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Treasury Chambers, Parliament Street, SW1P 3AG
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6 July 1989

Paul Gray
10 Downing Street
LONDON
SW1

Dear Paul

PUBLIC EXPENDITURE CABINET

I attach a draft speaking note for the Prime Minister for Cabinet next Wednesday. I also attach a draft of the Chancellor's paper; since Cabinet this year is on Wednesday, our timetable has been compressed, and it would be most helpful if it was possible to have any comments during the course of tomorrow.

Yours
Alex

A C S ALLAN

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CABINET

ECONOMIC PROSPECTS

Memorandum by the Chancellor of the Exchequer

During the 1980s, the British economy has experienced a period of sustained economic growth, at a rate faster than that of our major European competitors. Profitability has recovered dramatically, and private investment has exceeded all previous peaks. This performance has been the result of major supply side reforms carried out in a context of prudent monetary and fiscal policies.

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2. Over the past two years, growth has been particularly rapid. This has caused unemployment to fall fast; but it has also brought about a re-emergence of inflationary pressures. In order to deal with these pressures, monetary policy has been progressively tightened.

3. There is clear evidence that this policy is having its desired effects, particularly on the personal sector. The housing market has slowed right down, and retail sales have slowed down considerably. But some worrying signs remain. Inflation has risen slightly higher than forecast at the time of the Budget, and the continuing strength of the investment boom - welcome though that is - means that other demands on the economy must be reined back further if the growth of overall domestic demand is to be adequately restrained. And some sectors - particularly construction - are continuing to experience considerable pressures on capacity.

4. Our first, and overriding, priority must be to get inflation back on to a sustained downward path. This will require monetary policy to remain tight for [some time to come.] It also means that we cannot allow the consequent curb in the growth of private spending - achieved at no little political cost - to be undermined by any let-up on our policy of restraining the growth of public

a sustained period

spending. The fact that we are currently running a budget surplus in no way modifies this conclusion, as the economy slows down the surplus is likely to fall. ~~in any event~~

WORLD ECONOMY

5. The world economy grew much more rapidly than expected in 1988, and in every country within the G7 forecasts of the growth of GNP and domestic demand were exceeded. GNP growth in the G7 as a whole reached 4½ per cent and world trade in manufactures grew by 10½ per cent.

6. The indications are that the world economy has remained very buoyant in the first half of this year. Growth in Japan and Germany appears to be particularly strong, though there are clear signs of growth slowing in the US in response to tighter monetary policy.

7. The strong growth of the past two years is in large part the result of a worldwide investment boom, in response to the more stable economic environment of the 1980s with lower inflation and less intervention by governments.

8. This dynamism in the world economy has, however, brought with it increasing inflationary pressures. Capacity utilisation is at historically high levels, and inflation has risen in all the major industrial countries. In response, all the major countries have raised interest rates since the spring of last year. While in the US interest rates may already have peaked, European interest rates were raised further in the last week in June, and a further increase is also likely in Japan.

9. Provided that countries continue to take this necessary action to restrain inflation the prospect is for further satisfactory growth in the world economy, though at a somewhat lower rate than in 1988.

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THE BRITISH ECONOMY

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10. There are now clear signs that growth of GDP and domestic demand have begun to moderate in response to recent rises in interest rates. GDP growth in 1989 as a whole is now forecast to be 2¼ per cent, just a little below the Budget forecast. But this is more than accounted for by lower North Sea production following recent accidents.

11. The growth of personal sector spending has slowed down sharply. Retail sales have risen only slowly so far this year, and indicators of consumer confidence indicate that growth will continue to be slow. Reduced mortgage lending and a very depressed housing market suggest that consumers will be more cautious from now on and will gradually increase net saving from the very low recent levels. Even with continued strong growth of private investment the growth of total domestic demand is likely to be much lower in 1989, at 3 per cent, than the 6½ per cent recorded last year. Nevertheless in the circumstances this is still too rapid, and needs to come down further if inflation and the current account deficit are to fall significantly. This will require policy to remain tight for some time yet.

