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PART B

Part B

CONFIDENTIAL

(Circulate under cover and notify REGISTRY of movement)

Begins: 15/11/88.
Ends: 16/10/89.

PO -CH /NL/0114

PART B

Chancellor's (Lawson) Papers:

PRODUCTIVITY AND INVESTMENT IN UNITED KINGDOM INDUSTRIES

Disposal Directions: 25 Years

16/8/95

PO -CH /NL/0114

PART B

dti

the department for Enterprise

17/11

BF

The Rt. Hon. Lord Young of Graffham
Secretary of State for Trade and Industry

The Rt Hon Sir Geoffrey Howe QC MP
Foreign Secretary
Foreign & Commonwealth Office
Downing Street
LONDON
SW1A 2AL

Department of Trade and Industry

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CH/EXCHEQUER
REC. 15 NOV 1988 15/11
ACTION MS YOUNG
COPIES TO FST, SIR P M. ODLETON
MR MONCK, MR BURGNER
MR BURR, MR TYRIE
MR CALL

Mr Neil

Direct line 215 5422
Our ref PS6APM
Your ref
Date 15 November 1988

Dear Geoffrey

I am writing to ask for your agreement to the tactics and negotiating line to be followed in the discussion on the European Company Statute (ECS) at the 18 November Internal Market Council. This has been agreed at official level.

The effect of the proposed ECS would be to create a specific legal instrument enabling companies to create new, or combine existing, cross-frontier operations on the basis of European rather than national law. Such a company would, however, remain subject also in important respects to national laws in which it operates. Its formation would in all cases be optional.

Although the proposal is superficially attractive consultations have indicated that neither UK nor European businessmen find the proposal intrinsically useful. Even if the provisions for mandatory worker participation were to be dropped, very few businessmen would wish to set up a European company as the proposal does not meet any identified need. Differing company law requirements in the different Member States are not regarded as being an obstacle to cross-frontier operations, and businessmen consider that the proposed ECS is irrelevant to the completion of the Single Market. Consequently we do not consider that it should take up the considerable resources that would be needed for its negotiation.

dti

the department for Enterprise

The consultations about the proposed ECS have confirmed our views that we should oppose the proposal in principle, not just because of its provisions for mandatory systems of worker participation. If we concentrate on the latter, other Member States - for several of whom the worker participation proposals are a political attraction - will tend to assume that this is our main reason for opposing work in the Statute and our opposition will carry less weight as a result. We must therefore start by concentrating on whether there is a need for an ECS at this stage. Our objective must be to secure a debate on this question, and to seek to persuade other Member States not to undertake further work on the ECS, drawing particularly on the arguments advanced by the European Round Table in their recent letter to Mr Delors opposing giving priority to it. The debate will, however, certainly also cover the questions of worker participation and the proposed special tax treatment, and we shall then make clear our strong opposition to a requirement for mandatory worker participation and to the proposed tax concessions for European companies which would give them an unfair competitive advantage in relation to other companies operating cross-frontiers within the Community.

Soundings of other Member States do however make us pessimistic about the prospect of success, as there appears to be some support for the proposal for political rather than practical reasons. Nevertheless, it is important that we should try to convince others of the soundness of our view. Should we be unsuccessful, we should ultimately dissociate ourselves from any request to the Commission for further work. We should avoid giving a commitment in principle to further work either at the IMC or Rhodes, but without giving an impression of such outright hostility that our subsequent negotiating position would be undermined. If, despite our efforts, the Commission is told to prepare proposals for an ECS which includes mandatory worker participation, then we shall have to try to take tactical advantage of this to reduce the pressure for the inclusion of similar provisions in the fifth directive, which is expected to be discussed at the December IMC, almost immediately after Rhodes.

I should be grateful for any comments on this approach by Wednesday evening.

