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P R C Gray Esq
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Prime Minister
10 Downing Street
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Dear Paul

ECONOMIC STRATEGY PAPER FOR CABINET

... I attach a copy of the draft Memorandum by the Chancellor for Cabinet next week. Subject to any comments that the Prime Minister may have, and to the addition of a fourth annex on the Economic Implications of German Monetary Union, the Chancellor would propose to circulate this to colleagues on Monday.

V.-s

Jst.

JOHN GIEVE
Principal Private Secretary

ECONOMIC STRATEGY

Memorandum by the Chancellor of the Exchequer

Introduction

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Following the exceptional growth in 1987 and 1988, we saw a slowdown last year in both consumer demand and business investment. However, demand proved more resilient than we expected at this time last year. The current account deficit rose in 1989; ^{RPI}inflation remained stuck at 7½ per cent or more (around 6 per cent excluding mortgage interest payments); and in the labour market, earnings growth increased and unemployment continued to fall. As a result we were obliged to raise interest rates by a further 2 per cent.

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2. Recent figures for retail sales, trade, and both business and consumer confidence provide further evidence that demand is slowing down; and the foreign exchange and money markets have been steady. The tightening of policy is clearly working. Our central forecast is that, provided we keep policy tight, we will see a further slowdown this year with a reduction in the current account deficit and, in due course, an easing in inflation. This is in line with most outside forecasts. But there nevertheless remains considerable uncertainty; growth in the monetary aggregates, for example, remains uncomfortably high and there is always a danger of market turbulence. Moreover, the ^{RPI}rate of inflation is bound to rise in the next few months and remain high until well into the Autumn. The prospect for 1990 is therefore an unappealing combination of low growth, possibly rising unemployment, and little progress on inflation. But as long as we avoid the temptation to relax policy too quickly, we should see inflation coming down at the end of the year and during 1991, and a recovery in output growth.

3. In the circumstances, I am sure that we must maintain a cautious approach in the Budget as well as in monetary policy, while continuing our policies to improve the efficiency and flexibility of the economy. If we do so I have no doubt that our economic performance over the next decade can be at least as successful as in the 1980s, and probably more so.

The world economy

4. The world economy grew rapidly in 1988 and 1989, but GNP and world trade have been slowing during 1989 in response to higher interest rates worldwide. Within the Group of Seven growth has slowed most in North America, while in West Germany and other European economies activity has remained strong throughout 1989. G7 growth is expected to slow a little further in 1990, though the scale of the slowdown is likely to be modest when compared with the downswings of the 1970s and early 1980s - a soft landing. Events in Eastern Europe will tend to boost world trade and output, but are unlikely to have significant effects in the short term.

5. Consumer price inflation has risen in all G7 economies, but remains on average some way below underlying inflation in the UK. Because monetary policy is now tighter worldwide than in 1988, and GNP growth is forecast to ease, consumer price inflation in the G7 should fall gradually over the coming year, from $4\frac{1}{2}$ per cent now to $3\frac{1}{2}$ per cent by the end of the year. Real non-oil commodity prices fell during 1989, and a further small fall may occur this year: in contrast oil prices rose during 1989 and the beginning of this year.

Demand, output, and unemployment

6. In the UK, domestic demand - the sum of consumption, fixed investment and stockbuilding - grew by $5\frac{1}{4}$ per cent on average in the four years to 1989. Over the same period non-oil GDP grew by over $4\frac{1}{4}$ per cent. Growth in both domestic demand and GDP at such

rates is some way above the growth of productive capacity in the economy, and faster than over any four year period since the war.

7. Growth on this scale was in part the result of an investment boom. Business investment grew rapidly from the mid-1980s, and by over 10 per cent in each of the last three years. A higher rate of return on capital, now back to its highest level for over twenty years, and the creation of an environment that encourages enterprise, contributed to this remarkable surge in investment, which is already enhancing the supply potential of the economy. While we expected investment and productivity to benefit from our policies, no-one expected a boom on the scale that actually occurred.

