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FROM: JOHN GIEVE

DATE: 19 March 1990

SIR T BURNS

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir J Anson
Mr Scholar
Mr Wicks
Mr Monck
Mr Odling-Smee
Mr A J C Edwards
Mr Culpin
Mrs Lomax
Mr Peretz
Mr Riley
Mr Sedgwick
Mr Hibberd

Mr Mowl
Mr Owen
Mr O'Donnell
Miss O'Mara
Mr Grice
Mr Ritchie
Miss Wallace
Mr Deane
Miss James
Mrs Chaplin
Mr Tyrie
Mr Lightfoot

Sir A Battishill - IR
PS/IR

Mr Unwin - C&E
PS/C&E

Mr Grey - No 10.

BUDGET SPEECH: ECONOMIC SECTION

... The Chancellor was most grateful for the further comments he received on the draft I circulated on 15 March. He has reworked this section over the weekend and I attach the latest version [which contains further amendments to the version I circulated to a few people on Friday evening].

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2. He has made a number of minor drafting changes. I have sidelined the main changes (since the 15 March version). I would be grateful for comments by noon on Monday. In particular:

- would Mr Peretz check paragraph 40 on credit marketing;
(including para 24)
- would Mr Ritchie check all the numbers and facts;
- would Mr Sedgwick and Mr Riley check paragraphs 11-13 on the world.
- would Mr Moul check paras 60 & 61

Jc

JOHN GIEVE

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OF .

Draft 18 March 1990

DRAFT

BUDGET SPEECH

Mr Speaker, [the Government's economic policy/policy over the next year] has two main objectives.

2. The first is to again bring down inflation. Until that happens, we cannot reduce interest rates and keep them down.

3. The second is to enable this country to take the opportunities that exist in the 1990s. In Western Europe, the single market, a British concept, is nearly on us. And the whole of Eastern Europe, where there is great goodwill for Britain, has opened up in a most dramatic way. We need to make sure that British business can take advantage of these changes.

4. These two objectives are closely related. Unless we succeed in the first, we are unlikely to do so in the second.

5. So this Budget will take no risks with inflation. It will maintain a strong fiscal surplus.

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6. It will, above all, be a budget for savers. It will provide a range of incentives to save and a novel incentives to give. It will bring the introduction of independent taxation for married women. It will introduce important new measures for business and keep up the pace of supply side reform. It will remove an old grievance from the tax system and make the social security system fairer. And it will abolish two taxes.

7. In framing my first Budget I have had the great advantage of following my RHF, Blaby who has left the public finances stronger than at any time [in living memory/ since Gladstone's time]. His record of tax reform, too, is one that few have matched in the past and few will match in future.

8. I will come to the detailed measures later. First, I wish to review the performance of the economy in 1989 and look at the prospects for 1990; I will then deal with monetary policy and public sector finances.

9. As usual, the Red Book, together with a number of Press Releases filling out the details of the Budget measures, will be available from the Vote Office as soon as I have sat down.

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ECONOMIC PERFORMANCE AND PROSPECTS

10. First, the economic background.

11. 1989 saw continued buoyant growth in world trade despite some slow down in the growth of the major economies particularly in the United States. However increased inflation and fears of overheating in continental Europe led to increases in short-term interest rates in most major economies during the year. More recently we have seen a rise in long-term interest rates - particularly in Germany where uncertainty about the effects of monetary union has been an additional factor.

12. This tightening of monetary policy is likely to bring lower growth generally in 1990 than last year and, in due course a fall in inflation. We are likely, therefore, also to see a slower growth in world trade in the current year, although the astonishing developments in Eastern Europe improve the longer-term prospects.

13. The rise in interest rates also reflect [a fall in savings/a fall in savings relative to investment] that has been apparent in the '80s in all the leading economies. This fall is a matter for concern since it not only exacerbates inflationary pressures but also constrains the amount of

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investment that can be financed. The fall has gone furthest in the US and the UK and has been reflected in current account deficits. While in Japan and Germany domestic savings have remained more than sufficient to finance their own investment. In the medium term the UK's savings and investment need to come back into line and it is certainly desirable that savings should rise rather than investment fall.

14. During the last year, business confidence in Britain has remained a good deal stronger than many expected. New businesses have outnumbered closures, by around 1,500 every week; a larger figure than we previously estimated and a record never before approached. Employment has continued to rise, and unemployment to fall. Almost 27 million men and women are in work today - a larger number than ever before and $1\frac{1}{2}$ million more than at the beginning of the '80s. Business investment has risen by a further 9 per cent in the last year, taking it to 15 per cent of national output - the highest level ever. And a great part of this investment has been financed from rising company profits. Profitability at the end of the eighties was at its highest for 20 years.

