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

10 March 1989

Paul Gray Esq
10 Downing Street
LONDON
SW1

Dear Paul,

BUDGET SPEECH: ECONOMIC SECTION

... I enclose, as promised, two copies of the latest draft of the
... Economic Section of the Budget speech. I also enclose, for
completeness, two copies of the peroration for the end of the
speech.

Yours,

Moir

MOIRA WALLACE

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CONCLUSION

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Mr Deputy Speaker, in this Budget I have reaffirmed the Government's commitment to the defeat of inflation through the maintenance of prudent monetary and fiscal policies. I have budgeted for a debt repayment of £14 billion - the largest ever. I have announced a major reform and reduction in employees national insurance contributions; and I have fulfilled our pledge to abolish the earnings rule for pensioners.

I commend this Budget to the House.

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The background to this year's Budget is the unprecedented strength of the British economy, coupled with the continuing need to combat inflation, at a time when, throughout the world, it is unmistakably edging up again.

2. I shall begin with an account of the performance of the economy in 1988 and the prospects for 1989, set in the context of the past ten years. I shall then deal with monetary policy and the public sector finances. Finally, I shall propose a number of measures to carry forward the process of tax reform.

3. As usual, the Financial Statement and Budget Report, together with a number of Press Releases filling out the details of my proposals, will be available from the Vote Office as soon as I have sat down.

ECONOMIC PERFORMANCE AND PROSPECTS

4. The Government's first ten years in office have seen a transformation both in the way in which economic

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policy is conducted, and in the results that have been achieved.

5. For the first time, financial policy has been set firmly and explicitly in a medium-term context. We have been guided by the basic philosophy that the Government should set a sound medium-term financial framework and leave the private sector free to operate with confidence within it.

6. The Government came to office with two central objectives - to defeat inflation, and to breathe new life into a moribund economy - and a clear idea of how to achieve those objectives. Inflation is a disease of money; and monetary policy is its cure. The role of fiscal policy is to bring the public accounts into balance and keep them there, and thus complete the process of re-establishing sound money. And strong sustainable growth is achieved, not through any artificial stimulus, but by allowing markets to work again and restoring the enterprise culture, by removing unnecessary restrictions and controls and rolling back the frontiers of the State, by reforming trade union law and promoting all forms of capital ownership, and by reforming and reducing taxation.

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7. Our first and most urgent task was to stamp out the inflationary fires that had raged in the '70s, and wrought so much economic and social havoc. And we succeeded. Between 1974 and 1979 inflation had averaged more than 15 per cent. Over the past six years it has averaged 5 per cent.

8. Once business and industry recognised the fundamental changes that were taking place, they responded to the new economic climate with vigour and confidence. As a result, we have experienced the longest period of strong and steady growth this century. Output in the United Kingdom has grown faster than in all the other main European nations during the '80s - a marked contrast to the previous two decades, when we were bottom of the league. And this growth has been based on a dramatic and sustained improvement in productivity. For the economy as a whole our productivity growth has been second only to that of Japan among all the major nations during the '80s. In manufacturing it has exceeded even Japan's.

9. In Britain today we have more people in work than ever before in our history; they are better motivated than ever before, and their living standards have improved beyond recognition.

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10. But it is not just our economic performance that has been transformed: so have our prospects for the future. For over the past seven years, investment has grown more than twice as fast as consumption, creating the increased capacity necessary to meet future demand. Total business investment is now a higher proportion of national income than ever before. And its quality has improved immeasurably, too; as has the quality of British management. We have seen a dramatic and long overdue improvement in company profits. And a remarkable growth in the total number of businesses, now at the rate of more than a thousand a week.

11. Provided we stand firm in our resolve to get on top of inflation, the prospects before us are excellent. And at least on this side of the House, we do.

12. A year ago, in the aftermath of the worldwide stock market crash, it looked as if there would be some slowing down from the rapid growth of 1987. In fact that was not to be.

13. As the House knows, the state of the national income statistics leaves much to be desired. But it now appears that we had in 1988 a second successive year of

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growth at $4\frac{1}{2}$ per cent, with unemployment falling by over half a million to well below the European average.

14. Manufacturing output grew particularly rapidly, by more than 7 per cent, to a level well above the previous peak.

15. But total spending also grew by getting on for 7 per cent, mainly because of the boom in industrial investment, in itself a welcome event, but also because of continued strong growth in consumer spending. This last was financed to an unprecedented degree by borrowing, overwhelmingly mortgage borrowing.