8. Consumer spending has also grown very rapidly - by over 5 per cent per annum on average over the four years to 1989. The confidence generated by rising wealth and incomes since the early 1980s has been reflected in a sharp reduction in the saving ratio, associated with higher borrowing. Consumers are in a better position to arrange their spending and borrowing as they wish, now that the controls on the financial system in place until the 1970s have been lifted.

9. A sharp slowdown in demand was clearly necessary after this period of excessive growth and the inflationary pressures thus generated. Recently there have been some welcome signs that this adjustment is indeed occurring. Consumer spending has slowed, and in the last three months the volume of retail sales was only 1½ per cent higher than a year earlier. It looks as if business investment may have peaked in the middle of 1989. Industrial output has also slowed down, and capacity constraints have eased.

10. Domestic demand may well fall a little in 1990. Consumers' expenditure is forecast to follow the trend of recent months, rising only very slowly as the personal sector adjusts further to high interest rates. The end of the housing boom should be an important restraining influence. Companies are likely to trim

their stocks and cut their capital expenditure by a modest amount. After so powerful an investment boom it is not at all surprising that in the very short term some retrenchment is likely.

11. While domestic demand may fall slightly, net exports should continue to grow strongly, sustaining the growth of output. I have no reason to change the forecast of GDP growth I made in the Autumn Statement - just under 1 per cent. GDP growth at this rate would in normal circumstances lead to a rise in unemployment. But while the monthly path for unemployment could be on a rising trend during much of the year, unemployment may be lower on average in 1990 than in 1989.

12. The precise timing and extent of any rise in unemployment will depend crucially on how companies react to high wage demands. They already face a difficult financial position. With a tight policy stance they will have limited scope for passing on cost increases in higher prices. If they allow wages and unit labour costs to accelerate, many are likely to face a severe squeeze later in the year, which in turn could lead to sharper cutbacks in employment, investment, and stocks.

13. Clearly there is great uncertainty attaching to forecasts for growth and unemployment when the economy is at a turning point. It looks as if GDP growth will moderate without the level of GDP actually falling. But the uncertainties are such that it is not possible to rule out a fall in output over a short period. We must continue to stress the need for pay restraint, and to exercise it ourselves in the public sector.

Inflation and the current account

14. The excessive growth of demand and output until early 1989 caused considerable strain in the economy, with serious capacity constraints emerging in a number of industries and rising inflationary pressure. One symptom was the current account deficit of just over £20 billion in 1989. Another was the most

unwelcome rise in RPI inflation - to over 8 per cent between April and July last year. While the inclusion of mortgage interest payments in the RPI makes it a distorted measure of underlying consumer price inflation, the latter also rose - to just over 6 per cent.

15. We cannot be content with an underlying inflation rate of over 6 per cent. The fact that RPI inflation has consistently been below the levels recorded under the last Labour government is small consolation in either economic or political terms. Our performance is still markedly worse than our major overseas competitors. We remain committed to the further reduction of inflation, and any rise in it, however modest by historical standards, requires a firm policy response.

16. RPI inflation is likely to rise to over 8 per cent in the next month or so and is unlikely to come down very far until well into the autumn. One contributory factor is the recent rise in mortgage rates. And a number of special factors, of which the introduction of the community charge at unjustifiably high rates is the most notable, will also add to inflation over this period. (Conversely as they fall out of the 12 month comparisons these factors will tend to depress the rate of inflation in Spring 1991.) A tight policy stance always takes time to influence underlying price and wage inflation, and there could be an uncomfortable period during 1990 while output growth appears to be very low without any apparent progress on inflation. However, by the end of the year, and during 1991, the tight policy stance should be seen to be having the desired results, and both underlying and recorded RPI inflation should be on a downward trend.

Challenge to forecasts
17. Progress is likely to be quicker in reducing the current account deficit. Companies have clearly already switched production to overseas markets as domestic demand and capacity constraints have eased; exports of non-oil goods have risen by 15 per cent over the last year. Because world trade growth is

likely to fall a little, export growth may be somewhat slower over the coming year than in recent months; but it should nevertheless remain higher than import growth which has already fallen sharply. As a result the prospect is for a substantial fall in the current account deficit in 1990, broadly in line with the Autumn Statement forecast of £15 billion.