12. There was evidence of widespread pressure on capacity in manufacturing industry in the second half of last year. These pressures have eased a little in 1989, and should ease further as output grows more slowly and new capacity comes on stream as a result of the investment boom. The construction industry, however, has shown more worrying symptoms of capacity constraints, with serious shortages of labour and evidence that prices are rising much faster than in the rest of the economy - well into double figures. The latest DTI and CBI surveys of investment intentions, together with evidence from the industry itself, suggests continuing growth of construction demand; capacity constraints are likely to persist for some while yet in this sector.

13. Underlying inflation has been ~~slightly~~ higher so far in 1989 than envisaged at Budget time, having risen throughout the recent

period of very strong growth. The RPI excluding mortgage interest payments - the nearest equivalent to the measures of consumer prices used in nearly all other major countries - was 6 per cent higher than a year ago in May. Including mortgage interest payments, RPI inflation in May was 8.3 per cent. And pay is continuing to grow more rapidly than is desirable, especially in the public sector.

14. I now expect total RPI inflation to be 6¾ per cent in the fourth quarter of this year, above the forecast of 5½ per cent published at the time of the Budget. By that time, however, other less distorted measures of inflation - such as producer prices and the RPI less mortgage interest payments - should also have clearly stabilised and begun to fall. Growth of the GDP deflator may nevertheless be about 7 per cent in 1989-90 as a whole, compared with 5½ per cent in the Budget forecast, with especially strong pressures on prices in the investment sector where demand is particularly buoyant.

15. There was a recorded current account deficit of £15 billion in 1988 and a substantial deficit has persisted so far this year - though in the light of the enormous balancing items in the accounts the true deficit may well be overstated. It should be possible gradually to reduce this deficit, and in the meantime to finance it, provided we maintain a policy stance that severely restrains the growth of domestic demand.

16. The public finances remain strong, though there are some signs that the PSDR in 1989-90 may prove slightly smaller than I budgeted for in March. Our policies to boost personal pensions have been more successful than anyone foresaw and the consequential rebates of national insurance contributions will reduce government revenues, though in the longer term there will be substantial savings on SERPS spending. And the favourable cyclical influences which have boosted the surplus over the past two years will tend to unwind as the economy slows down. The fiscal projections in the MTFS showed minimal scope for discretionary tax reductions given present public expenditure plans, even with the budget reverting gradually to balance. It

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would clearly be a very dangerous reversal of policy if increased public expenditure obliged us to raise taxes to maintain an adequately tight fiscal stance.

CONCLUSION

17. The policies which we have pursued in the 1980s have greatly strengthened the British economy. But there are clear risks in the present situation. We must not weaken in the fight against inflation. At a time when we are seeking to reduce the growth of private sector demand it is vital not add to our difficulties by expanding to public sector's claims on resources.

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

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MAJOR ECONOMIC INDICATORS

	UK 1986	UK 1987	UK 1988	FORECAST UK 1989	FORECAST G7 excl UK 1989
A. Demand & Activity					
GDP	3	4½	4½†	2¼†	3¼
Domestic demand of which	4¼	5	6½	3	3¼
- consumers'expenditure	5¾	5½	6½	3½	2¾
- fixed investment	1¾	8	12¼	6½	5½
Exports of Goods & Services	3¾	5½	-1	4½	8½**
Imports of goods & Services	6½	7½	12	6¾	7**
B. Inflation					
RPI (Q4 on year earlier)	3½	4	6½	6¾	4¼***
RPI excluding mortgage interest payments	3½	4	5¼	5½	
GDP deflator (financial years)	3¾	5¼	7½	7	4
C. Other items (levels)					
Current balance (£bn)	0	-3	-15	-16	
Unemployment (per cent, narrow definition)	11	10	8	6½	6
Average earnings (per cent change: financial years)	7½	7¾	8½	9½	4½††
3 month interest rate	11	9½	10½	14*	8½*
Sterling index (1985=100)	92	90	96	91.8*	
Oil price (Brent, $barrel)	14½	18	15	18.7*	

* close July 5
** goods only
*** Of the rest of the G7 only Canada has mortgage interest payments in its consumer price index

† output measure
†† manufacturing earnings