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NOTE FOR THE RECORD

DINNER WITH THE CHANCELLOR AND OTHERS
ON SUNDAY 15 DECEMBER 1985

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The Prime Minister yesterday gave dinner to the Chancellor of the Exchequer, Chief Secretary, Sir Peter Middleton, and Sir Terence Burns. Nigel Wicks and Professor Brian Griffiths were also present.

The Prime Minister opened the discussion by expressing serious concern about the stance of policy at present. She believed it to be too loose, citing the growth of broad money, unit labour costs, house prices, retail sales and the behaviour of the stock market. There was evidence of excessive demand which risked higher inflation. The Treasury sought to reassure arguing that there had been a tightening of policy over last winter after a period during the Autumn of 1984 in which - with hindsight - policy had been a little loose. The indicators were not clear cut (see below) but on balance they supported the view that policy was not loose, and there was probably some effect of the tightening still to come. The Prime Minister appeared to take some reassurance from this, though she was ~~perhaps~~ not completely convinced.

Looking ahead, the Treasury pointed to the generally acceptable reception given to the Autumn Statement and argued that it was in any case premature to say that fiscal policy next year appeared to run risks of being on the loose side: no decision about the PSBR had yet been taken, and, when it was, the effect of the sizeable receipts from privatisation would need to be given proper weight - receipts from privatisation had in the past helped to hold borrowing below what it would otherwise have been. The Prime Minister concluded by emphasising the need for a prudent Budget, and indeed that there was a case for not making it too imaginative.

Generally, the theme of the evening was the Prime Minister urging prudence and caution. The Treasury whilst agreeing, also pointed to the need for balance: UK industry was the only industry we had, and the pressures brought to bear on it had to take account of their ability to adapt, otherwise the result might be further increases in unemployment.

In greater detail, the main areas discussed were as follows:

- money and particularly £M3;
- labour costs;
- progress on inflation;
- stock market and mergers;
- consumer spending;
- house prices;
- interest rates.

Money

The Prime Minister was concerned about the high rate of growth of £M3 and its downgrading in the assessment of monetary conditions. After a period when its rate of growth seemed to be coming under control, it had now been rising for two years at an increasingly rapid rate. This could itself be seen as an indicator of loosening conditions and the build-up of liquidity could lead at some stage to excessive spending. It was important to have some measure of broad currency in the MTFS. The Treasury pointed to the slow growth of narrow money and argued that high real interest rates, falling inflation and increasing competition in the banking system were contributing to the rate of growth of £M3 and causing it to become a misleading indicator. They did not ignore it, or other indicators of broad money, though they themselves were mystified by the high level of bank lending. The changes to capital allowances were perhaps causing companies to borrow to finance higher investment in advance of the reductions in capital allowances. (The final stage would be reached next April.) Another possible explanation was that increasing use of financial swaps was leading banks to expand both sides of their balance sheets. Nevertheless, the Treasury accepted that there was a build-up of potential spending power. What could trigger its use would be expectations of a rapid fall in the exchange rate and/or a rapid increase in house prices. These were threats to be watched, but on balance the Treasury did not feel that the behaviour of £M3 at present was a cause for major concern. Interest rates however had to remain high to keep downward pressure on inflation.

Labour Costs

The Prime Minister and the Treasury agreed readily that the rapid growth in unit labour costs was of course of concern. The broad stability of the exchange rate in the past few months (in effective terms) was increasingly coming into conflict with this growth, and employers needed to understand that depreciation of the exchange rate would not be accepted as a mechanism to bail them out. Rising costs, primarily reflected management. In this context it was noted that depreciation against the DM tended to help the competitiveness of exports, whilst appreciation against the Dollar tended to help import costs. But that was not a reason to look for continuing movement of the respective paraties in those directions. There had already been recently a substantial depreciation against the DM.

Inflation

The Prime Minister expressed concern about the slow progress being made on inflation, particularly against a background where inflation had fallen fast in other countries and had been as low as 3.7 per cent in the UK May 1983. The Treasury argued that the figure of 3.7 per cent had been to some extent artificial, since nationalised industry price increases that year had been low, and there had possibly also been some help from a lower mortgage rate. Most other countries excluded the mortgage rate from their price indices. If the mortgage rate was taken out of the RPI it seemed likely that underlying inflation would have been running at 4.5 - 5 per cent for two years or more. Inflation next year should fall to 3.5 - 4 per cent by the summer, but again this was likely to be artificially helped by a lower mortgage rate. The underlying rate of inflation next year might still be more than 4 per cent. The Prime Minister urged the need to keep inflation from the middle of next year down to the "artificial" level it would reach in the middle of the year.

Stock Market

It was agreed that the present level of the Stock Market and the wave of take-over activity was "frothy".

The Chancellor pointed to the benefits which could sometimes be secured by take-over activity of the kind now going on, which led to de-mergers in some cases. The Treasury argued further that there was no real cause for concern: stock markets were high around the world and in real terms the UK Stock Market was not much higher than in 1973 even though corporate profits were much higher.

Consumer Spending

The Prime Minister pointed to the rebound of retail sales and to the expected rapid growth of consumer spending (4 per cent next year) as indicators of excessive demand. There was no substantive discussion of this point.

House Prices

Terry Burns argued that house prices were probably rising at about 8 - 9 per cent a year, on average, though there were wide regional variations. House prices tended to rise broadly in line with earnings. Their behaviour would become a case for concern if they were to rise much more rapidly than earnings.

Interest Rates

The Prime Minister pointed to the high level of real interest rates in the United Kingdom, and also to the way in which the markets had reacted quickly and adversely to the fall in oil prices as if they did not fully accept the rectitude of the Government's economic policies. The Treasury argued that market confidence had been substantially restored by, among other things, only two or three speeches from the Prime Minister and the Chancellor. This was encouraging. But in any case the United Kingdom did not have the long successful track record of Germany and Switzerland in running prudent economic policies. It therefore had to pay a premium in higher interest rates, and the Chancellor argued that this premium was linked in particular to the inducement needed to maintain the exchange rate at its present level.

The evening also included some discussion of mortgage interest relief, where the Prime Minister argued the need for an increase to help particularly younger people in London; and teachers' pay, where the Prime Minister showed some inclination to share the doubts expressed by the Chancellor and the Chief Secretary about the wisdom of an inquiry, though without committing herself: she continued to see some merit in an inquiry which focussed on teachers' contracts and conditions of service.

(Dictated from memory 16/1)

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DAVID NORGROVE

16 December 1985