

PRIME MINISTER

## ECONOMIC POLICY

I had a useful talk over lunch with Terry Burns about the present state of the economy. Terry spoke very frankly, and you may find it helpful to have his summary assessment.

This boiled down to:

- the present stance of policy, particularly on interest rates, is absolutely right. There is nothing further or different that we should be doing at the moment;
- he continues to be surprised at the strength of economic growth this year. It is too soon to assess just how the economy is responding to the higher interest rates, but there are clear signs, particularly in the housing market, that they are having the expected effect. He would expect (hope) that import growth will slow down within the next couple of months;
- he was not as optimistic as the Chancellor about the prospects for achieving a "soft landing". Given the strength of the growth in demand this year, we may need to face up to two years of quite slow growth in order to achieve the counter-inflation objective;
- that means there will be some difficult times ahead. We will need to be patient, sitting on our hands for quite a long time and resisting the temptation, e.g. to reduce interest rates;
- on the fiscal front, the Budget judgment will need to be straight down the middle, and the contents frankly rather dull. He confirmed my impression that the revolutionary idea the Chancellor put to you recently for the conduct of monetary policy reflected his wish to find something exciting to include in the Budget. (Senior Treasury

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officials are very pleased with your reaction to that proposal and had themselves made the same points to the Chancellor as you did.)

- he confirmed the point Alan Walters made to you that, as the economy slows down, the public sector surplus could quickly disappear. In a way we should not worry about that, because a public sector surplus and debt repayment were not necessarily good things in their own right. But given that he puts total public sector asset sales within public expenditure as high as £11 billion, the prospect of a receding overall Budget surplus meant we had to take a very tough line on public spending. And, given the extent of the tax reductions in the 1988 Budget - the full effect of which will not work through until next year - he currently sees little if any scope for tax reductions over the next 2-3 years.

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PAUL GRAY

16 December 1988

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