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From the Private Secretary

1 February 1990

Dear John,

SEMINAR ON ECONOMIC PROSPECTS

The Prime Minister held a seminar on 30 January to discuss the latest economic position and prospects and the appropriate policy stance. Those present were the Chancellor, the Economic Secretary, Sir Terence Burns and Mr. Michael Scholar. The papers before the meeting were the Treasury's January 1990 economic forecast, and the annotated agenda supplied with your letter of Friday 26 January.

I should be grateful if you would ensure that this record is seen only by a strictly limited number of people.

In discussion of the present economic position the following main points were made:

(i) There was now clear evidence that the desired aims from the tightening of policy were being achieved. Despite the monthly jump in December the volume of retail sales compared with a year ago was now sluggish, and indicators of consumer confidence were low. The housing market was very weak. Imports had slowed down considerably, and this was particularly noticeable for basic materials and capital equipment. The profile of industrial production had flattened and the latest intentions survey from the CBI pointed to the volume of investment being broadly flat. All in all the rapid growth of demand seen from 1987 to early 1989 had now been contained, and the large private sector financial deficit was probably beginning to turn.

(ii) The effect of this slow down was also to be seen in the latest figures and prospects for the PSDR. The surplus was now falling quite sharply and might in the event be only some £8 billion in the current financial year, falling to some £5 billion on present policies in 1990-91. To a substantial extent the position this year reflected special factors, in particular the higher than expected take up of personal pensions and further growth in local authority expenditure: taken together these factors had an impact of some

£4 billion. Corporation tax proceeds had fallen more than expected in December, but first signs were that this may have been largely reversed in January. In 1990-91 the main factor underlying a further fall in the PSBR would be the cyclical impact of a slowing economy, reversing the factors which in 1987 and 1988 had led to a much sharper growth of the surplus than anticipated. It seemed that changes in the public sector financial position, in either direction, were more highly geared to levels of economic activity than was generally recognised or allowed for.

(iii) Recent company news indicated that there had been substantial over-confidence in the retail sector, with acquisitions at high prices that could not be justified once the rapid growth of demand had fallen off. In this respect there were similarities with 1973. It could also be expected that the tighter financial position of the retail sector would again have knock on consequences for the commercial property market.

(iv) It was possible that house prices could still fall substantially further, given that the ratio of house prices to average earnings was still at a historically high level. There were, however, considerable regional variations in house price trends, and these were mirrored in similar variations in retail sales trends.

(v) The rate of fall in unemployment had slowed in recent months in response to the lower growth in demand. Although the precise timing was uncertain it seemed inevitable that unemployment would start to rise again before too long.

(vi) Although the majority of the indicators pointed to a broadly satisfactory response to tightening of policy there were still some major problem areas. In particular it was both disappointing and puzzling that the growth of M0 continued to be in excess of the target range, with the broader aggregates and lending also continuing to grow at a high rate. It was difficult to understand why M0 had been so slow to respond, although one explanation might be that the greater availability of cash dispensers was increasing the use of cash rather than alternative means of payment. But the temptation to regard the high growth of M0 and the broader aggregates as due to some unexplained and benign special factors should be resisted; the money figures were amongst the economic statistics that could be most accurately measured. It was also noticeable that mortgage lending continued to rise month-by-month even though the volume of house transactions was very low; this was because much of the borrowing was remortgaging and second mortgages with the funds being used for consumption purposes. There had been a major revolution in the easy availability of finance secured on housing over a short period; Alan Greenspan had suggested that the UK was experiencing

within the space of just a few years the sort of developments that had taken place over some 7-8 years in the United States. For all these reasons there were continuing grounds for concern about whether inflationary pressures had yet been contained; as long as the high growth of monetary aggregates continued, it would be right to remain cautious about the stance of policy.

(vii) This was reinforced by the latest prospects for inflation. The January forecast showed that there was now little expectation of significant progress in reducing the 12-monthly growth of the RPI during the course of 1990.

Discussion then turned to the implications of the present position and the forecast for the stance of policy. The main points raised were:

(a) There was a strong case for seeking to maintain a broadly balanced budget and for avoiding intentionally moving back into a position of net public sector borrowing. The assessment of a balanced budget was most appropriately made on the basis of the PSBR excluding privatisation proceeds. On that definition it appeared that a position of budget balance was already close to being reached.

