the national archives

Index

SUBJECT

MOST CONFIDENTIAL RECORD

No.	Contents	Date
	CC(89) 6th Conclusions Thursday 16 February 1989 ECONOMIC STRATEGY	

Copy No 1 of 3 copies

MOST CONFIDENTIAL RECORD
TO
CC(89) 6th Conclusions

ECONOMIC STRATEGY

The Cabinet considered a memorandum by the Chancellor of the Exchequer (C(89)3) on economic strategy.

THE CHANCELLOR OF THE EXCHEQUER said that the past year had had both good features and bad. The good features had been rapid investment-led growth; a sharp fall in unemployment; the fastest growth of manufacturing productivity in any major nation; and profitability in the company sector at its highest level for twenty-five years. But there had also been an increase in domestic demand exceeding the capacity of the economy to meet it. Another way of expressing it was that total savings had remained constant, with a rise in company savings offsetting a fall in personal savings, while investment had gone up. This would take time to correct. It had been reflected in a substantial current account deficit, but the major problem had been the growth of inflation, although its extent was exaggerated by the inclusion of mortgage interest in the Retail Price Index.

Continuing, THE CHANCELLOR OF THE EXCHEQUER said that the problem of excess demand had been dealt with by a rise in interest rates. This was already starting to affect the housing market, retail sales and the growth of narrow money, although inflation was likely to go on rising for a few months. There were good signs therefore that the policy was working. But interest rates would have to remain high until it was quite clear that inflation was coming down. Indeed, if more needed to be done to control inflation, it would be done. Although monetary policy was the key to reducing inflation, fiscal policy must support it. A prudent and cautious fiscal stance was therefore essential. This indicated another sizeable Public Sector Debt Repayment during the coming year. The scope for tax reduction might well be largely restricted to offsetting fiscal drag, and any tax reform would have to be accommodated within this tight constraint. A difficult year lay ahead. The growth of the economy, and with it the decline in unemployment, must slow. It would be a few months yet before the inflation figure started to come down. But the prospects thereafter were good so long as the Government maintained its policy.

In discussion the following main points were made:

a. The underlying economic position was strong but there was considerable evidence of the resurgence of inflation, for example in the construction industry. A revival of inflationary expectations could be extremely damaging. The need for prudence in framing the Budget was paramount.

b. The increase in interest rates had so far had less political impact than might have been expected. The reasons for this might be that real earnings had continued to increase, that interest rates had only gone back to the level prevailing in the quite recent past, and that savers, especially the elderly, benefitted from higher rates. Nevertheless, the possibility had to be allowed for that general public reaction might now become much sharper, especially among groups, like recent house buyers on low incomes, who were being especially hard hit. It was relevant that the full effect of the rise in rates had not yet been felt by borrowers with endowment mortgages from Building Societies which adjusted their rates only annually. Farmers also felt interest rates acutely, having suffered a fall in real income. It could be argued that, to the extent that tax reductions and interest rate reductions were alternatives, it was better to choose the latter.

c. A decision to make only small tax reductions when the Government had such a large Budget surplus would require careful presentation. More could be done to emphasise the advantages of debt repayment, which would be readily appreciated by the public at large.

d. There were some disturbing signs that retail sales, for instance of motor vehicles, were not responding to the tightening of monetary conditions. Indeed, since interest payments were often not separately identified in retail transactions, it was not clear how effective increases in interest rates were in this area. Moreover, banks, with foreign deposits encouraged by high interest rates in this country, were putting considerable effort into encouraging more borrowing. In the light of this, prospects for the balance of payments and inflation were bound to give cause for concern. On the other hand, some other indicators of retail sales, overseas holiday bookings and house prices indicated a response to the measures taken.

e. Table 2 in Annex 3 to C(89)3 showed that since 1979 Income Tax and National Insurance Contributions (NICs) had risen as a percentage of earnings for those on half average earnings. There was therefore a very strong case for concentrating on the lower paid the benefit of any tax reductions that fiscal policy allowed. This could most readily be done by raising the tax threshold rather than reducing the basic rate. Generally, action on the threshold was very attractive, although it could be argued that recent changes in the benefit system had reduced its impact on incentives. Another possibility was action on NICs, for example to raise the starting-point and improve the transition to the higher rates.

f. Other attractive possibilities for the use of any fiscal surplus that was available were: abolition of the pensioners' earnings rule, to encourage pensioners to stay in, or return to, the labour market; further concessions on lead-free petrol; under-indexation of the duty on petrol; and further action to encourage savings, perhaps by allowing tax relief on the initial investment. It would be important to take the opportunity of future privatisations to spread share ownership.

THE PRIME MINISTER, summing up the discussion, said that the Cabinet endorsed the approach to economic strategy set out by the Chancellor of the Exchequer in C(89)3. In particular, they agreed on the need to give priority to countering inflation and on the case for a cautious fiscal policy. They also believed that any tax reductions that were possible should bring particular benefit to the lower paid.

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

17 February 1989