I am copying this letter to all members of OD(E).

the enterprise initiative

16/11

FCS/88/193

SECRETARY OF STATE FOR TRADE AND INDUSTRY

1. Thank you for your letter of 15 November on the European Company Statute.

2. I agree with the line you propose for the 18 November IMC and the Rhodes European Council. As you say you can take as your text on the 18th the admirable letter (copy enclosed) which the Round Table of European Industrialists have sent to the Commission. It is very helpful that our point about the absence of any perceived need for a European Company Statute is now not just a UK point but one that has been formally conveyed to Delors by European business. If the Commission attach importance to the "social dialogue", they should listen to such advice.

3. Copies of this minute go to the other members of OD(E).

(GEOFFREY HOWE)

Foreign and Commonwealth Office
16 November 1988

EUROPEAN ROUNDTABLE

October 25th, 1988

Mr. Jacques Delors, President
The Commission of European Communities,
Rue de la Loi 200,
B-1049 BRUSSELS
Belgium.

Dear Mr. Delors,

The Round Table of European Industrialists took advantage of its Plenary Session in London on October 17th to engage in a thorough discussion on the Commission's important proposal for a European Company Statute. I would be most grateful if you could give me an opportunity to call on you in person in the near future to discuss the views of industry and the lines on which it would be best to proceed.

I should make it clear that the senior industrialists of the ERT react positively to the emphasis placed by the Commission on the vigorous restucturing needed to make European industry competitive by 1992. Indeed we are convinced that the test of every measure proposed must be whether it adds to the Community's competitive position in the world market place.

We also recognise the need to ensure that all members of society feel that they share in the activity of building a single internal market. The market place itself is the prime mechanism for bringing the benefits to everybody, in their role as consumers, employees, taxpayers and recipients of social benefits. But more is needed, and the ERT endorses the importance of many of the policy areas known as the "Social Dimension" - including positive employment policies, training and job mobility, and measures to help adjustment.

THE ROUNDTABLE OF EUROPEAN INDUSTRIALISTS

Rue Guimard 16 - B-1040 BRUSSELS (Belgium) Tél. (32) 2 - 511 58 00
Tx. 61511 PHEMB B (Routing : BELERTS) - Tlx. (32) 2 - 511 65 77

But when there are so many urgent and pressing needs in the field of economic and social policy, the ERT has doubts as to whether any high priority can be given to the proposed European Company Statute in its present form.

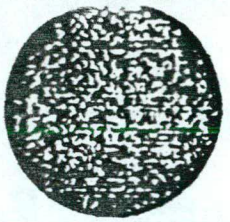
Firstly, we do not feel that the legal structure offers important benefits. Companies have learned to handle the complex structures of national legal systems. Problems that arise in practice are specific and technical rather than of the general nature suggested in the Memorandum, and must be seen in the broad context of mergers and competition policy.

Secondly, we appreciate your concern about corporate taxation, but feel that this is more complex than the Memorandum suggests, and should be dealt with separately. Lengthy negotiations with member states will be needed. And it is vital for the good functioning of the internal market that the benefits of a more logical tax environment, as we eliminate the anomalies of the present system, should be extended to all companies, not limited to a privileged class.

Thirdly, we have serious reservations about extending the system of worker participation in the manner suggested. All professional managers recognise the fundamental importance of communicating with their employees. But the best way of doing so must depend on individual circumstances.

The social and economic climates, and the attitudes of the people involved, vary widely from country to country. To try to harmonise on the lines proposed would bring serious risks to the competitiveness of the European Community- and I must emphasise that this view is fully shared even by those of our Members who have managed with advanced systems of worker participation in the special circumstances of their own countries.

As a practical proposal the ERT has decided to set up a working party of company experts on personnel, legal and taxation matters, to look at the general problems discussed in your Memorandum and to propose alternative approaches. At the same time our Employment Working Group is preparing a detailed response to the Commission's paper on the "Social Dimension", where we see many opportunities for cooperation.



EUROPEAN ROUNDTABLE

I hope to have the pleasure of discussing these important matters with you. May I add that my Members are looking forward to a wider-ranging discussion with yourself and your colleagues in the New Commission at a date in February, which is being arranged. And I am delighted to hear that you may find it possible to be present at the important Seminar on European Education which is also being arranged between the ERT and the Commission in the New Year. I am sure that Europe can only benefit from this continual exchange of views.

With kind regards,

Wisse Dekker.