(b) There were a number of arguments that pointed to the conclusion that the present overall stance of economic policy was not tight enough. As indicated in the earlier discussion the figures for the monetary aggregate were worrying, and it was reasonable to conclude that inadequate notice had been taken in the past of the signals they were giving. A substantial number of mortgage holders had yet to face up to the cash flow consequences of higher interest rates because of yearly lags in the adjustment of monthly payments; however even when the process had fully adjusted the intense competition amongst mortgage lenders meant that most mortgage borrowers were in practice paying significantly below 15 per cent. The same was true of business borrowing, which was generally tax deductible. The fact that many businesses still seemed willing to agree to large wage increases suggested there must still be considerable slack in business finances.

(c) Even though effective borrowing rates for many people could be below 15 per cent, there was no doubt that monetary policy had been greatly tightened since mid 1988, and it was therefore surprising that it had not had a greater effect. This prompted the question whether the normal mechanisms for transmitting the impact of tighter monetary policy were breaking down. It was important to bear in mind however that over recent years there had been major structural changes in the financial markets consequent on deregulation and the removal of controls. When policy instruments had

included direct controls and other rationing devices, these mechanisms provided a considerable reinforcement to the impact of a higher price of money via interest rates. Following deregulation this was no longer the position and full reliance therefore fell on interest rates. The implication was that, for a given overall tightening of policy, it might now be necessary to pull the interest rate lever harder. That said it remained important not to underestimate the effects that monetary tightening had had over the last year.

(d) If monetary policy was tightened further it would lead to major economic and political difficulties. The impact of high interest rates tended to be concentrated on particular, politically sensitive, groups such as mortgage holders and small businesses. With that in mind it was highly desirable to strain against pressures for any further interest rate increase. But if the monetary indicators continued to be unfavourable this possibility could not be absolutely ruled out.

(e) One possible means to reinforce the impact of interest rate policy would be the introduction of a consumer credit tax. Its advantage was that it could be targeted on particular groups or types of borrowing. There was however a major presentational drawback in the introduction of a new tax.

(f) One of the major difficulties with higher interest rates was the short term adverse impact on the RPI. It was essential once the RPI began significantly to be reduced to look again at the arrangements for calculating the RPI, including the advisory committee system. The present conventions were full of anomalies and unjustified assumptions, and these needed to be challenged. One possible solution in the longer term was to move towards adopting a common OECD or EC approach. A more immediate problem was the impact on the RPI of the introduction of the community charge. At an earlier stage the Government had gone along with the approach of including the community charge in the RPI (unlike rates), mainly because of worries over the likely cost of having to redeem index linked gilts (at a possible cost of some £3 billion) if the community charge was excluded from the index. But the logic for including the community charge was extremely weak, and the nonsense of this approach was under-lined by the fact that an inconsistent approach was being used by the national income statisticians in measuring GDP. It might not be possible at this stage to change the basic decisions to include the community charge in the RPI and to exclude from it credit for community charge rebates; however it was essential to make an early approach to the RPIAC to look at the treatment of the community charge transitional relief scheme. This had been introduced since the original RPIAC decision, and no effort should be spared in seeking to persuade the Committee that transitional relief should be taken into

account in the index so that the RPI more closely measured the net payments being faced by charge payers.

(g) If some tightening of economic policy was judged appropriate, it might be preferable to tighten the fiscal rather than the monetary position. In this context a key issue would be the Budget decision about the revalorisation of excise duties. It was now clear that it had been a mistake in 1989 not to revalorise; and if that decision was to be repeated this year an impossible position could be faced in 1991 given the worries that would then be expressed about the RPI impact of higher excise duties. Following the decisions in recent years to increase indirect taxes less than the rate of inflation there was a strong case for more than indexing them this year; indeed some duties were now 30 per cent lower in real terms than in 1979. On the other hand, given the latest RPI prospect set out in the January forecast, to more than index this year would have obvious draw-backs.

(h) One potential weakening of the fiscal stance would arise if it was necessary, in view of Stock Exchange developments, to reduce Stamp Duty. But as a result of delays in the planned introduction of Taurus the implementation of fiscal changes following the start of paper-less transitions might not be necessary in 1990-91.