Monetary developments

18. Concern about inflationary pressures and the slow response of the economy to the tightening of policy, together with political uncertainties at the end of 1989 and a strong deutschemark, led to a fall in the sterling index of just over 10 per cent during 1989. Recently sterling has firmed, and returned to the level of last Autumn. But that is still over 8 cent below its level at the beginning of 1989. This has added to upward pressure on costs and prices. Growth of M0 has been above its target range since April 1988; and broad money (M4) and credit have continued to grow rapidly.

19. Against this background, monetary policy was tightened during 1989, with two increases of 1 per cent in the general level of short-term interest rates. Mortgage rates also rose during 1989, and have risen further in the last few days to a level nearer their normal relationship with base rates. (The most recent increase in mortgage rates will not immediately affect those whose monthly payments are fixed under annual schemes and have already been set for 1990.) Unpopular as these rises have been, they are having their desired effect, with an adjustment in the housing market a necessary part of the process of restraining domestic demand. We shall have to keep interest rates high until inflation is clearly back on a downward track; it would be folly to lower them prematurely and then be forced to raise them again.

Public finances

20. It now looks as if the PSDR for 1989-90 will be a good deal lower than the £12½ billion I forecast in the Autumn Statement, which was itself below the £14 billion expected at budget time and the £14½ billion recorded last year. There are a number of factors behind the shortfall: on the expenditure side, the outturn is expected to be over £2 billion higher than planned, with privatisation proceeds lower than expected, and a surge in capital expenditure and borrowing by local authorities seeking to forestall the tighter controls that will apply next year; and on the revenue side, corporate tax payments have been lower, and - as a result of our policy on personal pensions - rebates have been a little under £2 billion higher than expected. These adverse influences have been offset only partially by higher income tax receipts than expected.

21. Looking forward to 1990-91, there are a number of factors which will tend to reduce the PSDR further. Some tax changes announced in earlier Budgets have not yet had their full effect: independent taxation, which was announced in the 1988 Budget, comes into effect in April; and PSDR will reflect the full year effect of the reform of National Insurance Contributions which came into effect last October. At the same time, the cyclical slowdown in the economy will reduce the growth of tax revenue, particularly from companies, and increase the upward pressure on public expenditure. I expect to see a smaller surplus in 1990-91 than this year, and a quicker fall from budget surplus to budget balance than envisaged in last year's MTFS.

Conclusion

22. After two years in which the economy had been growing at an unsustainably rapid rate, there are now clear signs of a slowdown. This is to be expected, and indeed welcomed prior to the resumption of steady growth. Already the current account deficit is showing signs of falling.

23. But progress on inflation will be slower. If we are to succeed in getting inflation down, fiscal policy must support monetary policy. This means a cautious Budget, with little if any scope for reducing tax rates or other reliefs.

24. I have endeavoured to set out all the difficulties before us in this paper. But I see no need for excessive pessimism. By next year I do expect a lower trade gap, lower inflation and rising growth. But that does depend on our policies this year.

25. I would welcome colleagues' views on the Budget in the light of the fiscal and economic prospects which I have outlined.

... 26. As background, I attach the three usual annexes on the economic record and prospect, the direct effects of tax changes, and the public finances and the tax burden. I have added an annex this year on the economic implications of German monetary union.

