BF 6/12

Domestic Monetary Policy

10 DOWNING STREET

Prime Minister (2)

To note. I interpret JR's first suggestion not as a wish to reopen the 1983 PES Survey, but as the call to start work identifying the options which will provide the savings which will inevitably be needed in 1984's Survey.

On the state of the economy and the tightness or otherwise of policy, a discussion with the Chancellor would be useful

Yes These two items for a bilateral?

Chancellor has also attempted to clarify capital / current debate in his speech - see attached.

AT 28/11

BF 6/12

KCJR

28 November 1983
Policy Unit

PRIME MINISTER

THE STATE OF THE ECONOMY

Since the recession hit bottom in the second quarter of 1981, there has been a strong recovery in many areas. It has been led by buoyant consumer spending, with total consumers' expenditure likely to be up 3.5 per cent in 1983 following growth of 1.3 per cent in 1982. This year is likely to see 14 per cent growth in the sales of durable goods, and 20 per cent growth in cars and motor cycles. Housing activity and the sales of furniture, clothing and footwear have also been growing rapidly.

The current debate about how the recovery can be sustained is common at this stage of the cycle. It would be fatal to take any action which added to demand from Government sources or by monetary stimulus at this juncture. Such action would increase the chances of requiring heavy restraint next year. The worry at the moment should not be about the economy and its recovery running out of steam, but about overheating in certain sectors that are responding well.

Companies are already reporting shortages of skilled labour in some areas. Whilst much industrial capacity lies unutilised, in those areas where the shifting patterns of demand are having their biggest impact, there are shortages of capacity. The falling savings ratio, growing consumer spending, the upturn in general investment, and the continued high level of government spending all point to the need for caution rather than for expansion.

Why are our opponents arguing for an increase in general demand?

The Labour Party, the CBI, NIESR, NEDO and others all draw on the same common fear which emanates from the poor performance of basic manufacturing industry in the UK. The inability of the car industry to meet the demand in the best ever vehicle year is a symbol of the conflict. The deficit on trade in motor vehicles has surged in the first 9 months of 1983 by 168 per cent, from £751 million to £2,010 million. Nothing would be gained by pumping even more money in the system to enable people to buy yet more cars, other than some further increase in imports. Our message to manufacturing industry must be that the demand is there, and it is up to them to produce the right goods at the right price to satisfy it.

We have frequently used this argument

Will the rate of growth in consumer expenditure tail off next year?

The savings ratio has fallen to 8.5 per cent this year, compared with almost 11 per cent last year. Some think this is now far too low, and implies that consumers will have to stop borrowing. Messels have recently argued that consumer borrowing has been rising because wealth has increased. The substantial rise in house prices in the last 2 years has meant that the consumer can borrow more money without worsening the relationship between his total borrowings and his total assets. In addition, much of the new borrowing has gone towards the purchase of assets which will have some second-hand value. Messels overstate their case: it would be difficult for there to be a good market in second-hand videos of sufficient size to make people regard their video as they do their savings deposit - as a liquid asset. Nonetheless, there is some truth in their case.

The prospects for the pay round in 1983/4 also imply continued consumer spending. There is little prospect of wage settlements falling below the 5-6 per cent range. This implies that average earnings growth will remain around 8 per cent in 1984, as the year will still see some increase in activity and a satisfactory background for bonus payments and overtime. This will be ahead of the rate of price increase, and will therefore mean that consumers' real incomes will carry on rising next year. At the same time, the level of unemployment will tail off and so consumers will be less nervous about losing their jobs. All this points to further buoyancy in retail spending, and we would expect an extremely good Christmas this year for most shopkeepers.

Are we spending enough on capital account?

Total capital expenditure rose by 5.8 per cent in real terms in 1982, and is set for further modest growth in 1983. It is rising in both the public and the private sectors this year. The nationalised industries are spending more, housebuilding will be up by at least 10 per cent in real terms, and in every area of the private sector, apart from manufacturing, increasing investment is the order of the day.