16. Inevitably the rapid growth of total spending led to renewed inflationary pressure. To some extent this was diverted into a sharp rise in imports, and hence in the deficit on the current account of the balance of payments. The published figures put this at $\text{£}14\frac{1}{2}$ billion in 1988, although given the $\text{£}15$ billion positive balancing item - another name for errors and omissions - the true figure is almost certainly less than this. But whatever the true figure, it is undoubtedly large, and a sharp increase on the deficit recorded in 1987 after seven successive years of surplus.

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17. But given sound policies it can readily be financed. Moreover, unlike previous current account deficits we have known in this country, it reflects not excessive Government borrowing, but rather an upsurge of private investment unmatched by private savings. This is something that will in due course correct itself.

18. As the House knows, however, there has also been some pick up in recorded inflation. Excluding the distorting effect of mortgage interest payments, the RPI rose by $4\frac{1}{2}$ per cent last year, much the same as the average over the previous five years. But this underlying rate increased significantly through the year, and now stands at $5\frac{1}{2}$ per cent.

19. Moreover the pick up in inflation appears to be a worldwide trend. Taking the seven major industrial nations as a whole, inflation is now at its highest level for some three years.

20. In the UK, as in a number of other countries, it became clear that it was necessary to tighten monetary policy sharply. That meant raising short-term interest rates, which I duly did, starting last June.

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21. I am of course keenly conscious of the difficulties many borrowers, particularly home owners, and now experiencing. But however unwelcome high interest rates are, they are infinitely preferable to the damage that would be done by high inflation.

22. There are now increasing signs that the determined action I have taken is having the desired effect. The housing boom that played such a large part in the events of last year has subsided. Monetary growth has slowed down appreciably. And retail sales, too, seem to have levelled off over the past four months, presaging a gradual recovery in the personal savings ratio.

23. The outlook for 1989 is for inflation to rise a little further over the next few months, from $7\frac{1}{2}$ per cent including mortgage interest payments to about 8 per cent, before falling back in the second half of the year to $5\frac{1}{2}$ per cent in the fourth quarter and perhaps $4\frac{1}{2}$ per cent in the second quarter of 1990.

24. Some slow down in real growth is inevitable as we get inflation back onto a downward path - indeed, it has almost certainly already begun to happen. Overall growth is forecast to fall from the $4\frac{1}{2}$ per cent recorded last year to $2\frac{1}{2}$ per cent this year, with

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growth through the year at 2 per cent. Domestic demand is forecast to slow down even more markedly. But within this, investment, which is holding up well, is once again forecast to grow faster than consumption. The current account deficit is forecast to remain at the same level as last year.

25. But the question of just how "soft" or "hard" the so-called landing will be is not in the hands of Government alone. The Government's task is to reduce inflation by acting, through monetary policy, to bring down the growth of national income in money terms. The extent to which, over the short term, this is reflected in a reduction in inflation, and the extent to which it is reflected in slower output growth, is largely up to business and industry.

26. The better that industry succeeds in controlling its pay and other costs, the less painful the necessary adjustment will be, not least in terms of employment prospects.

27. But over the medium-term, it is clear from our experience over the past ten years that the policy we are pursuing will bring inflation down, and steady growth will resume. The best contribution the

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Government can make to this is to carry forward the process of supply side reform, to help make the economy work better. That is the objective of the specific measures to which I shall turn in the second part of my speech.

Monetary policy

28. As I said at the outset, monetary policy plays and must always play, the central role in the battle against inflation. It is at the very heart of the medium-term financial strategy, the tenth edition of which I am publishing today.

29. I have described the monetary tightening that has taken place over the past nine months. This has already led to a sharp deceleration in the rate of growth of the target aggregate, narrow money, or M0.

30. For 1989-90, the target range for M0 will be 1-5 per cent, as envisaged in last year's MTFS. Although it will start the year above the top of that range, its very low growth over the past six months - under 3 per cent at an annualised rate - suggests that it will fairly soon come back within the range. As in the past two years, there is no target for the growth of broad

money, or liquidity, but I will continue to take it into account in assessing monetary conditions.

31. The exchange rate is of particular importance in the conduct of monetary policy. A clear commitment not to accommodate increases in domestic costs by exchange rate depreciation remains a key safeguard against inflation. This has been demonstrated both by the level of interest rates and by our readiness to use the massive reserves we have accumulated. In this context, we will continue to work with our G7 partners to maintain the exchange rate stability that has been a feature of the past two years.

32. Short-term interest rates remain the essential instrument of monetary policy. I repeat what I have stated clearly on a number of previous occasions: interest rates will stay as high as is needed for as long as is needed. For there will be no letting up in our determination to get on top of inflation.