(i) Further consideration needed to be given to the tax treatment of fixed investment. One potential problem area was short life or high technology investment; there was already a short life asset scheme which was thought to provide more generous tax treatment than the actual writing down periods that businesses use, but this was certainly an issue that could be looked at again. A wider possibility would be to consider a more general change in tax allowances so that capital investment could be written off much more rapidly for tax purposes than its actual period of use; in effect to use the tax system to subsidise investment. The attraction of such an approach was the importance, following several years of strong growth in fixed investment, to ensure that this record was maintained and that the UK's productivity performance relative to Germany and other strong competitor countries was improved. On the other hand if tax allowances were significantly increased that could pre-empt the possibility of lower corporation tax rates in later years; it might therefore be better to focus on the longer term aim of tax rate reduction and leave businesses to reach their investment decisions on the basis of purely business rather than tax reasons.

(j) A key issue for the Budget and for economic management more generally was the need to reach a view on an acceptable rate of inflation in the near term. There was general agreement that by mid-1991 the inflation

rate must be brought down to 5 per cent or less. On one view it would be necessary to administer a sharp policy shock to deliver such an objective. On the other hand it was felt that shock treatment could have very serious adverse economic and political effects, and it would therefore be highly desirable to achieve the lower inflation objective by a steadier application of policy instruments.

(k) The existing MTFS targets had now lost credibility. If the MTFS approach was to be maintained it was essential the targets set at Budget time to be realistic. But equally it was necessary to take action which would give the MTFS a new stamp and a new credibility. Hitherto the MTFS had set targets for interim policy objectives, but not for inflation itself. It was therefore for consideration whether there would be advantage in setting a medium term target for the reduction of inflation to a specified rate by, say, 1993-94. This might provide the means of giving the MTFS credibility, and it would provide an excellent discipline for the conduct of the policy over a period of years. On the other setting a precise inflation target was a high risk strategy and a hostage to fortune particularly when, following recent experience, there were doubts about exactly how it would be achieved. On this view the necessary pre-requisite to any such targeting would be to get the rate of inflation down further first. On the other hand if some new ingredient could not be introduced into the MTFS it might be better to drop the whole approach; simply to roll forward the existing MTFS with higher numbers could lack credibility. Against that, to drop the MTFS and replace it with nothing would provide a very bad signal for the markets. A further alterative might be to consider setting a shorter time-frame on the MTFS than had been done in the past, and to reinforce this with non-quantified intentions for the future. Given these conflicting considerations it was not possible at this stage to reach a final decision on the role and nature of the MTFS in this year's Budget; it would need to take into account the latest available pre-Budget information on the monetary and other indicators.

(l) It would be necessary in the Budget documentation to include a form of words about UK entry into the Exchange Rate Mechanism. There was a strong case for sticking closely to the post-Madrid formula; any other approach would raise difficult questions. It would also be desirable to say as little as possible about exchange rate policy, perhaps relying on the phrase that the Government favoured a strong pound, and to focus heavily on past exchange rate developments rather than speculating about the future.

(m) Outside the Budget context it would be necessary to consider carefully the approach to

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possible ERM entry over the months ahead. The UK was now committed to entry unless there was some further dramatic development, for example in the context of the IGC next winter. A key issue on possible timing of entry would be the profile of UK inflation, and against the background of the latest forecast it may well be that the UK would not join before the next January election. If the UK was to enter the mechanism before the election then there was a strong case for ensuring this was at least 4-6 months in advance of the election itself, in order to allow for the markets to settle down; it was likely that there would be an initial period of turbulence. An essential pre-requisite to entry would be reasonable assurance that sterling would stay steady if UK interest rates were significantly lower; and an assessment that lower UK interest rates would not undermine the necessary tightness of domestic economic conditions. All these considerations pointed to reviewing the position reached towards the end of 1990 which, given the current RPI profile, was the earliest date that entry could be contemplated. In the meantime it seemed likely to be appropriate to keep interest rates at or close to present levels.

Yours,
Paul

(PAUL GRAY)

John Gieve, Esq.,
HM Treasury.