It is important that we begin to win the argument about the virtues and vices of capital expenditure. Not all capital expenditure is a good. Capital expenditure may be undertaken for one of three reasons:

(a) For growth. There is no point in spending money on building new schools or additional electricity generating capacity when school rolls are falling and when we already have 30 per cent more power capacity than we need on average.

(b) To improve efficiency. This type of expenditure is already under way on a large scale throughout the private, industrial and service sectors. More could be done in the public sector, particularly in automating offices.

(c) For replacement. The Social Democrats have begun to move their position and to accept that not all capital expenditure is a good thing. They are left with attacking the Government on the grounds that it is not replacing the sewers. The whole system is not as bad as a few pieces under the most heavily trafficked streets of Manchester would imply. New technology may also come to our rescue in cheapening repairs. It is true that there are some other sections of the public infrastructure that are tatty and need better maintenance or replacement. We are already tackling the difficult problems of refurbishing and maintaining the ageing motorway network, whilst at the same time trying belatedly to complete it.

Chancellor also

Peter Rees has voiced some interesting arguments analysing in more detail our capital spending activities. It is also important to win the general argument that not all capital expenditure is a good thing, and that in those areas where it is a good thing, this Government is making ~~steps~~ to improve our programme.

The Public Sector Borrowing Requirement and the Government's Fiscal Stance

The Chancellor has fought long and hard to come up with a reasonable settlement for public spending next year. However, the outturn is still a little disappointing for the first year of a Government which wishes to embark on a major programme of tax reductions.

The £8,500 million PSBR for 1984-5 is not the full story. It is struck after crediting £1,900 million of asset sales which are an alternative method of financing a deficit. Part of the action taken to curb spending entails additional sales of council houses. £730 million has been slashed off the programme for public corporations. Past experience indicates that public corporations usually come back during the financial year at an inconvenient time seeking more money. Next year is likely to see problems in the basic industrial businesses controlled by the DTI which could well blow the public expenditure target off course.

Finally, we have to remember that we have now sold over £6,000 million of indexed gilts. In the early years, the interest service costs on these are artificially depressed, and this would account for another £400 million plus of public spending if we had issued conventional debt instead of index-linked debt.

The facts underline the need to look at certain of the large programmes like the programme on industrial and nationalised industries support, with a view to improving our controls and taking some of the painful decisions that need to be taken to arrest and reverse the spending in those programmes. They also underline the need for the Government this year to press ahead with its funding programme as monetary policy is at the top end of the 7-11 per cent target range against the background of 5 per cent inflation. This is generous, and the results can be seen in asset markets and in the buoyancy of consumer spending.

Conclusion

Action is needed in two areas. Firstly, we need to return to the attack on public spending as we cannot rest contented with the settlement we have reached so far. You could review with the Chancellor and Chief Secretary the measures they are taking to gain greater discipline over public spending and to identify more targets for genuine cuts. Secondly, we need to be careful in the present conduct of our monetary policy as the dangers are on the side of undue laxity. It is better to tighten a little now than to have to tighten in a year's time against a more explosive background.

Agreed MT

J Redwood

JOHN REDWOOD

Andrew. How far has the DHSS study of the future go. (Highly confidential - only ask Minister's private office or Ken Stowe's private office)

[Mr. Lawson]

and since then it has been falling steadily year by year. The main reason why it increased was that the economy was affected by the world recession.

We in this country are not alone in that perception. The world recovery now under way is built not on some artificial expansion of demand but on a strategy of monetary and fiscal discipline endorsed at successive summits at Ottawa, Versailles and Williamsburg. There is a strategic consensus throughout the industrialised world on what has to be done, a consensus which even embraces Socialist Governments in Paris and Rome. It has helped to reduce inflation in the major countries to its lowest rate for more than a decade and has laid firm foundations for economic recovery. Only the British Labour party cannot accept the logic of the policies or commend their success. Evidently the world is out of step with the Labour party.

The need for firm monetary and fiscal policies applies equally to the developing countries, which have been especially hard hit in recent years by the combination of high interest rates, depressed commodity prices and more costly oil imports. Firm adjustment programmes supported by the International Monetary Fund are crucial. I particularly welcome the long-awaited decision of the United States Congress to support the increase in IMf quotas. I hope that the Administration will be no less successful in securing support from Congress for measures to reduce the Federal Budget deficit, because a fll in dollar interest rates would be the single most significant boost to recovery in the developing and industrial countries alike.