15. And now companies are profitable they have been investing in more than just plant and machinery. Their spending on research and development has also risen in real

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terms by almost 50 per cent in the five years to 1988. They now spend over £500 million a year on R&D which is, of course, allowable against tax. Similarly in the 5 years up to 1989 the numbers of employees receiving training has increased by over 70 per cent.

16. These are all favourable developments which reflect well on businesses' preparation for the future. But recently they have been accompanied by the return of inflationary pressures. That, beyond any doubt, is the most urgent problem, before us today.

17. To a degree it is a problem common to all nations. Since its low point in 1986 and 1987 inflation has risen significantly throughout the Group of Seven - the leading economies of the Western world. But our affliction has been sharper. There are a number of reasons for this - some welcome and some not. The record rise in business investment is obviously welcome; but it has been accompanied by a similar growth in borrowing and in consumer spending. Thus investment has been rising but the savings to finance it have not.

18. This has led to excessive growth in domestic demand, a revival of inflationary pressures, and a current account

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deficit, a good deal of which itself represents suppressed inflation.

19. Policy was therefore tightened, and interest rates have now been in double figures for 20 months. This tight monetary policy has been backed by large Budget surpluses throughout the last three years. So monetary and fiscal policy have acted together.

20. Squeezing out inflation is always difficult but there is now clear evidence that demand is slowing down. High Street sales are now only 2 per cent up on a year ago. The housing market has cooled off noticeably. New car and vehicle registrations are down. Business spending is slowing and import growth has been sharply reduced.

21. And as demand has fallen back so has output growth, to just over 2 per cent in 1989.

22. No one likes to see the economy slow but it is inevitable if we are to push inflation downwards. I now expect the economy to grow by only 1 per cent this year, compared with the above trend growth of $4\frac{1}{2}$ per cent in 1987 and 1988. The size of this fall shows the extent of the downward pressure on inflation. But growth should return in 1991 towards its sustainable rate of around $2\frac{3}{4}$ per cent.

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23. I am confident that the period of low growth will be short-lived - not least because of the permanent improvements in the underlying economy in the 1980s. For example, investment has grown more than twice as fast as consumption over the last eight years. As this additional capacity comes fully into use inflationary pressures will lessen and more normal growth will resume. No one need have any doubt about that.

24. Last year also saw a record level of foreign direct investment into Britain. Overseas investors see the potential for investment in this country in 1990's. These investments are particularly welcome as they are in industrial sectors like cars and electronic goods where a high proportion of the output is usually exported. For example, Britain already runs a trade surplus in colour TVs, and by the mid-1990s we could well be in surplus again in cars.

25. This increased investment will enable British industry both to meet domestic demand and to respond to export opportunities. Indeed, that is already beginning to happen. The current account deficit for 1989 as a whole was a little over the £20 billion I forecast at the time of the Autumn Statement. But the deficit in the last 3 months was

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substantially lower than in the previous quarter and, in particular, the manufacturing deficit is now improving. Exports have been growing faster than imports for at last [X] months.

26. The reason for this improvement is twofold. A year ago, rapidly expanding domestic demand sucked in imports to meet a market that domestic manufacturers could not supply. Moreover, that same demand absorbed British goods that would otherwise have been exported. This pattern is now reversing.

27. Exports are now growing rapidly, regaining the share of world markets they lost in 1988. Last year, the volume of exports of manufactures grew by $11\frac{1}{2}$ per cent - the highest recorded rate for nearly 20 years.

28. So, British industry is responding extremely well to export opportunities. The fact that they are doing so illustrates clearly that the present trade deficit is not caused by poor industrial competitiveness. It does result from excess demand and as that is reduced the current account deficit will fall - initially to £15 billion in 1990 and further thereafter.

29. But we cannot [yet] afford to relax policy notwithstanding the prospect of lower growth. The buoyancy of past demand

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means that inflation has been far more stubborn than anyone expected. A significant fall is still some months away and a number of factors will ensure that the position will worsen noticeably before it improves. This will be reflected in the Retail Price Index during the next few months.

30. The largest single factor is the growth of some £4,000 million in local authority spending next year. This is mainly responsible for the expected growth of over 30 per cent in average community charges compared with domestic rates. This will add over 1 per cent to the RPI next month.

31. Similarly the further rise in mortgage rates last month will also increase the Retail Price Index. As a result, I now expect that RPI inflation may still be a little over 7 per cent by the fourth quarter of this year, compared to the $5\frac{3}{4}$ per cent I had previously forecast.