Public Sector finances

33. I now turn to fiscal policy.

34. When we first took office the public sector borrowing requirement was over 5 per cent of GDP - equivalent to £25 billion in today's terms.

35. This we steadily reduced over the years as a deliberate act of policy, until, by 1987-88, the PSBR had been eliminated altogether and we started to repay the public debt.

36. Accordingly, last year I budgeted for a further Public Sector Debt Repayment, or PSDR, of some £3 billion. In the event, it looks like turning out almost five times as large, at £14 billion, or 3 per cent of GDP. Even if there had been no privatisation proceeds at all, the public finances would still be in surplus, to the tune of some £7 billion. Government debt as a proportion of GDP is now lower than at any time since the First World War.

37. Nothing like this has ever been achieved in the past 40 years. And no other major country enjoys a comparable budget surplus. It has not been easy, even though we have been assisted this year by the exceptional buoyancy of the economy, which both boosted tax receipts and reduced public expenditure well below the planned level.

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38. Moreover, the substantial net repayment of public debt over the past two years has permanently reduced the burden of debt servicing, both now and for future generations. For the coming year, for example, the debt repayments of the last two years mean that net debt interest costs will be lower by some $\text{£}1\frac{3}{4}$ billion a year. This saving is being put to good use, allowing extra spending on departmental programmes within our overall public expenditure constraints.

39. The dramatic improvement in the United Kingdom's public finances has also provided a welcome opportunity to devote more attention to the structure of the debt that remains. We will continue to seek both to minimise the cost of servicing the Government's domestic debt and to improve its quality by relying less on the more liquid borrowing instruments.

40. We have also been able to restructure part of the Government's foreign currency debt, launching an innovative and cost-effective programme of Treasury Bills denominated and payable in ecu. The first series of six monthly tenders for these bills has proved very successful, and this is an innovation we plan to continue, at around the current level.

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41. Meanwhile, I am today adding one more entry to the long list of financial controls which we have swept away during our term of office. The last surviving relic of the post-War apparatus for the direction of capital by the State is the Control of Borrowing Order, which since 1946 has involved first the Treasury and then the Bank of England in giving consents for equity and bond issues in the capital markets. As from today it will no longer be necessary for companies who wish to make capital market issues to obtain the Bank of England's consent to the timing of such issues; and we will, as soon as possible, revoke the Order itself and repeal the 1946 Act from which it stems.

42. The sterling capital market has in recent times been going through a period of considerable adjustment, as the Government has changed from being a large issuer to a large purchaser of its own debt. The abolition of the Control of Borrowing Order will remove an unnecessary and bureaucratic restriction on issuers of capital as they move into the space formerly occupied by the Government when it was a borrower.

43. This new freedom will be enhanced by a further, important, set of deregulatory measures for the sterling

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capital market which are being promulgated today in notices issued by the Bank of England. These measures will open up the market for sterling paper of less than 5 years' maturity by extending the range of institutions which can make such issues; and they will create a unified regime for all these issues.

44. Taken together the changes I have described constitute a major liberalisation of the arrangements for London's capital markets. They will give greater flexibility to issuers and wider choice to investors.

45. In last year's Budget Speech, I set out the principle of a balanced budget as the proper objective of fiscal policy, in these terms:

"A balanced budget is a valuable discipline for the medium term. It represents security for the present and an investment for the future. Having achieved it, I intend to stick to it. In other words, henceforth a zero PSBR will be the norm. This provides a clear and simple rule, with a good historical pedigree."

46. It is a rule that ensures that, as national income continues to rise, the ratio of public debt to national

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income continues to fall, and with it the burden of debt interest. It ensures, too, that the State makes no claim either on the savings of the private sector or on flows of finance from overseas. To go further than this, and seek to achieve the maximum possible repayment of public debt, would not be consistent with the Government's policy, as it would mean deferring for a very long time the benefits of a reduction in the burden of taxation.

47. So I reaffirm the principle of the balanced budget. However, given the substantial surplus we now have, the path of prudence and caution must be to return to balance not overnight, but gradually, over a period of years. Thus we can expect to have a number of further years of debt repayment ahead of us.

48. Moreover, given the particular uncertainties there are at the present time, I believe it would be right to budget for 1989-90 for a surplus similar to that secured in the year now ending; in other words, a further public sector debt repayment, or PSDR, of some £14 billion. This means that, in the space of three years, we shall have repaid roughly a sixth of the public debt that has accumulated over two centuries. But it also means that it will not be possible in this year's Budget to reduce

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the burden of taxation; that is to say, to reduce
taxation as a share of national income.

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