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SUBJECT CC MASTER

NOTE FOR THE RECORD

ECONOMIC SEMINAR: 17 APRIL

Opening the seminar, the Chancellor said there was little room for manoeuvre on monetary and fiscal policy. There had been a downturn in business activity: but the level of retail demand was still high. The RPI figure for April at 10 per cent or so reflected high mortgage interest payments and the introduction of the community charge. But the underlying rate of inflation was also rising, with food prices particularly buoyant.

The growth in the monetary aggregates was still too high though the increase in M0 had now stopped accelerating. The exchange rate was too low and also vulnerable - for example to adverse RPI or trade figures. The normal policy response in such circumstances would be to raise interest rates: politically he recognised it would very difficult to do so.

Sir Terence Burns said that the most difficult problem was to interpret conflicting signals in the statistics. Tight monetary policy was achieving a slowdown in demand but it was proving to be a much longer haul than expected. The economy was surprisingly resilient and the underlying inflation rate was creeping up. Personal sector demand had proved particularly and unexpectedly stubborn.

The following points were made in discussion:

- i) The Exchequer and equities market had responded surprisingly quickly to the announcement of a public expenditure overspend for 1989/90. The markets would move adversely if there were evidence of greater spending in prospect for 1990/91 or in the plans over the survey period. The exchange rate could fall sharply if there were indications that public spending was being increased.

SECRET

- ii) There had been a prolonged if lagged effect from the deregulation in financial markets. Despite high interest rates, the private sector was still willing to acquire more debt. Some switching from high cost to low cost borrowing through second mortgages was playing an important part in sustaining debt levels. Indeed some households first rescheduled their debt in this way to lower its cost, then increased their debt so as to bring payments back to their previous levels.
- iii) It was now desirable to consider further stronger measures to limit the growth in credit, particularly to the personal sector. Possible mechanisms included inviting in commercial bankers and encouraging them to restrain lending; discouraging the advertising of credit and ensuring that the ban on promoting credit to minors was effective; and restricting the conditions and terms of second mortgages.
- iv) It would also be useful to review various reforms of monetary policy, including the use of reserve asset ratios, special deposits, and a limited role for temporary over-funding. The treatment of write-off of commercial banks' debt for tax purposes should also be investigated.
- v) National savings could also make a contribution. They formed a useful weapon in the armoury which it might be appropriate to use in certain circumstances.
- vi) There could be attractions in linking any changes to the operation of monetary policy, particularly any which the Government had previously rejected, to the decision to join the ERM. The possible timing of a decision to join the ERM would need to be considered further. But the early autumn was a possible candidate.

- vii) The treatment of the community charge in the RPI was making the headline RIP figures worse. It was important to reconsider how the RPI was constructed, perhaps to bring it into line with European practice, and whether the existing RPIAC should be replaced. This could be linked in public statements with the decision on the ERM and any changes to the conduct of monetary policy.
- viii) More generally the economy's present difficulties reflected the long period of sustained growth. Latterly demand growth had exceeded the capacity of the economy to respond. Officials may have taken too optimistic an interpretation of the available economic data over the last two or three years.
- ix) In present circumstances, it could be that any sustained fall in the exchange rate might not be reversed simply by changes in interest rates. Clear resolution on fiscal policy, particularly on public expenditure, might also have to be demonstrated.
- x) Ideally, the Government should aim to hold the planning totals for public spending over the present survey period. For the forthcoming survey Departments should be required to put forward options for cuts in their programme, if they wished to put forward further bids. Re-examination of baselines was also desirable. The key areas were the community charge, health, education and defence. Progress on housing might have to be slowed down and HATs abandoned. Transport projects such as new rail links in London, could only be accommodated by phasing and cutting back elsewhere.

Summing up the discussion, the Prime Minister said that the Treasury should prepare a further report on the various ideas on restraining the growth of credit and reform of monetary policy.

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- 4 -

A possible policy package which had emerged would involve the changes to the conduct of monetary policy, to the construction of the RPI and a decision to join the ERM being announced in the autumn. Further work should be undertaken on options, mechanisms, timing, etc., of any decision to join the ERM.

BH

Barry H Potter

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