32. Beyond that - as these one-off increases drop out of the index and the lagged effect of monetary tightening builds up, I expect inflation to fall below 5 per cent during 1991.

33. To summarise, the economy - both consumption and investment - has been very resilient in recent years. Adjustment so far has been gradual. But this is not necessarily a good guide to the future. The gradual

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adjustment may continue but equally the downturn may become quite sharp.

34. It is against this uncertain background that I must set monetary and fiscal policy, to which I now turn.

MONETARY POLICY

35. I want to deal with monetary policy and interest rates first for two reasons: because they are of great concern in the House and in the country and because as always they provide the key to progress on inflation.

36. And, I repeat, my first priority is to prevent inflation re-imposing itself. For inflation is immensely damaging socially as well as economically. It damages business by undermining planning and investment and it foments industrial strife. And socially, it penalises the weak. Those on fixed incomes see their savings eaten away and security and self-sufficiency destroyed. That was what happened in the 1970s it must not happen again.

37. I know that high interest rates are unpopular. They are generally most unpopular as they become most effective. They discourage spending and borrowing. They act directly on the things we have to influence if we are to get inflation down.

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38. But interest rates are also the most flexible way of responding to what can be a rapidly changing situation. They can be raised quickly when necessary. And they can be reduced just as quickly when it is safe to do so.

39. In recent months I have looked carefully to see if there is an effective alternative to interest rates. Because I am very conscious of the burden they place on business and on individuals purchasing their own houses.

40. I know many people favour direct controls on lending, hire purchase and consumer credit. I do understand that. In particular, I understand the distaste many people feel for the widespread marketing of credit that is so evident today and that is characterised by indiscriminate mailshots encouraging people to borrow. I do believe the financial institutions would be wise to reconsider their policy and I hope that this will be one subject covered in the Code of Practice the banks are currently preparing in the wake of the Jack Report.

41. But having looked at the matter I have concluded that it is extremely unlikely that credit controls would work in the modern world in anything other than the very short-term. They were becoming less and less effective even before

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exchange controls were abolished over ten years ago. Their main impact now would be to replace domestic borrowing with overseas borrowing. For these days it would be a simple matter for any High Street bank to arrange its lending through an overseas branch.

42. This, of course, applies to other countries too, and it is for this reason that governments of all persuasions throughout the Western world are abolishing credit controls and are relying on interest rates to control money - and thus inflation. The same is true of those countries in Eastern Europe who are seeking to join the Western system.

43. In recent years financial markets have become more open to competition and their behaviour has changed enormously. As a result monetary conditions have become more difficult to judge. This is one of the problems of financial deregulation but one that must be set against the great benefits it has brought.

44. So, although monetary policy remains the key to controlling inflation, it is not realistic to suppose that we can take decisions solely by reference to the way any one particular measure of money is growing. In a more sophisticated world, we must apply judgement and take into account the other evidence about monetary conditions that may

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be available including for example the exchange rate and asset prices.

45. In recent weeks I have looked afresh at the role of monetary targets. Having done so, I am clear that it is sensible to maintain a target for narrow money, and that this is best measured by the familiar aggregate M0. Since this is essentially notes and coin, it clearly is not a comprehensive measure of money in all its uses. But it does have value as a proven indicator of transactions and has been a reliable guide for many years. For next year I have set the target range at 1 to 5 per cent. Although the growth of M0 has fallen from its earlier peaks, it is likely to start the year above the range and it may be some months before it falls within it.

46. In this re-examination of policy, I have also looked closely at the case for reintroducing a target for broad money. I can understand why some favour this. At times broad money has given a useful indication of the build up of inflationary pressure. The difficulty is that its message has always varied in quality: its growth can represent money that is about to be spent, or money that is very definitely being saved: savings which I wish to encourage as will become apparent later this afternoon. So, although we will

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monitor M4 carefully, and give it weight in our decisions, I do not intend to set an target for the year ahead.

47. I have also reviewed whether there should be any changes in the Government's funding policy. The objectives must be to manage public debt in a way that supports monetary policy in bearing down on inflation, without distorting financial markets. I have concluded that in general policy should continue to be guided by the funding rule followed in recent years, with the public sector avoiding sustained under or overfunding. But I am also clear that in practice the rule cannot and should not be operated rigidly. In particular, in recent years there has been an increase in the size of the Treasury bill issue, largely as a result of a change in the financial position of local authorities. In the circumstances, the Government will if necessary adjust its funding operations, increasing gilt sales or reducing gilt purchases, to take account of this.

