



cc: sup
7 (A-J.) D

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

10 February 1989

Paul Gray Esq
No.10 Downing Street
London SW1

Dear Paul,

PAPER FOR ECONOMIC CABINET

... I attach a draft of the Chancellor's paper for the Economic Cabinet next Thursday. He himself will be working further on the draft over the weekend, but would welcome any comments the Prime Minister has. I should be grateful if you could pass these on to me as soon as possible on Monday morning so that we can get the paper circulated on Monday evening.

It needs to be signed more clearly the very real issues on inflation and the danger that the economy is going to be stuck.

Probe

AT passed on the PM's comment to Alex Allan.

REC 6
13/2

Yours
Alex

A C S ALLAN
Principal Private
Secretary

Also needs to print.

and that

on growth has

ballooned the

reserve than can

no fullup growth

could print the

balloon next year if

it occurred. my worry

is that it is

still going to last.

A

DRAFT

ECONOMIC STRATEGY

Memorandum by the Chancellor of the Exchequer

Growth in the UK, which had been stronger in 1987, accelerated further in 1988, largely as a result of an investment boom, but also reflecting continued strong consumer demand. With profitability now at its highest levels since the 1960s and with continued rapid growth in productivity, companies are in a very strong position and have been investing heavily to meet future demand. Consumers have seen their real incomes rise strongly and have felt more confident about the future; as a result they have been prepared to finance their spending by borrowing more.

2. As a result, total domestic demand rise faster than the economy's capacity to supply, leading to a re-emergence of inflationary pressure, manifesting itself both directly in a pick-up in the underlying increases in the RPI, and indirectly in a sharp growth in imports and hence a widening current account deficit.

3. Since the summer, monetary policy has been tightened considerably to deal with the emerging inflationary pressure. The evidence is mounting that this tightening is starting to bring the economy back to a sustainable path, but there is still some way to

go. The RPI exaggerates the extent of the rise in prices because of the perverse inclusion of mortgage interest payments. But even so, ^{will} getting inflation on to a clear downward path may mean keeping interest rates high for some time. Fiscal policy has been tighter than forecast over the past year and we now seem set for a Public Sector Debt Repayment greater than the £10 billion I indicated in the Autumn Statement.

4. ^{needs strengthening} I am sure, in the circumstances, that we should aim for a ^{must} cautious approach to the Budget. Sound and prudent financial policies are essential if we are to maintain the confidence of the markets and sustain the improvement in economic performance of recent years. If as I expect, we succeed in reversing the recent rise in inflation, while continuing our policies to improve the efficiency and flexibility of the economy, the prospect remains a very good one.

Economic prospects

5. As in the UK, growth in the rest of the world in 1988 was more buoyant than expected a year ago, exceeding expectations in each of the major industrial countries, in most cases substantially so. World trade in manufactures probably grew by 10 per cent. Even those European economies that have been sluggish in recent years are now experiencing faster growth.

Partly as a result, consumer price inflation edged up a little in a number of countries and most commodity prices have risen.

6. The latest indicators suggest that activity in the major economies remains strong, though increases in short term interest rates to counter rising inflation may lead to some slow down through 1989. GNP growth may fall from 4 per cent in 1988 to a still healthy 3 per cent this year. World trade growth should still be high.

7. One threat to this prospect is that the persistence of sizeable current account imbalances between the largest economies could lead to renewed turmoil in financial markets. Domestic demand growth in the US needs to slow, and the US Government needs to reduce its Budget deficit; at the same time, the surplus countries - Germany and Japan - need to remove the obstacles which restrict the growth of their domestic markets.

8. The UK has experienced a sharper acceleration of output than most of its G7 partners, with unemployment falling faster than in any other major country. In spite of the major problems in interpreting recent macroeconomic statistics it looks as if we have had two years with GDP growth at about (4½) per cent, the first time this has happened since the mid-sixties. Domestic demand probably grew considerably more quickly than this in 1988, mainly because of the strength of investment. It seems likely that the growth of total fixed investment will have been well into double

should not ignore consumer at 2 1/4 %

figures last year - the largest increase for almost 25 years. Indeed once the full figures are available it is possible that growth of investment even surpassed the 1964 growth rate - previously the strongest post-war year on record. At the same time, productivity in manufacturing has continued to grow rapidly.

9. Apart from fixed investment, the housing market has been the other major source of rapid demand growth. A significant house price bubble emerged last year and with it a rapid turnover in housing. It is likely this had a significant effect on consumption in general and spending on durables in particular.

10. As already mentioned, the increase in inflationary pressure has been countered by the only effective means: a tightening of monetary policy via higher short term interest rates. There are now increasing signs that this firm action has begun to check the growth of spending by households. Growth of the narrow measure of the money supply, M0, has begun to slow down appreciably. The housing market has cooled down markedly, particularly in the South East, with both house prices and lending for house purchase rising much less rapidly than in the middle of last year. The growth of retail sales has moderated, and sales of certain consumer durables have fallen. Indicators of consumer confidence suggest that expenditure growth in the year ahead will be modest. The personal sector savings ratio should begin to recover.

or possibly falling

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E.

11. Meanwhile, company sector saving remains high and the signs are that the very strong investment performance of the last two years will continue in 1989, though growth will probably be at a less heady pace. The rate of return on capital is at its highest level for over twenty years, and the extra investment that this is generating will help to underpin the supply side improvements of recent years.

12. The latest rise in the mortgage rate will almost certainly lead to inflation as recorded by the RPI rising above 7 per cent for some months (although excluding mortgage interest payments the rate should remain below 6 per cent). But as the effects of the rises in mortgage rates during last year begin to drop out, RPI inflation itself should fall back to well below 6 per cent by the fourth quarter of this year. ^{rise} The blip in inflation during the first half of this year will undoubtedly cause us considerable problems. We must clearly do everything in our power to ensure that it does not lead to a pay explosion.

