation proceeds. The growth of private sector demand in recent months had been significantly greater than forecast, with the high degree of confidence exhibited in an investment boom and strong growth of personal consumption. The current account deficit reflected an excess of private investment over private savings, which could not go on for ever but was sustainable for a period of time.

Continuing, the Chancellor said that the action already taken on interest rates would lead in August to the largest increase in mortgage rates for four years, which should have a significant dampening effect on the housing market. M0 growth would also peak this month, and would gradually come down from now on as a result of existing levels of interest rates. Nonetheless, further action to tighten monetary conditions through interest rate increases might be needed.

In discussion the following points were raised:

- (i) It was most unusual to have the combination of a very strong fiscal position and a current account deficit. A key policy question was whether the

private sector deficit should be allowed to work itself out through the operation of market forces or whether there was a need for Government action to correct it. One view was that it was too soon to conclude that private sector savings would not re-adjust in response to the tightening of monetary conditions already undertaken. On the other hand, it was essential that the Government should not be seen to be complacent in the face of a large current account deficit which showed no immediate signs of narrowing;

- (ii) the emergence of the current account deficit raised the question whether the supply side performance of the UK economy had improved sufficiently. It had to be recognised, however, that a number of the supply side improvements would take several years to work through and have their full impact;
- (iii) it was common ground that the fundamental requirement was to get inflation down by a tightening of monetary policy. But it was not clear how far this approach would also serve to reduce the current account deficit. Tighter monetary conditions could, for example, imply a higher exchange rate than would otherwise result. A key factor was the extent to which private sector borrowers, who had increased their levels of debt following liberalisation in access to sources of credit and lower levels of interest rates, would react to the disciplines imposed by increases in interest rates. Their response would determine the extent to which the personal savings ratio recovered and consumption was curtailed;
- (iv) all the recent increases in interest rates had been in steps of $\frac{1}{2}$ per cent. It was arguable that this process merely served to lead the markets to expect further moves. This could result in the total increase being greater than if rates were increased in larger, more decisive steps which gave stronger signals of the authorities' determination to get inflation down. On the other hand, it would always be possible for the authorities to hold to the tactics of $\frac{1}{2}$ per cent increases but at the end of the desired process of adjustment make clear their view that sufficient tightening had been achieved. It was also difficult to form a firm judgement on when the "right" level of interest rates had been reached, and continuing to move in $\frac{1}{2}$ per cent steps gave the authorities greater flexibility to tighten conditions further if this was judged to be necessary;
- (v) it was important to consider the quality of the present large increase in investment; investment was not a good thing in its own right, only if it

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was productive. The impression was that the bulk of current increases in manufacturing investment were to be welcomed, particularly as under the present fiscal regime artificial incentives to invest had been removed. The one area of worry, however, was the high level of investment in the housing sector;

- (vi) in considering action to stimulate the level of private sector saving, regular consideration needed to be given to ensuring that rates offered on national savings instruments were appropriate. Work was in hand on a new national savings product which it was planned to launch at the end of the year.

Summing up the discussion, the Prime Minister said that the fundamental requirement was to get inflation down. The paramount need was to tighten monetary policy through increases in interest rates sufficient to ensure that MO growth moved quickly down to well within its target range. Serious attention also had to be given to the balance of payments current account position, which was a political touchstone. In the light of progress achieved over the next few months, decisions in the run up to the next Budget on the stance of fiscal policy would need to take into account whether it was necessary to boost the level of public sector savings to offset a continuing low level of private sector savings.

Yan,
Pcl

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