48. Progress on reducing inflation is also a vital pre-condition of our commitment to take sterling into the exchange rate mechanism of the European Monetary System. Our commitment to do so was set out at Madrid. It remains firm, and the conditions for entry remain unchanged.

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49. When we join the exchange rate mechanism it will provide a new short term framework for interest rate decisions. But even then, no one should suppose it will bring a dispensation from the need for strong domestic monetary control. Indeed, quite the reverse. Commitment to the one will reinforce the commitment to the other.

50. To sum up, interest rate decisions will continue to be made on the basis of the growth of monetary aggregates, and a range of other evidence most notably the exchange rate. This matters because it provides important information about domestic monetary conditions - quite apart from having an effect on prices. Therefore I favour a strong exchange rate. But there is, as I have made clear, no single lodestar to guide us in monetary policy. Life would be simpler if there were but it just does not exist. So judgement is unavoidable.

51. And my judgement is that interest rates will stay high for some time to come. The moment I judge I can safely lower them, I will. But to reduce them prematurely only to increase them again would be extremely damaging. When I bring them down it will be because I believe they are likely to stay down.

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52. In Chapter 2 of this year's Red Book I have provided a much longer and more comprehensive account than usual of how monetary policy, including funding policy, is to be operated over the years ahead. I hope this will be helpful to the House, and in particular to members of the Treasury and Civil Service Select Committee when they come to examine the Budget documents in detail.

FISCAL POLICY

53. Although monetary policy must play the main role in tackling inflation, a tight fiscal policy is also essential. It cannot do the work of monetary policy, but it can and must support it.

54. The dramatic improvement in the state of public finances over the last 10 years under the stewardships of my RHF's is an achievement of which they can be rightly proud. For decades successive Governments have spent more than they were prepared to raise honestly from taxation and made up the shortfall by borrowing. They left the bill to be picked up by future generations.

55. Over decades that bill mounted to very considerable levels. Today, just paying the interest on the accumulated debt accounts for 10p on income tax.

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56. Over the past 10 years we have reversed that trend; and in the last three we have re-paid around £25 billion, reducing the burden of government debt to levels we have not seen since before the first world war.

| 57. The rewards of this repayment will be felt by future generations but they bring also an immediate benefit. As a result of the debt repayments we are saving over £2,500 million a year in debt interest. That is sufficient to meet the annual cost of around 150 district general hospitals.

58. The very large Budget surpluses in 1988 and 1989 owed much to cyclical factors. In the current year, as I indicated to the House some months ago, we expect the surplus to fall back. The position will remain uncertain until the year is complete but our best estimate is that the debt repayment this year will be around £7 billion.

| 59. This fall in the surplus owes less to the slowdown in growth than to a number of special factors. We have seen a fall in privatisation proceeds from the very high level achieved in 1988-89. There has also been a sharp and unwelcome increase in local authority spending. This has been particularly marked in their capital spending, as they

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have sought to forestall the new controls which will take effect in April. As a direct result of this spending, we now expect the public expenditure planning total this year to be overshot by £2¹/₄ billion. The overshoot arises solely because of overspending by local authorities; central government expenditure remains well under control.

60. Another, but much more welcome, factor reducing the surplus has been the higher national insurance rebates that have resulted from the huge success of personal pensions. This extension of choice is a considerable tribute to my RHF, Sutton Coldfield. Over 3¹/₂ million people have now been taken out personal pensions. As well as benefiting the individuals concerned, in the long-term this will reduce public spending. But it also reduces national insurance receipts, by £2¹/₂ billion this year.

61. Next year, some of these factors will not be repeated but we will see the effect of slower growth on the debt repayment. In particular corporation tax receipts are likely to be significantly lower, not least because of the higher investment of recent years which entitles businesses to higher allowances against tax. These allowances will be worth over £9 billion to companies next year. These cyclical factors will build further in subsequent years.

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62. It is against the medium-term fiscal prospect that I have framed the Budget judgement; for fiscal policy is not a flexible instrument which should be altered to meet short-term contingencies. Fine tuning fiscal policy is not only disruptive to the public sector, business, and to taxpayers but its effects on the economy are both uncertain and often destabilising.

63. Accordingly, I am budgeting next year for a further Public Sector Debt repayment of £7 billion - the same as this year. Looking further ahead, I expect our fiscal position to move towards the medium-term objective of a balanced budget, an objective I reaffirm today.

64. The overall effect of the Budget measures I announce today will be to tighten fiscal policy modestly by increasing the yield from taxation by £¹/₂ billion next year and just under £1 billion in 1991.

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