I have outlined our policy on the overall level of spending. Many of my right hon. and hon. Friends in particular are anxious about the balance between capital and current expenditure in the public sector. Gross fixed investment in the public sector, as it is defined in the national accounts, fell under Labour between 1974 and 1979 from 6·5 per cent. of total national output to 4·4 per cent. It fell further until mid-1981 to about 3·4 per cent., but has been broadly stable since then.

The amount of capital expenditure within the public expenditure White Paper planning total, which is the usual basis on which this argument is conducted, provides a poor guide to the impact of the public sector on this country's capital goods industry. For example, the White Paper figure for capital spending amounts to only a fraction of the total public sector capital spending. It does not, for example, include the capital spending of the nationalised industries, which is running at about £7 billion in the current year, which is broadly the same as the 1979-80 level in real terms.

Furthermore, all these capital spending figures are expressed net of asset sales. Sales of public sector housing amounting to over £2 billion last year have to be added back to the totals. The existing convention leads to the absurdity that the more successful the Government are in pushing forward their privatisation programme, the lower the public capital spending figures appear. The figures are also further distorted by the somewhat eccentric treatment of defence in the official statistics. By international convention, virtually all defence spending is classified as current; even expenditure on new barracks or a new service hospital. More importantly, a fleet support vessel in one berth for the Navy counts as current expenditure while its neighbour built for BP scores as capital expenditure.

With the defence equipment programme running at about £7 billion, much of which is capital spending, it makes a big difference to the figures and, because defence spending has been growing as a proportion of public expenditure, it makes a difference to the trend. If we consider these figures outside the straitjacket of the misleading White Paper definition of capital spending, we find that between 1978-79 and 1982-83 total public sector capital spending, including nationalised industries' investment, rose by 38 per cent. from just over £12 billion to £17 billion.

If we adjust the 1982-83 figures to take account of special sales of assets and council house sales, that figure rises to nearly £20 billion or twice the White Paper figure for the earlier year. The figure would be still higher if some credit were taken for defence capital spending. In other words, taking defence equipment as capital expenditure, total public sector capital expenditure in real terms has been broadly stable since 1978-79. As I told my right hon. Friend the Member for Guildford (Mr. Howell) last Thursday, I hope to improve the clarity with which these matters are presented in the next public expenditure White Paper.

Mr. Hal Miller (Bromsgrove): On the subject of capital expenditure, will my right hon. Friend accept that, for example, local authority road programmes rarely meet planning targets and that local authority borrowing for capital expenditure since the introduction of the GRE penalties has dropped from £2·287 billion to £7 million? Widespread anxiety is felt that the necessary capital expenditure on infrastructure is not being undertaken.

Mr. Lawson: It is true that over the years local authorities have regrettably shown a tendency to overspend on their current account and underspend on capital account. The responsibility for that lies with the local authorities.

In any event, what matters most is investment as a whole — private as well as public sector. The autumn statement forecast is for fixed investment rising by 4 per cent. next year against a rate of growth of up to 3 per cent. in the economy as a whole.

Mr. Terence Higgins (Worthing): My right hon. Friend is making an important distinction within the public sector between capital formation as regards defence expenditure and other public sector investment. Does he agree that, in terms of the country's productive capacity, it is only public sector investment outside the defence sphere that increases our capacity to produce? That is not true of capital formation in defence industries.

Mr. Lawson: I have the greatest respect for my right hon. Friend, but I am afraid there is absolutely no distinction between a hospital built by the private sector for the defence services and one built for civilian use. It is precisely the same. Conventional treatment in the public sector White Paper is totally different.

I come to another issue which has aroused a fair amount of comment — the Government's programme of asset sales. The privatisation programme is designed to improve efficiency and to bring about greater competition, to the benefit of the customer and the nation. It reduces the Government's need to borrow, but that is not the programme's principal aim although the beneficial effect on the gilts market is welcome.