

PRIME MINISTER

STANCE OF FISCAL POLICY

The outcome of your meeting with the Chancellor is that he is aiming at a Budget which raises taxes (from an indexed base) by about £170 million in 1990-91 with little change in 1991-92 discounting the cash flow effect, of perhaps £500 million, of the composite rate abolition which is reversed the following year. This will leave published PSBRs of around £7 billion in 1990-91 and £6 billion in 1991-92, falling to £2 billion by 1992-93, and

Since that meeting:

- (i) the pound has fallen sharply;
- (ii) the retail sales figures for February have become available. The latter show a rise of 2.4 per cent to a new record. Even when using three month averages, the latest three months are 1.3 per cent up on the previous three.

In my view, the effect of these developments is to make a Budget that was barely tight enough, into one which is too lax. I suspect that the foreign exchange markets may not react sharply to the retail sales figures as people will be reluctant to go very short of Sterling when it is possible that the Budget the following week may change perceptions for the better, but if the Budget when it is revealed is seen as weak, there could be a reaction at that stage. There is already a perception that the Government has already gone as far as it dare on interest rates. A no change Budget will indicate that it has reached the same position on taxation. It will have shot its bolt on both fronts and the economy will be left to come right on its own or not at all.

I think you should ask the Chancellor to reassess the position and to consider going for a net tax increase of around £1 billion, probably by not indexing fully.

At present spending is being restrained by cutting the purchasing power of those who have borrowed. It does so, however, by putting the strain heavily on this group while leaving those who are net depositors better off. The policy works only because the depositors tend to spend less than the borrowers.

By tightening fiscal policy, the restraint is spread more widely. This will bring forward the time when the interest rate can be relaxed. In my view, it would be wrong to relieve borrowers by raising mortgage interest relief

- (a) because this is a net loosening of fiscal policy when tightening is called for;
- (b) it encourages borrowing on the security of property and makes the conduct of monetary policy even more difficult;
- (c) it drives up the price of houses relative to other goods when they are already much too high.

The argument against a tighter budget is that one should not put too much weight on one month's retail figures (I don't, and base the argument on three months) and that there are other indicators which point to slowing down, such as the very small fall in unemployment and the fall in car sales. But if demand falls off faster than expected, you will get an easing in inflationary pressure and can then bring forward the reduction in interest rates, which is the object of the exercise. In short, if you err on the restrictive side on fiscal policy, you can correct on the monetary side; but if you err on the lax side on fiscal policy, it is much more difficult to correct by putting interest rates up.

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