

28 January 1985

PRIME MINISTER

② To raise at Cabinet?
AT 28/1, - 7/25 ml

INTEREST RATES AND THE BUDGET DEFICIT

Very high real interest rates - they are now 9% - destroys hopes of jobs and increases the burden on public sector finances.

Paying for Government borrowings was already the fastest growing Government programme as set out in this year's Public Expenditure White Paper.

Forecast of net debt interest payments (£bn):

78/79	79/80	80/81	81/82	82/83	83/84	84/85	85/86
2.2	3.4	4.5	5.7	5.9	7.2	8.5	9.0

Following the 5.5% increase in interest rates in recent weeks, the burden of interest will rise higher than this forecast suggests. In 1984/85 alone, interest payments probably totalled £1,000 million over forecast.

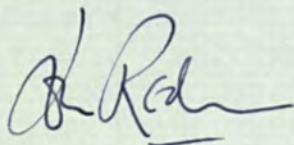
These high interest rates will be good at depressing real activity that depends on low interest rates for success - eg housing. It should also begin to squeeze those in the corporate sector, flush with money and devoid of positive

ideas, who have been busy borrowing to go short of the
currency and to round trip in money and gilt markets.

As soon as it does, we have to lower interest rates again
and bring back the downward pressure on rates.

To be able to do so with comfort, we need to use this period
of gloom and doom to sharpen the knives on public
expenditure. Real public expenditure is 9% higher than when
the Conservative first took over. Even in those programmes
where people feel it has been cut to the bone - eg education
- it is considerably higher in real terms than when the
Government took over, despite falling pupil numbers.

We would recommend that the gravity of the economic position
be brought to the attention of Cabinet; that the job
destruction properties of higher interest rates be brought
to their attention; and the impact of compound interest on
Government finances. If we are to avoid much of the
Government's scope for tax cuts being swallowed up by higher
interest burdens and expenditure, we need to take action now
to reduce public expenditure programmes across the board.



JOHN REDWOOD