CHIEF SECRETARY TO THE TREASURY

Mr. Potter

You might find the attached useful. I should emphasise

- the "answers" have not been approved by Ministers
- the numbers are still provisional
- I am sending this on a strictly "blind" basis!

Jerry.

P.S. Feel free to phone if you want any clarifications.

12(A-G)

DIFFICULT QUESTIONS

THE ECONOMY

Q1. **Are we in recession? Doesn't the available information point to a weaker path of output than in the forecast?**

A. Forecast shows output in the second half of 1990 slightly down on first half, but a small rise next year. We believe the forecast to be central, though note that if anything we have tended to underestimate the strength of domestic demand in the recent past. After a period of very rapid growth, some slowdown was necessary as a prelude to lower inflation and a resumption of sustainable growth. [Refuse to be drawn on definition of what constitutes a recession - see Gus O'Donnell, 24 October.]

Q2. **Inflation being brought down only by decimation of industry?**

A. Some slowdown in the economy was necessary, given the unsustainably rapid growth in 1987 and 1988. The relatively mild fall in output in the forecast can hardly be described as decimation.

Q3. **Investment prospect poor? Bad for the economy.**

A. Some fall is inevitable at this stage of the cycle. But the fall shown in the forecast is small, and from a high level.

Q4. **Once again, inflation is higher than in the previous published forecast. Can you really expect us to believe the sharp fall projected for 1991?**

A. The encouraging monetary position and signs of weaker activity mean that underlying inflation will soon be falling. The stance of policy will remain tight, and our presence in the ERM will ensure that this is so. In addition, last year's mortgage rate increases and the community charge effect will drop out of the index, and food price inflation will abate. The forecast is also

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constructed on the basis that oil prices will come down somewhat from present levels during the course of 1991, a similar assumption to that adopted by other forecasters. [We regard the inflation forecast as central, and it is worth remembering that when inflation fell sharply in the early 1980s our forecasts tended to be too high.]

Q5. A sharp fall in inflation will require falling mortgage rates. Is this what you are forecasting?

A. It is not our practice to divulge the interest rate path assumed in the forecast. Interest rates will be kept as high as is necessary to bear down on inflation and maintain the exchange rate in its ERM band. There are many factors tending to reduce the inflation rate - see above.

Q6. UK relapsing into stagflation?

A. Inflation tends to lag behind the output cycle, and at this stage it is quite common for output to weaken while inflation continues to rise. But as inflation comes down, output growth will resume.

Q7. Present ERM band not sustainable given the picture shown in the forecast? Entry rate too high, and inflation remains well above our community partners, implying downward pressure. Alternatively, higher interest rates necessary to bear down on inflation will mean upward pressure.

A. See the ERM entry brief.

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Q8. Current account in substantial deficit. Competitiveness has deteriorated during the year, and will deteriorate further as a consequence of ERM entry.

A. Current account has improved in 1990, and forecast to improve further in 1991. No need for ERM membership to imply deterioration in competitiveness so long as firms maintain control over growth of domestic costs. Cannot rely on depreciation to bale them out.

Q9. Sharp rise in unemployment likely?

A. As with previous Governments, we don't publish a forecast of unemployment. But some rise is likely given the projected path of output. The extent of any rise in practice will depend on wage bargaining.

Q10. Has the MTFS now been abandoned? Upward revisions mean that the money GDP path can no longer be taken seriously.

A. The MTFS has certainly not been abandoned. ERM membership provides a further counter-inflationary discipline, and helps strengthen monetary policy. MTFS will be restated at Budget time.

Q11. ERM entry means the end of monetary targets?

A. No reason to change present policy of targeting MO. Monetary growth in the UK is falling, with MO now inside its target range. Most ERM members continue to have monetary targets.

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PUBLIC EXPENDITURE AND FISCAL POLICY

Q1. **Why such a huge increase in planning total in 1991-92**

- **on last year's plans (up £8 billion)**
- **on this year's outturn (up £20 billion)**

A.

- Sharp fall in ratio 1984-85 to 1988-89 helped by very buoyant economic growth (savings from unemployment, asset sales etc). [Weaker activity means no such benefit this time.] ~~Bigger~~ weaker activity usually has pushed up ratio. Determined not to allow this to happen.

- higher than expected inflation has put upward pressure on cash plans. Social security benefits indexed to September RPI - running well above other measures of inflation (including GDP deflator).

