

*downgraded to:***CONFIDENTIAL**

COPY NO

1

OF 14

Treasury Chambers, Parliament Street, SW1P 3AG

01-270 3000

PRIME MINISTER

*Note**Seen and agreed by Prime Minister. REC 11/3*

With PSDR figures now available for the first 11 months of the year - the last figures we shall have before the Budget - I am in a position to let you have my usual note on the Medium Term Financial Strategy.

This will be the tenth occasion on which we have set out the MTFS in the Red Book. I propose to use this opportunity to highlight the transformation of the economy that has followed our pursuit of sound financial policies coupled with supply-side reforms. I will stress that, although the details of the MTFS have changed over the last decade as the economy has evolved, the essence of the strategy has remained unchanged.

At the centre of the MTFS, as always, is the over-riding requirement to bring down the rate of inflation and not to accommodate inflationary impulses. Over the past two years, money GDP growth has exceeded the rate we have been aiming for. In part this reflects a better supply performance in the economy; but it also reflects stronger inflationary pressures. We have taken firm action since the summer to bring the economy back onto track, and the decline in money GDP growth which I propose to aim for over the medium term should bring about a decisive reduction in inflation.



Fiscal policy

The PSDR in 1988-89 will turn out significantly higher than the £10 billion I forecast at the time of the Autumn Statement. So far, we have a surplus of £16 billion with one month to go, though with the usual surge of spending in the final month the figure for the year as a whole is likely to turn out somewhat lower. I intend to publish a figure of £14 billion as our best guess.

Last year I set out the principle of a balanced budget as the norm for fiscal policy, and I intend to reaffirm it this year. I do not believe that we should aim for the maximum possible repayment of debt, because that would unnecessarily delay the reductions in taxation needed to build on the supply side improvements already achieved. But given the size of the present surplus, and the need to maintain a prudent and cautious approach, I am sure we should only aim to return to balance gradually over a period of years.

The tax and national insurance package we have agreed will enable me to budget for a PSDR of almost £14 billion in 1989-90, the same as in 1988-89. This implies no change in the overall tax burden between the two years: the package merely offsets the fiscal drag in the system. (It also means that excluding privatisation proceeds, which will total £7 billion in 1988-89 but are planned to return to £5 billion in 1989-90, I am budgeting for a rise in the PSDR, from £7 billion to almost £9 billion.) Thereafter I propose to show a gradual return towards budget balance, and thus a number of further years of debt repayment. Provided we continue to restrain the growth of public expenditure, this should enable us to bring down the tax burden over the medium term.

Monetary policy

The MTFs will once again emphasise that the task of exerting downward pressure on inflation falls to monetary policy. It will also make it clear again that short-term interest rates are the



CONFIDENTIAL

essential instrument of monetary policy; that interest rate decisions are made on the basis of a comprehensive assessment of monetary conditions, with particular weight given to the behaviour of MO in relation to its target range and to exchange rate; and that the Government is not prepared to accommodate increases in domestic costs by exchange rate depreciation.

I intend to set a target range for MO growth in 1989-90 of 1 to 5%, as foreshadowed in last year's MTFS; this is the same as the range for 1988-89. Although the 12 month growth rate of MO is likely to start the year above the target range, the tightening of monetary policy since the summer should bring it back within the range before too long. We have already seen a sharp deceleration, with the annualised six month growth rate now well within the range.

For subsequent years I propose to show a declining path for monetary growth in line with that shown in last year's MTFS. The range -1 to 3% for the final year (1992-93) should be consistent with money GDP growth of around 5%, and hence a decisive fall in inflation from the average rate of the last five years.

Capital market liberalisation

I shall also be announcing on Budget day a substantial liberalisation of the London sterling capital market. I am abolishing the queue for bond and equity issues which has been operated by the Bank of England since 1946, opening up the market for sterling paper and at the same time simplifying its regulatory

~~BUDGET SECRET~~

~~CONFIDENTIAL~~



regime. I am also making some consequential changes in the taxation of deep discount and other bonds. Taken together all these changes will give greater flexibility to those who issue capital in London; and wider choice to those who invest here.

ML

[NL]

10 March 1989