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MOST CONFIDENTIAL RECORD

CC(90) 7th Conclusions

Thursday 22 February 1990

ECONOMIC STRATEGY

CAB 128 / 98

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TO
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STRATEGY

The Cabinet considered a memorandum by the Chancellor of the Exchequer on economic strategy (C(90)2).

THE CHANCELLOR OF THE EXCHEQUER said that over the last two or three years there had been both an investment boom and a fall in the savings ratio. Both had been unusual in their magnitude, and for the two to occur together was probably without precedent. They had contributed to a faster than expected rise in demand, and a deterioration in the current account. There were now however convincing signs that the economy was slowing down. In the last three months the volume of retail sales had been only 1.5 per cent higher than a year earlier. Progress was also being made in reducing the current account deficit, with a rise in non-oil exports of 15 per cent over the last year. For 1990, he expected domestic demand to fall slightly, by about 1 per cent. Gross Domestic Product might rise by rather less than 1 per cent. Recession over the year as a whole should be avoided, but the uncertainties were such that it was not possible to rule out a fall in output over short periods. High wage settlements increased the risk of recession and of rising unemployment. Rising food prices, the latest increase in mortgage rates and the higher than expected level of the community charge had all contributed to worsen the outlook for inflation. He expected that the Retail Price Index (RPI) would rise for a time, and it was unlikely to come down very far for some months. There was a clear risk that his forecast of a 6.5 per cent rise in the RPI between the last quarters of 1989 and 1990 could be exceeded. For 1990, therefore, the prospect was for an unattractive combination of low growth and high inflation. The following year should however be the mirror image of 1990, with growth rising and inflation falling. The current account position already looked more favourable than it did a few months ago, and the improvement in it should be at least as great as he had forecast in the Autumn Statement and perhaps greater. He now expected the Public Sector Debt Repayment (PSDR) in 1989-90 to be a good deal lower than the £12.5 billion forecast in the Autumn Statement, for a number of reasons including continued overspending by local authorities, lower Corporation Tax payments as a result of higher company expenditure on investment and the success of the Government's policy on personal pensions. The PSDR might decline a little further in 1990-91, because of the introduction of independent taxation, the full effect of the reform of National Insurance Contributions, and the slowing down of the economy. The budget was moving more quickly than had earlier been expected from surplus to balance, even without discretionary tax reductions.

Continuing, THE CHANCELLOR OF THE EXCHEQUER said that it was wrong to draw a pessimistic conclusion from the unattractive prospects for 1990. If the Government persevered in reducing inflation, the longer-term prospects for the economy were very good, as it benefited from the supply side improvements of the last few years, and the Government would be able to resume its policy of tax reductions. But it was essential that there should be no change of policy now and in particular that the Budget should be cautious. It was right to get the difficult remedial action over as quickly as possible, so as to open the way for the subsequent recovery.

In discussion the following were the main points raised:

- a. There was an overwhelming case for a cautious Budget. It was widely expected and necessary for maintaining confidence. In particular, the Government must demonstrate its determination to control inflation, a task which the Chancellor of the Exchequer was right to make his first priority.
- b. There was also a strong case for a tight fiscal stance. It could be argued that the aim should be that the budget should still be in surplus by the end of the following year, rather than in balance. The Budget should be considered from the point of view of its effect on interest rates, which could come under pressure if German rates rose as a consequence of monetary unification. One advantage of the tight financial policies followed so far was that they had more effect in restraining demand in the overheated South East than in parts of the country where there was still surplus capacity. However, a further rise in interest rates would be extremely damaging, especially since the United Kingdom had to borrow abroad to finance its current account deficit. The United Kingdom's vulnerability while it remained a borrower for this purpose showed the importance of cutting the deficit. The worst case of all would be to cut interest rates now, only to have to raise them again a little while later. The greatest risk to the Government was a loss of political and economic confidence, which would have a devastating effect on investment.
- c. An increase in excise duties would raise the RPI and this might in turn intensify wage pressures. Nevertheless, the case for revalorisation at least was very strong, to maintain the proper balance between direct and indirect taxes. The case was especially strong if the alternative would be a decision not to index personal tax allowances, to the disadvantage in particular of the lower paid. The effect on the RPI would be unwound in 1991. The excise duties should however be considered separately. Some changes in relativities could be desirable. For example,

there was a case for an extra increase in the duty on high strength lager, consumption of which contributed to the problem of hooliganism. It was anomalous too that this lager, which was mainly imported, was taxed at a lower rate than spirits, which were mainly produced in this country. On environmental grounds there was a case for an increase in petrol duty and the possibility of a switch from Vehicle Excise Duty to higher duty on petrol might be re-examined.

d. It would be desirable, within a tight fiscal stance, to target any concessions on groups which were being particularly hard hit by other changes. The prime example was those who were specially affected by the introduction of the community charge, such as one earner couples and pensioner couples. There was indeed a large group of the Government's supporters, affected by high community charges and high mortgage interest, whose allegiance must not be lost permanently, although increasing tax relief on mortgage interest would not be the right response. There was a strong case for targeting some help on the lower paid, partly so as to exert a moderating influence on wage demands.

e. Similarly, again within a tight fiscal stance, there would be considerable advantage in modest concessions to promote the Government's general policy objectives. There was a case, for example, for providing more incentives for savings. The decline in the savings ratio had been one of the most unfortunate developments in recent years. There was also a case for more incentives for investment and venture capital, to sustain the investment boom which now seemed to be coming to an end, and also for tax reliefs to encourage training and the acquisition of qualifications. Another concession that could be highly desirable would be to remove employees' liability to tax on child care facilities provided by an employer. However, it was desirable that the Government's policy on child care should be considered as part of its approach to supporting the family as a whole.

f. Experience in 1989 had borne out earlier warnings that policy would be undermined by the growth of credit. The greater difficulty of controlling the growth of credit, compared with the time at which the medium term financial strategy had first been launched ten years ago, was one argument in favour of joining the European Exchange Rate Mechanism when conditions were right. Lenders, including overseas lenders, were still trying to encourage borrowing, and the United Kingdom was now faced simultaneously with a credit boom and very high interest rates. Direct controls on lending, like those applied in Germany and Japan, should be considered. On the other hand, more recent statistics

showed that credit was already being satisfactorily restrained.

g. In seeking a tight fiscal stance, the importance of maintaining discipline on the expenditure as well as the revenue side of the account must not be overlooked.

THE PRIME MINISTER, summing up the discussion said that the pessimism about immediate economic prospects must not be exaggerated. The numbers in employment, and the standard of living, were higher than ever before. There should be some growth in the economy in 1990 and it should accelerate in 1991. These facts should be fully reflected in public presentation. The Cabinet endorsed the approach to economic strategy set out by the Chancellor of the Exchequer in C(90)2. In particular, they reaffirmed the economic strategy and the central objective of bringing down inflation, and agreed that economic policy should remain prudent and cautious.

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 1990