13. The increase in underlying inflation - whether measured by the RPI less mortgage interest payments or by producer prices - is less worrying, but [at over 5 per cent] is still much too high. We will have to maintain the present very tight monetary policy long enough to ensure that it is put firmly on a renewed downward trend.

too
complex
NB GDP
deflate
- perhaps
the best
underlying
measure -
is about 7%.

PM agrees

14. The sharp worsening of the current account deficit may be exaggerated to some extent by the published figures. The preliminary estimate published for 1988 is £14½ billion, but the "balancing item" in the balance of payments - which consists of unrecorded flows to the UK - for the first three quarters (the latest available period) was even greater than the recorded deficit. The slow down in domestic demand will lead to a reduction in the current account deficit, but this is unlikely to occur quickly. The continued strong growth of investment could keep imports of capital goods high, and it may take a little while for the adverse effects on trade performance of very high capacity utilisation in some industries to unwind. Even though the deficit could fall from now on, the outturn for 1989 as a whole might be close to that for 1988.

15. To summarise, following a period of above average growth the likelihood is that growth will be somewhat below the recent trend in the near future. GDP growth could be [2½] per cent in 1989, though with the statistics for the recent past in such disarray and the economy at a turning point the forecast is even more uncertain than usual.

Fiscal prospects

16. In last year's Budget I announced major tax reforms, including cuts in both the basic and higher rates of income tax.

Yet despite this I budgeted for a Public Sector Debt Repayment (PSDR) in 1988-89 of some £3 billion, or $\frac{3}{4}$ per cent of GDP. In the event, the public finances have turned out considerably stronger. The forecast I gave in the Autumn Statement was for a PSDR of £10 billion, or 2 per cent of GDP. Later information suggests that the surplus will exceed even this. And so will

inflation

17. This remarkable improvement in the fiscal position - no other major country enjoys a comparable surplus - owes much to the buoyancy of the economy, as well as somewhat higher privatisation proceeds than originally planned. Given the continuing strength of domestic demand, the need for a cautious approach to policy, and market expectations, it is essential to maintain a prudent fiscal stance. In present circumstances I believe we must aim for a sizeable PSDR in the coming financial year.

18. On this basis I expect the scope for reductions in taxation to be very limited this year. It may prove best to do little more than offset the natural tendency for the non-oil tax burden to rise as a result of fiscal drag. Looking further ahead, the return to a sustainable growth rate may lead to some unwinding of the favourable cyclical effects on public finances which we have recently experienced. So future reductions in taxation will depend crucially on our continued ability to restrain the growth of public expenditure.

Better to
explain
clearly the
effects -
low inflation
& VAT rebate

Summary and conclusions

19. Output growth in the last two years has been faster than we can sustain in the medium term. Some slow down is inevitable. With the current account likely to improve only rather slowly, we must avoid taking any risks which damage the credibility of our policies. This means a cautious Budget and a further year of substantial budget surplus.

20. I would welcome colleagues' views on the Budget against the background of the fiscal and economic prospects I have outlined.

ANNEX 1

	1981	1982	1983	1984	1985	1986	1987	1988	1989(1)
World GNP, (2) in major 7 economies (per cent change)	1½	-½	3	5	3½	2½	3½	4	3
UK GDP, (2) (per cent change)	-1	1¾	3½	1½	3¾	3¾	4½	4½	2½
Domestic demand, (2) (per cent change)	-1½	2¼	4¾	2½	2¾	4	4¾	7	2½
Retail prices Q4 (per cent change) on a year earlier	12	6	5	5	5½	3½	4	6½	5½
Interest rates (average 3-month interbank)	14	12½	10	10	12	11	9½	12½	12 ⁷ / ₈ (3)
Unemployment (UK, per cent of working population excluding school leavers)	8½	10	11	11	11	11¼	10¼	8½	7½
Sterling index	117	113½	105½	100½	100	91½	90	95½	97¼(3)

(1) Provisional pre-Budget figures

(2) At constant prices

(3) February 6

J.

ANNEX 2: DIRECT EFFECTS OF TAX CHANGESA. Direct Taxes: Indexation

The RPI increased in the year to December 1988 by 6.8 per cent. With indexation by this amount and statutory rounding, the figures for the main allowances and other thresholds would be:

<u>Personal allowances</u>	<u>1988-89</u>	<u>1989-90</u>
Single and wife's earned income allowance	<u>2,605</u>	<u>2,785</u>
Married allowance	<u>4,095</u>	<u>4,375</u>
<u>Tax rate bands</u>		
25% rate	19,300	20,700 —
40% rate	over 19,300	over <u>20,700</u>

The total revenue cost of indexation of income tax (included in the forecast) is £1,455 million in 1989-90.

B. Indirect Taxes: Indexation

The effects of 6.8 per cent revalorisation of the excise duties (including VAT effects) are as follows:

<u>VAT inclusive price change</u>		<u>Yield in</u>	<u>RPI impact</u>
		<u>1989-90</u>	
		£m	% points
Beer	1.5p/pint	140	0.07
Wine	6.0p/75cl light wine	45	0.04
Spirits	37.0p/bottle	65	0.04
Tobacco	6.5p/20 king size	235	<u>0.14</u>
Petrol	7.3p/gallon	440	<u>0.12</u>
Derv	6.1p/gallon	95	0.01
VED	£6.80/car	<u>155</u>	<u>0.05</u>
Overall effect, (including minor duties)		<u>1225</u>	<u>0.48</u> ⁽¹⁾

⁽¹⁾ Figures do not sum due to rounding