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CAB 128/101

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**MOST CONFIDENTIAL RECORD
TO
CM(91) 7TH CONCLUSIONS**

ECONOMIC
STRATEGY

The Cabinet considered a memorandum by the Chancellor of the Exchequer on economic strategy (CP(91)3).

THE CHANCELLOR OF THE EXCHEQUER said that the economy had taken a long time to respond to the tightening of monetary policy since 1988, but it had weakened significantly in the second half of 1990 and was now weaker than expected at the time of the Autumn Statement. The economic situation was difficult, although relieved by falling inflation. Three of the Group of Seven main industrial countries were experiencing recession, which was therefore not unique to the United Kingdom, although continental Europe had been less affected. For 1991 as a whole there was likely to be a fall of about 1 per cent in gross domestic product and a 2 per cent fall in domestic demand, with inflation down to 5 per cent by the fourth quarter of the year. The recession was likely to be shallower than 1980-81 and perhaps also 1974-75. The former had mainly affected manufacturing, whereas the current recession was more widespread and was also affecting the service and the financial sectors. In consequence, parts of the country were affected which had not experienced earlier recessions. Resumed growth was to be expected in the second half of the year. The fall in inflation would help to increase real wages and therefore demand, as in 1980-81, and the drawdown of stocks would come to an end. There were also good prospects for a recovery in the United States. Meanwhile the pressures on business remained intense, though more through the effect of high interest rates on demand than their direct effect on costs. The need to restrain costs would reinforce downward pressure on inflation. Unemployment was likely to rise sharply this year, and to reach around 21 million by December. The situation in the Gulf was affecting sectors such as airlines, hotels and tourism, though they could be expected to revive after the war ended. The key policy aim was to ensure the success of United Kingdom membership of the European Exchange Rate Mechanism (ERM), which was essential to credibility in the financial markets. Maintaining the ERM commitment required caution on interest rates, though reductions should in due course be possible. The fiscal position was likely to be in balance for 1990-91, as compared with the £3 billion surplus expected at the time of the Autumn Statement. The deterioration partly reflected the Gulf war, but mainly weaker economic activity. The financial markets would notice the expected £0.6 billion overshoot compared with the public expenditure plans in the Autumn Statement, which were themselves £1.6 billion more than originally planned; and the total excess of £2.2 billion would attract critical comment.

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For 1991-92 he expected to budget for a public sector borrowing requirement, which would be the first since 1986-87; but this was appropriate when the output was weak, and mirrored the large surpluses when the economy had been buoyant. It would be important to reaffirm the objective of balancing the Budget over the economic cycle as a whole, so that the borrowing was seen to be temporary. Firm control of spending would need to be maintained. He saw no scope for tax reductions in the Budget, and some limited increases might be necessary. The key requirement was a Budget and a fiscal stance which would give the maximum room for manoeuvre on interest rates.

In discussion, the following main points were made:

- a. There were grounds for concern that the recession might be deeper and more prolonged than anticipated in the memorandum. Many companies were taking a very bleak view, including major firms on which large numbers of smaller businesses depended. Both confidence and order books were low, and labour costs had risen rapidly. The global economic context also differed from that in previous recessions. Demand from Eastern bloc and Arab countries had been little affected then, but could not be relied on now. On the other hand the United States economy could be expected to strengthen, and lower inflation should also stimulate recovery. There was also increased investment and output in the North Sea oil industry, which illustrated the advantages of the stable fiscal regime in the industry over the last eight years.
- b. Some of those who had argued most strongly for ERM membership had now turned to supporting the argument that devaluation would permit lower interest rates. This overlooked the difficulty of reducing interest rates if the currency was seen to be weak, but it would be important to counter this argument effectively in public presentation of economic policy, and to dispel the impression that the Government was relying on interest rates alone.
- c. Although there was much complaint about the burden of interest rates, no convincing alternative to the Government's economy strategy had been put forward. Premature reductions in interest rates which then had to be reversed would be particularly damaging. Priority should be given to creating scope for sustainable interest rate reductions, which would be of greater benefit to many households than any likely tax relief.



- d. There was clearly no significant scope for tax reductions, but the Government should also seek to maintain its record of not increasing taxation, although it would be wrong to suggest that taxation should never be increased. In particular, there should be no additional burden on business. Tax allowances should if possible be indexed, even at the cost of not indexing the starting point for higher rate tax. There should also be scope for continued simplification of taxation and for reducing special reliefs.
- e. There was a case for tax incentives for expenditure on training by individuals, and also for going further on relief for child care, which could ease pressure for spending on nursery education and help to reduce the dependence of single parents on social security benefits. However it was also argued that there was room for doubt about the value and effectiveness of reliefs in either of these areas. There was also a good case for measures to help small firms, many of which were under severe pressure, for increasing incentives for saving and for looking again at the taxation of let land. It was questionable whether capital gains should be taxed at the same level as income, and a reduction should be considered. There was a case for a national lottery.
- f. There would be advantage in measures of benefit to the environment, such as increased taxation of petrol to discourage consumption and increase fuel efficiency. The real cost of tobacco had fallen since 1986, and now that inflation was coming down there were strong arguments for taking the opportunity to increase taxation in this area, which would be popular and would particularly help to discourage smoking among young people. Undue increases in tobacco taxation could however have adverse effects on employment in Northern Ireland. Increased taxation of spirits would tend to discriminate against British products, and the whisky industry in particular.
- g. The economic and public expenditure impact of the situation in the Gulf would not end when the war stopped. The threat of terrorism would remain and might intensify, and the price of oil might settle at a higher level than now. Planned savings in defence spending had also had to be deferred, and a substantial addition to the defence budget was likely to be needed in 1991-92. Once those savings were implemented, however, they could be expected to lead



to factory closures and add to rising unemployment.

- h. It was argued that the underlying economic growth rate of 2 per cent through the 1980s had been no higher than in the 1960s and 1970s. There was a need to consider how resources could be shifted from consumption into wealth creation and investment in such areas as education, training, and infrastructure. On the other hand it was pointed out that economic performance in the 1980s had been better relative to that of other countries than in earlier decades, as indicated by productivity performance and the United Kingdom's share of world trade, and there were grounds for thinking that the supply capacity of the British economy had increased.
- i. The quality of economic statistics remained a cause for concern. Resources had been put into improving them, but some deficiencies were inevitable. Similarly the economic forecasts, while the best central estimates that could be made, were inevitably subject to a margin of error.
- j. In presenting the effect of the Budget on personal incomes, it was worth drawing attention to the £1 billion which was being made available through the community charge relief scheme, and to the social security uprating in April which would be well in excess of inflation at that time.

THE PRIME MINISTER, summing up the discussion, said that the economic situation clearly provided a difficult background to the Budget. The Cabinet nevertheless endorsed the approach set out by the Chancellor of the Exchequer in CP(91)3. In particular, they reaffirmed their commitment to United Kingdom membership of the ERM, and agreed that economic policy should be geared to getting inflation down and keeping it down.

The Cabinet -

- 1. Took note, with approval, of the Prime Minister's summing up of their discussion.
- 2. Invited the Chancellor of the Exchequer to take account of the discussion in preparing his Budget.

Cabinet Office

22 February 1991