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6 July 1988

Paul Gray, Esq
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Dear Paul

CHANCELLOR'S PAPER FOR CABINET ON 14 JULY

... I attach the latest draft of the Chancellor's paper for Cabinet next week. He will be looking at it further over the weekend, and would be grateful for any comments the Prime Minister has.

Jill Rutter is sending you separately a copy of the latest draft of the Chief Secretary's paper.

Yours
Alex

A C S ALLAN
Principal Private
Secretary

CHANCELLOR'S CABINET PAPER ON ECONOMIC PROSPECTS

The British economy has been performing well in recent years, thanks to prudent monetary and fiscal policies and supply side reforms. Growth this year is turning out stronger than expected at the time of the Budget, and may reach 4 per cent. Unemployment has fallen by over 500,000 over the last 12 months, and is now lower than any other major European country except Germany.

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2. But we cannot afford to be complacent, or to relax our vigilance. Inflationary pressures remain, which we have recently had to counter by raising interest rates by 2½ per cent from their low point at the beginning of last month; and the current account of the balance of payments has moved sharply into deficit. Domestic demand is higher than expected and the economy is growing faster than is sustainable in the medium term - even allowing for the supply side improvement which has undeniably taken place.

to get inflation down by [

3. In these circumstances the top priority must be ~~to~~ supporting and strengthening the prudent monetary and fiscal policies which have butressed the good performance of the economy. It would be very damaging if the public sector were to add any more to the demands which the private sector is putting on the economy. That would further increase upward pressure on prices and on interest rates, and could seriously damage confidence both internally and externally.

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4. But provided that we ~~maintain~~ ensure that our ~~sound~~ financial policies are sound, there is no reason why we should be blown off course. Our underlying position is strong, and we have built up larger net external assets than any other country except Japan. The private sector should have no

? Omit this whole paragraph, which is better suited to external presentation rather than internal policy debate?

I agree - this is much too complacent

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difficulty financing, from a combination of domestic and overseas sources, the investment boom which is currently adding to domestic demand, and we can expect a recovery in personal savings.

5. We must at the same time continue to focus our attention on improving the supply performance of the economy. A lower tax burden and falling share of public expenditure in the economy are essential components of this policy. To achieve them requires continued restraint on spending.

WORLD ECONOMY

6. Growth in the world economy picked up strongly in the second half of last year, and the signs are that this buoyancy has continued in the first half of 1988. World trade growth in 1988 could be the fastest since 1984.

If the world economy is growing this fast, there's no excuse for our heavy b/p. deficit.

7. A number of factors underlie this unexpectedly strong growth: the beneficial effects of the oil price fall have probably come through later than expected; the major economies, notably Japan, appear to have adjusted well to earlier sharp changes in exchange rates; the newly industrialised economies and some middle income countries have been growing rapidly; and the potentially harmful effects of the stock market collapse were successfully avoided.

8. Buoyant activity has so far had little effect on consumer price inflation in the major economies. There are, however, emerging signs of inflationary pressures. Commodity prices have risen by 50 per cent during the last year, albeit from a very depressed level. In response there have already been some rises in interest rates.

9. Whether the world economy grows at a sustainable rate with low inflation this year will largely depend on the policies followed by the major countries. The G7

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will need to ensure that any signs of rising inflation are dealt with promptly; that continued progress is made in reducing imbalances (in particular the US Budget deficit)~~; and~~ so that there is no repetition of the wild swings in exchange rates of the early 1980s.

THE BRITISH ECONOMY

10. The prospect for the UK is for another year of strong growth, for the seventh year running, and at a rate closer to 4 per cent than the 3 per cent I predicted at the time of the Budget. Manufacturing output has been growing particularly strongly; it has already passed the 1979 peak and should soon pass the all-time peak recorded in 1974. With such strong growth, employment should continue to rise and unemployment to fall. The Annex summarises the most recent Treasury assessment.

11. Domestic demand has so far been growing very rapidly in 1988. Consumers expenditure continues to rise strongly, but the main contrast with earlier years is the surge in investment, as companies (including foreign investors) take advantage of the highest rates of return in the UK since the early 1960s. Surveys of investment intentions and figures for orders - notably for construction - all demonstrate the strength of this investment boom.

12. There have been some worries on capacity shortages. But ~~only~~ It is chiefly in the construction sector that are there clear signs of ~~that~~ the industry ~~is~~ working close to its limits. Construction output rose by 10½ per cent in the year to the first quarter of 1988, and orders are very high. This has inevitably put upward pressure on construction costs. Elsewhere, CBI surveys show that manufacturing companies expect to be able to cope with likely demand in 1988, despite strong order books.

13. Inflation at the end of this year is likely to turn out higher than the Budget forecast, chiefly as a result

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of higher mortgage rates. Pay is continuing to grow much more rapidly than is desirable, especially in the public sector. A slowdown would improve the prospects for both inflation and employment.

Not really serious enough.

14. It was always likely that the current account would move into deficit during a period of strong investment growth. So far this year the recorded current account deficit has been running well above the level implied by the Budget forecast, at an annual rate equivalent to about 2 per cent of GDP.

? Omit - too complacent

15. A deficit of this size is unusual but can ~~readily~~ be financed provided we continue to pursue sound financial policies, including a healthy Budget surplus, which will keep downward pressure on inflation and thereby maintain the confidence of the financial markets. [There is a marked contrast between our present circumstances and earlier periods of current account deficit, in that public sector borrowing is now <u>negative</u> - we are repaying debt. The implication is that the current account deficit is a consequence of <u>private sector</u> behaviour, which will in time be self-correcting.] Nevertheless, there must be a risk with a deficit of the size now in prospect, that market sentiment will turn against us, especially if markets sense that we are losing our grip on either monetary policy or public expenditure.

Conclusion

16. Confidence in the UK remains high both at home and abroad. We must keep it so. That will require a continuation of firm financial policies to bear down on inflation. And it means that we must avoid expenditure commitments now that may be unsustainable as economic growth moderates. Recent rises in interest rates have demonstrated our determination to tighten monetary policy as and when necessary. We must show the same determination in the restraint of public spending.

17. It is essential, therefore, that we follow the recommendations in the Chief Secretary's paper.

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MAJOR ECONOMIC INDICATORS

	UK				G7 excl UK
	1985	1986	1987	1988	1988
A. Demand & Activity (per cent change)					
GDP	3½	3	4½	4	4
Domestic demand of which	3	4	4	6	4
- consumers' expenditure	4	6	5	6	3
- fixed investment	3	0	4	11	7½
Exports of goods & services	6	3	5½	2	7½***
Imports of goods & services	2½	6½	7½	9	9½***
B. Inflation (per cent)					
RPI (Q4 on year earlier)	5½	3½	4	5½	3
RPI excluding mortgage interest payments	5¼	3½	4	4½	
GDP deflator (financial years)	6	3¼	5	5	3
C. Other items					
Current balance (£bn)	3½	0	-1½	-9	
Unemployment (per cent, narrow definition)	11½	11½	10½	8½	6½
Average earnings (per cent change: financial years)	7½	7½	8	8½	
3 month interest rate (per cent)	12	11	9½	10¼	6¾*
Sterling index (1980=100)	78	73	73	74.6*	
Oil price (Brent, $barrel)	27	14	18	14**	

* close Monday 4 July
** delivery in August 88, as of 4 July
*** goods only
† manufacturing earnings