ANNEX 1

	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990 ⁽¹⁾	10 year average
									latest estimate	Forecast	
World GNP ⁽²⁾ in major 7 economies (per cent change)	1 1/2	-1/2	3	5	3 1/2	2 1/2	3 1/2	4 1/2	3 1/2	3	3
UK GDP ⁽²⁾ (per cent change)	-1	1 3/4	3 1/2	1 3/4	4	3 1/4	4 1/2	4 1/2	2 3/4	3/4	2 1/2
Domestic demand ⁽²⁾	-1 1/2	2 1/4	4 3/4	2 1/2	2 3/4	4 1/4	5 1/2	7 1/2	4	-1	3
Retail prices Q4 (per cent change on a year earlier)	12	6	5	5	5 1/2	3 1/2	4	6 1/2	7 1/2	6 1/2	6
Interest rates (average 3-month interbank)	14	12 1/2	10	10	12	11	9 1/2	10 1/2	14	15 1/8 ⁽³⁾	
Unemployment (UK, per cent of working population excluding school leavers)	8 1/2	10	10 3/4	10 3/4	11	11 1/4	10 1/4	8 1/4	6 1/2	6 1/4	
Sterling index	118 1/2	113	104 1/2	100	99 1/2	91 1/2	90	95 1/2	92 1/2	89 1/2 ⁽³⁾	
memorandum items											
Non-Oil GDP	-1 1/2	1	3 1/4	1 1/2	4	3 1/2	5	5	3 3/4		
Consumers expenditure	0	1	4 1/4	1 3/4	3 3/4	5 1/2	6	7	4 1/4		
Business investment	-9	2 3/4	3	10 1/4	7 1/2	-1/2	10 3/4	17 1/2	10 1/2		

⁽¹⁾ Provisional pre-Budget figures⁽²⁾ At constant prices⁽³⁾ February 12

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

The RPI increased in the year to December 1989 by 7.7 per cent. With indexation by this amount and statutory rounding, the figures for the main allowances and income tax bands, and their equivalents this year, would be:

	<u>1989-90</u>	<u>1990-91</u>	
Personal allowance	2,785	3,005	220
Married couple's allowance	1,590	1,720	130
<u>Tax rate bands</u>			
25% rate	20,700	22,300	
40% rate	over 20,700	over 22,300	

The total revenue cost of indexation of income tax (included in the forecast) is £1,670 million in 1990-91.

B. Indirect Taxes : Indexation

The effects of 7.7 per cent revalorisation of the excise duties (including VAT effects) are as follows:

<u>VAT inclusive price change</u>		<u>Yield in</u> <u>1990-91</u> <u>£m</u>	<u>RPI impact</u> <u>% points</u>
Beer	1.7p/pint	160	0.07
Wine	6.8p/75cl light wine	55	0.06
Spirits	41.9p/bottle	80	0.04
Tobacco	7.4p/20 king size	265	0.16
Leaded Petrol	8.2p/gallon	305	0.14
Unleaded Petrol	7.1p/gallon	175	neg
Derv	7.0p/gallon	110	0.01
VED	£7.70/car	180	0.06
Overall effect, (including minor duties)		1400	0.55 ⁽¹⁾

⁽¹⁾ Figures do not sum due to rounding.

C. Ready Reckoners : Illustrative Tax Changes

	£ million	
	<u>1990-91</u>	<u>1991-92</u>
INCOME TAX		
<u>Allowances and Thresholds</u>		
1% above indexation on all statutory allowances	180	250
1% above indexation on all statutory allowances and basic rate limit	205	295
<u>Rates</u>		
Change basic rate by 1p	1,500	1,900
Change higher rate by 1p	130	270
CORPORATION TAX		
Change in main rate of 1 percentage point	390	570
Change in small companies' rate of 1 percentage point	35	45
VALUE ADDED TAX		
Change in VAT rate of 1 percentage point ⁽¹⁾	1,515	2,070

⁽¹⁾ A 1% change in the VAT rate would change the RPI by 0.48%.

ANNEX 3 : PUBLIC FINANCES AND THE TAX BURDEN**Taxation, Expenditure and Borrowing**

Since the Government first took office, total taxes and NICs have risen by 3½ percentage points of GDP, though the ratio has fallen from its peak in 1981-82. This has enabled us to make net repayments of government debt in the last three years.