- even so, % addition to planning total less than % increase in price level. So cash plans do not accommodate expected increase in prices since last Survey.

- nearly two thirds of year on year increase in spending due to Social Security, Health and AEF (£12½ billion out of £19¾ billion). Government honouring commitments to most vulnerable groups, in difficult economic circumstance. AEF increase helps to hold down next year's community charges.

Q2. **Have you given up trying to reduce GGE/GDP?**

A. No. The GGE ratio fell very sharply when the economy was growing exceptionally strongly; as the economy slows down we would expect a temporary halt to the downward trend. By end of Survey period, the plans imply a resumption of the downward trend in the ratio. [Not for use: We estimate that broad stability in the ratio (compared with its underlying downward trend) between 1988-89 and 1992-93 can be entirely accounted for by the cycle. GGE ratio rose very sharply in previous periods of slow growth and relatively high inflation.]

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Q3. **Just accommodating inflation? (What happened to cash planning?)**

A. No. The addition to the cash planning totals has not fully compensated for higher expected prices either this year or in 1991-92. (Cash planning means all increases have to be justified ie no automatic compensation for inflation. Some programmes have been increased in real terms, others have been held to baseline).

Give figures

Q4. **Why is GGE growing less rapidly than the planning total?**

A. Two reasons. First, debt interest payments are falling because the public finances are strong. And second, local authority self-financed expenditure grows relatively slowly because of extra central government support.

Q5. **Public spending out of control**

- **Two successive overruns**
- **GGE overshot because of LA overspending. Why didn't you cut back on central government spending (as you said you would)?**

A. Expected overshoot in the planning total is [1 per cent], though GGE ratio slightly lower than expected. Reflects higher financing requirements of nationalised industries (notably Coal and electricity, where there are special factors) and the Gulf crisis as well as higher pay (NHS, police) and interest rates, and lower asset sales. Significant extra cost of rebates to community charge payers as a result of high level of charges set by local authorities. Planning total undershot in 1987-88 and 1988-89. [Answer to second part of question to come - depends on numbers.]

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Q6. **Plans not credible - optimistic economic assumptions**
- higher privatisation proceeds
- Gulf costs

A. Of course they are. Treasury forecasts not systematically biased: underforecast inflation when it fell in early 1980s. Privatisation proceeds have averaged £5½ billion a year over the past five years. Uncertainties about Gulf one reason for higher Reserves.

Q7. **Why has the PSDR for 1990-91 has been revised down?**

A. The PSDR tends to be strongly influenced by the economic cycle. We typically see a weakening of the public finances when demand and activity weaken. This is especially true of corporation tax, which is expected to be lower in 1990-91 than in 1989-90. And higher inflation has added to debt servicing costs. Can allow some of this adjustment to take place and still maintain a fiscal policy which is tight enough to support the counter-inflationary monetary strategy which we are operating within the ERM.

Q8. **Does this mean in practice that the public sector is moving back into deficit?**

A. Shall set out a revised path of the PSDR at Budget time when the MTFS is revised. Firm intention to stick with budget balance as a medium term objective, though of course this does not mean zero in every year. If pressed: Given prospect of lower outturn this year, and slower growth in 1991 than forecast at Budget time, it is probably realistic to assume that budget balance achieved earlier than the illustrative assumption used at Budget time.

Q9. **How does the loosening of fiscal policy square with ERM membership?**

A. ERM membership and counter-inflation strategy will require continuing tight fiscal and monetary stance. Shall maintain fiscal policy consistent with this objective.

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Q10. Do plans pose a threat to the balanced budget? Will taxes have to be raised?

A. Intend to balance the budget over the medium term, and will take steps necessary to achieve this. In practice, what is likely is small surpluses in some years and small deficits in others, rather than exact budget balance in each year. Too early to speculate on tax changes in the Budget. But will do whatever is necessary to maintain a firm fiscal stance. [Plans consistent with underlying objective of reducing GGE ratio in the medium term.]

Q11. Implications of LA projections for community charge/RPI.

A. Government not in the business of predicting community charges. Made clear its own view that most LAs should be able to set charges at or below CCSS (£380 GB). Note that <u>actual</u> changes will benefit from area protection grant (not taken into account in calculating CCSS). Autumn Statement projections entirely compatible with community charges at level of CCSS. For <u>later years</u>, expenditure figures consistent with wide range of possible outcomes. No simple connection between LASFE and community charge levels.