

Comm Charge

SECRET AND PERSONAL

9(a-d)

Portage

Food Prices - Petrol Prices

Demand - related to
Public Expenditure

PRIME MINISTER

Exchange Rate - vulnerable

MEETING WITH THE CHANCELLOR ET AL ON THE ECONOMY

You are meeting the Chancellor for a bilateral at 1045 on Tuesday morning. At 1115 the Chancellor will be joined by the Chief Secretary, Sir Peter Middleton, Sir Terry Burns, and Michael Scholar for a seminar on the economy.

Bilateral Meeting

Credit Control

The agenda for the bilateral is as follows:

- (i) A Ministerial matter;
- (ii) The Community Charge;
- (iii) ERM.

On item (i), I understand there is a Ministerial matter which you wish to discuss with the Chancellor.

On item (ii), the Community Charge, you may like to make the Chancellor aware in broad terms of the outcome of your discussion with Mr. Patten yesterday, and get his initial response to your proposal for a Community Charge surcharge.

It may be helpful to describe your discussion with Mr. Patten under the following headings:

- (a) Fairness: the proposed Community Charge surcharge as a transitional extra charge for those who tend to have gained most from the shift from rates to the Community Charge; and the use of the extra revenue to provide for improvements in the transitional relief scheme for those on low to middle income who have lost.
- (b) The cash limit/target approach for each authority: this would be combined with more extensive capping that will

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cover all the big spenders on a multi-year basis, plus grant bonuses for those who meet or do better than their target.

- (c) The need to consider extra AEF: despite the above measures, if Community Charges are to be at a politically tolerable level next year, extra AEF will be needed. The Chancellor needs to take this into account in formulating a strategy for this year's PES round.

You will wish to ascertain the Chancellor's response to your proposal on the surcharge. Does he consider it practicable? Could the necessary legislation be introduced in this year's Finance Bill? Has the Chancellor any improvements or modifications to the scheme to suggest?

On item (iii), ERM, the main issues for the bilateral will be the principle of joining before the next election; the options on timing; the appropriate exchange rate; and the broad strategy (revaluation, use of interest rates) after entry.

Seminar on the Economy

There are two main papers:

- (iv) A note on the RPI and the Community Charge provided by Sir Peter Middleton (Flag A), and
- (v) An annotated agenda for the main discussion on the economy (Flag C).

On the RPI, Sir Peter Middleton's conclusions can be summarised as follows.

- There are great obstacles to any short-term change in the construction of the RPI.
- There are three possible changes to the treatment of the Community Charge in the RPI-covering capping, transitional relief and rebates. Their maximum effect, taken together, might be to reduce the RPI by 0.4%. But it would go against

established principles which the Government itself has endorsed within the last few months. The changes would overturn the advice of the present RPIAC. And they would put at risk the position of Indexed Gilts.

- There is a case for taking both mortgage interest payments and the Community Charge out of the RPI. But this would need to be pursued over a longer period of time.

A note from Andrew Turnbull (Flag B) concludes that it would also be tactically wrong to go ahead with any of the short-term changes to the RPI discussed above.

On item (v), the economy, an annotated agenda is at Flag C. Also relevant is the latest monthly monetary assesement (Flag D), and a valedictory note from Paul Gray (Flag E).

In essence, the present position is as follows.

- (a) There is evidence of industry, particularly manufacturing, slowing down.
- (b) But the personal sector remains buoyant - indeed there are signs of minor increase in activity and confidence.
- (c) The narrow monetary aggregate (M0) is above its target range; wider monetary measures (M4) continue to grow rapidly.
- (d) Developments on inflation and the labour market are not encouraging.

The critical point on inflation is the pace of the slowdown. There is no reliable evidence of any turning point on inflation yet in prospect: despite the increased corporate sector deficit and heavy corporate borrowing, there are no indications of profit margins being squeezed or wage settlements reined back. Both must happen if underlying inflation is to come down.

The policy issues are set out from paragraph 10 onwards in the Treasury annotated agenda. The note identifies the possible

policy responses if the outcome is above or below the Treasury forecast.

The paper and extant evidence may be judged to suggest that there is more of an upside risk, i.e., that the economy is not slowing down quickly enough. Paragraph 14 identifies the possible monetary policy responses - higher interest rates, the imposition of credit controls and setting a reserve asset ratio requirement for the banks. (The City would no doubt add overfunding.) All of these options are regarded as flawed - either politically attractive or economically ineffective.

The final section of the paper presents the ERM as a better way forward.

BHP

BP

12 April 1990

jd c:bilateral