chex.ps/jg/21 BUDGET SECRET

15(a-f) A

REF NO. JM/90/22
COPY NO. 1 OF 18.

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

PRIME MINISTER

I thought it might be helpful to let you know the state of play on the economic forecast and the MTFS before our meeting on Wednesday. We are not yet in a position to take final decisions on the numbers - since we are still waiting for information on RPI inflation, trade and the public finances in February - but my provisional decisions are set out below.

The economic forecast

2. The current forecast is realistic without being unduly gloomy. It is summarised in the attached table and summary page from the FSBR. It shows that 1990 will be an uncomfortable year, with relatively low growth and little progress on inflation. But it will show a pick up in growth and a significant fall in inflation in the first half of 1991.

3. The outlook for demand and activity has changed little since the picture given in my paper for Cabinet in February. I am proposing to publish a figure of $^3/_4$ per cent for GDP growth in 1990, with a pick up to $1^1/_4$ per cent in the first half of 1991. A period of below-trend growth is inevitable if we are to get inflation down, and while the Treasury's forecast is somewhat below the consensus of outside forecasts I believe that it is reasonable. In the past we have tended to underestimate the extent of cyclical swings in the economy.

6

4. The immediate prospect for inflation has become rather worse in recent weeks. The high levels of community charge being set by local authorities and the rise in the mortgage rate will add to RPI inflation. My current proposal is to publish a forecast of 7 per cent for RPI inflation in the fourth quarter of 1990, while making clear that a sharp rise is to be expected in the next few months. This is an uncomfortable message, but I am satisfied that publishing a lower inflation forecast would strain credibility in the light of the poor figures we are likely to see in the next few months. But the forecast is for a considerable improvement to 5 per cent inflation (and falling) by mid-1991.

5. The current account forecast for 1990 is, at £14 billion, marginally lower than that published in the Autumn Statement. A further fall, to £12 billion at an annual rate, is forecast for the first half of 1991. This is in line with the consensus of outside forecasts.

The MTFS

6. The Red Book will also restate the MTFS. The essence of the strategy will, of course, remain unchanged. But I propose to give a rather fuller statement of the way we conduct policy, and the reasons behind it, than has been the practice in recent versions. I think this is essential if we are to enhance the credibility of our approach.

7. At the centre of the MTFS is the commitment to defeat inflation. This will be restated in unequivocal terms, and I propose to show a path for money GDP growth consistent with bringing inflation down to 3 per cent by 1993-94. I believe that this is a credible objective which is within our grasp if we pursue our policies with determination.

C

CHANCELLOR OF THE EXCHEQUER

	89-90	90-91	91-92	92-93	93-94
PSDR	7	6	2	0	0
ie after fiscal adjustment:					
- annual			1	1	1
- cumulative			1	2	3

Fiscal policy

8. The position on fiscal policy remains essentially as set out in my minute to you last week, although here again the numbers are subject to further change. I propose to restate the longer term objective of a balanced budget, with a medium term path as we discussed last week.

9. The GGE ratios we publish will inevitably be somewhat higher than in the public expenditure White Paper, given the increases in local authority expenditure we now expect in 1990-91. But we will show a downward trend in the medium term consistent with the cash figures for the planning total agreed in the Survey.

Monetary policy

10. I propose to include a fairly extended description of our approach to monetary policy in this year's MTFS. It will as usual make clear that monetary policy has to be in the forefront of the battle to conquer inflation, with support from a firm fiscal policy. It will explain our approach to setting monetary targets, and the factors we take into account in setting interest rates. And there will be detailed sections on funding policy, reserve asset ratios and the measurement of broad money.

11. I propose to retain the present approach to monetary targets. The only formal target will be for narrow money, as measured by MO, but I shall make clear that we also take account of the exchange rate, broad money, and other indicators in setting interest rates.

12. The underlying growth of MO has been outside its target range throughout the current financial year. Having fallen through much of 1989, it has if anything edged up again since the autumn and now stands at nearly $6^1/_2$ per cent. I therefore propose to set a

d.

CHANCELLOR OF THE EXCHEQUER

target range of 1-5 per cent for 1990-91, the same as in 1989-90, and I expect to see the growth rate come down within the range by the autumn. The proposed range is one point higher than the 0-4 per cent range foreshadowed in last year's MTFS, reflecting the higher path of money GDP growth which we now envisage. I see little prospect of MO growth falling below 4 per cent during 1990.