Table 1

Overall Taxation, Expenditure and Borrowing
(percentage of GDP at market prices)

	Non-North Sea Taxes plus NICs (as per cent of non-North Sea GDP)	Total Taxes plus NICs	General Government Expenditure (excluding) privatisation proceeds)	PSBR
1978-79	34.1	33.8	43.2	5.3
1979-80	35.0	35.0	43.4	4.8
1980-81	36.1	36.2	45.9	5.3
1981-82	38.6	39.3	46.5	3.3
1982-83	38.1	38.8	46.7	3.1
1983-84	37.6	38.4	45.8	3.1
1984-85	37.7	39.1	46.1	3.1
1985-86	37.0	38.5	44.4	1.5
1986-87	37.4	37.9	43.5	0.9
1987-88	37.6	37.9	41.3	-0.8
1988-89	37.1	37.3	39.0	-3.0

Personal Taxation

Despite reductions in income tax, total personal taxes (direct and indirect, including employees' NICs and domestic rates) in 1989-90 are over £30 billion higher in real terms (ie 1989-90 prices) than they were in 1978-79. For income tax and national insurance contributions the following table shows how the proportion of gross pay they represent rose up to 1981-82:

Table 2

Income Tax and NICs as a per cent of Gross Earnings*

	<u>½ average earnings</u>	<u>average earnings</u>	<u>2 average earnings</u>
1978-79	16.0	27.8	31.4
1981-82	20.8	29.3	32.2
1982-83	20.8	29.8	32.3
1983-84	20.1	29.6	31.7
1984-85	19.3	29.2	31.5
1985-86	18.9	29.0	31.5
1986-87	18.9	28.5	30.9
1987-88	19.1	27.6	29.9
1988-89	18.6	26.3	28.3
1989-90 (estimate)	17.9	26.0	28.3
1990-91 (indexation)	16.9	25.5	28.1

These figures reflect the rise in the standard employees' NIC rate from 6½ per cent to 9 per cent followed by the cut in the rate on earnings below the LEL to 2 per cent in 1989. The lower rates introduced in the 1985 Finance Act do not affect the cases shown. So far as income tax is concerned, personal allowances have increased by about 24 per cent in real terms since 1978-79, slightly less than earnings. The basic rate has been reduced from 33p to 25p.

Average earnings have of course increased by substantially more than prices since 1978-79. So a married man on average earnings has seen his real take-home pay rise by £54 per week. The increase for a married man on half average earnings has been £26 per week, and on twice average earnings £110 per week.

As the table shows, indexation of allowances in the Budget, with no reduction in the basic rate, would lead to a slight fall in the proportion of incomes taken in tax and NICs. This is because 1990-91 sees the effect of the October 1989 NIC reform throughout the year, whereas the financial year average figure given for 1989-90

*Adult male earnings (all occupations). Married couple, wife not working: the couple are assumed to have no children, to avoid distortion of the figures from the abolition of child tax allowances.

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includes half a year of the old system. If the post-October figure were looked at for 1989-90, indexation would lead to a very slight rise in the proportion of incomes taken in tax and NICs. This is because earnings are assumed to rise by more than the increase in tax thresholds, which is indexed to changes in prices.

Business Taxation

Following the sharp rise in corporation tax receipts since 1983-84, as a result of the substantial recovery in company profits, total taxes paid by businesses (outside the North Sea) are now higher as a percentage of GDP than in 1978-79. The rise in total taxes on business as a share of GDP was made up of a large rise in corporation tax and smaller rises in other taxes; employers' NICs and NIS fell.

Table 3**Tax paid by Businesses fbn in 1988-89 prices**

(figures in brackets are per cent of GDP)

	Corporation Tax ¹	Taxes on self employment incomes	Employers' NICs and NIS	Rates	Other ²	Total
1978-79	8.4	2.8	13.6	5.5	4.3	34.6
	(2.2)	(0.7)	(3.6)	(1.4)	(1.1)	(9.1)
1989-90	18.0	4.6	13.0	8.4	7.5	51.4
(forecast)	(3.7)	(0.9)	(2.7)	(1.7)	(1.5)	(10.5)

¹ Excludes North Sea, but includes ACT

² VED, car tax, road fuel duty, duty on rebated oils, capital taxes