13. I have looked in some detail at the arguments for setting a target for broad money, as we used to do. But I am convinced that this would not be appropriate. Although we have observed a reasonably stable trend in M4 velocity in the 1980s, there are good reasons for thinking that this might not continue in the 1990s given the probable turnround in the relationship between asset prices and incomes.

14. Finally, the MTFS will contain a statement of our intention to join the ERM when the Madrid conditions are satisfied. It is made clear that this will not be a substitute for the MTFS, but rather a complement to it. The Government will continue to conduct its monetary policy within the MTFS framework.

John M.

[J.M.]

13 March 1990

 0559

e

3 The economy: recent developments and prospects to mid-1991

Summary

3.1 GDP is forecast to grow by ¾ per cent in 1990, following above trend growth for three years. RPI inflation should begin to fall at the end of 1990, reaching 5 per cent by mid-1991.

Assumptions

3.2 The forecast assumes that fiscal and monetary policies are operated within the framework of the Medium Term Financial Strategy (MTFS). It assumes that both North Sea oil prices and sterling remain close to recent levels. The public sector debt repayment (PSDR) is forecast to be about £7 billion in 1989–90 and £6 billion in 1990–91.

Demand and activity

3.3 GDP growth slowed to 2¼ per cent in 1989, partly because of a large fall in North Sea oil output. Growth of consumers' expenditure slowed markedly through 1989 and fixed investment probably flattened off in mid-year. But exports accelerated sharply in the second half of 1989, while import growth fell.

3.4 Domestic demand is forecast to be lower in 1990 than in 1989. But this is likely to be offset by strong growth in net exports and GDP is forecast to rise by ¾ per cent.

Inflation

3.5 Total retail price inflation was 7½ per cent in the fourth quarter of 1989; excluding mortgage interest payments it was 6 per cent. Total RPI inflation is expected to rise further in the coming months, before falling to 7 per cent by the fourth quarter of 1990 in response to the continued slow-down in the economy. It is forecast to fall to ~~4¾~~ 5 per cent by mid-1991 and further thereafter.

Trade and current account

3.6 The current account deficit was nearly £21 billion in 1989, but began to fall in the closing months of the year. It is forecast to fall to £14 billion in 1990.

Labour market

3.7 Employment has continued to rise rapidly, while unemployment has fallen. With a forecast of low output growth, unemployment could level off in the coming months and may rise, although much depends on the behaviour of wage bargainers.

World economy

3.8 Growth of world trade and GNP slowed in 1989, but both were still above the trends for the 1970s and 1980s. A further slight slowing down is forecast for 1990. Inflation in the major economies picked up in 1989 and is now generally as high as or higher than a year ago. It is forecast to moderate very slightly in 1990.

f.

Table 3.10 Economic prospects: summary

Percentage changes on a year earlier unless otherwise stated

	1989	Forecast 1990	Forecast 1991 H1	Average errors from past forecasts[1]
GDP and domestic demand at constant prices				
Domestic demand	3¼	−¾	1	1¼
of which:				
Consumers' expenditure	3¾	¾	1	1¼
General government consumption	½	¼	2½	1
Fixed investment	4¾	−1¼	−1¼	3¼
Change in stockbuilding (as percent of GDP)	−¼	−1¼	¼	½
Exports of goods and services	4	7¼	4½	1½
Imports of goods and services	7	1¼	3¼	2¾
Gross domestic product (average measure)	2¼	~~¾~~ 1	1¼	¾
Manufacturing output	4¾	0 −	¾	1¾
Balance of payments current account (£ billion)	−21	~~−14~~ −15	−12[3]	3½
Inflation				
Retail price index (Q4 on Q4)	7½	~~7~~ 7¼	5 ~~4¾~~[4]	1¼
GDP deflator at market prices (financial year)[2]	6¼(6¼)	4 (6)		1
Money GDP at market prices (financial year)[2]	8¼(8¼)	5 (7)		1½
£ billion	517 (518)	541 (552)		
PSDR (financial year)				
£ billion	7	~~6~~ 7		3½
per cent of GDP	1¼	1		½

[1] *The errors relate to the average differences (on either side of the central figure) between FSBR Industry Act Forecasts and outturn over the last ten years, and apply to the forecasts for 1990.*

[2] *The figures in brackets adjust for the distortion to money GDP and the GDP deflator arising from the abolition of domestic rates. This is explained in the box on page xx.*

[3] *At an annual rate.*

[4] *Q2 on Q2.*