Prof.Dr. W. Dekker,
Chairman

THE ROUNDTABLE OF EUROPEAN INDUSTRIALISTS

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fim2.cd/ilett/min47

FROM: N J ILETT

DATE: 16 November 1988

PS/CHANCELLOR

cc: PS/Financial Secretary
PS/Sir P Middleton
Mr Monck
Mr Burgner
Mrs Lomax
Mr Burr
Mr Mortimer
Mr Sharples
Ms Symes
Mr Tyrie

Mr McGovern IR
Mr J Reed IR

EUROPEAN COMPANY STATUTE

Lord Young's letter of 15 November sets out tactics and negotiating line for the UK's opposition to the proposed European Company Statute at the 18 November Internal Market Council.

2. Lord Young's letter follows the line agreed by EQS last week, and, in particular, records strong opposition to the proposal to give "European Companies" special tax treatment. This is satisfactory, and - as Ms Symes advised by telephone last night - there is no need for the Chancellor to join in this correspondence.

N J ILETT

The Foreign and Commonwealth Secretary has now accepted Lord Young's proposed line.

CONFIDENTIAL

FROM: J S HIBBERD
DATE: 16 NOVEMBER 1988

CHANCELLOR OF THE EXCHEQUER

cc PS/Chief Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Odling-Smee
Mr Sedgwick
Mr Gieve
Mr Pickford
Mr Bush
Mr Darlington
Mrs Chaplin
Mr Tyrie
Mr Call

Thanks. I agree [illegible] a [illegible] unsatisfactory state of affairs!

INVESTMENT IN THE THIRD QUARTER OF 1988

The Department of Trade and Industry are to publish provisional estimates of investment by manufacturing industries and by construction, distribution and financial industries for 1988Q3 at 11.30 tomorrow, Thursday 17 November.

2. They reveal a substantial fall of 6 per cent in total investment between the second and third quarters of 1988. The figures are set out below:

£ million, 1985 prices

	Manufacturing (including leased assets)	Construction, distribution and financial industries (excl. assets leased to manufacturers)	Total
1987Q1	2330	4026	6356
Q2	2554	4287	6841
Q3	2592	4339	6931
Q4	2574	4901	7475
1988Q1	2638	4661	7299
Q2	2873	5143	8016
Q3	2721	4808	7529
Per cent change:			
1988Q3 on 1988Q2	-5.3	-6.5	-6.1
1988Q3 on 1987Q3	+5.0	+10.8	+8.6
1988Q1 to Q3 on 1987Q1 to Q3	+10.1	+15.5	+13.5
Autumn Statement forecast for 1988	18	[13½]*	[13½]*

*These figures are not on quite the same basis as the DTI estimates.

3. These figures, coming hard on the heels of the buoyant business investment forecast in the Autumn Statement are disappointing and opposition members can be expected to make mischief with them. But there are strong grounds for paying them little attention.

Provisional estimates and subsequent revisions

4. The provisional estimates are produced within eight weeks of the quarter ending. They are followed four weeks later by published revised estimates incorporating later data. An estimate further correcting for latecomers' data is subsequently incorporated (without fanfare) in the next quarterly GDP press notice. Finally, there are the annual Blue Book figures reflecting new benchmarking on the basis of the Annual Census of Production. This is a much more comprehensive and reliable estimate based on a considerably larger sample of firms.

5. Revisions between first provisional estimates and the next Blue Book are ordinarily very large. The recent history of revisions is summarised in the attached charts, where the revisions are all measured relative to the first provisional estimate. The most significant revisions for **manufacturing investment** occurred in the third and fourth quarters of 1985, when the Blue Book figures were **14-15 per cent** higher than the first provisional estimates. But in all cases, the upward revisions have been fairly substantial (downward revisions less so). For the **construction, distribution and financial service sectors**, the revisions are typically more muted, though there is something of an upward trend over the past two years. However, the revisions were large throughout 1987 culminating in a **22-23 per cent** upward revision to the provisional estimate for the fourth quarter of 1987.

6. Against this background, we should give very little weight to the provisional figures. (Arguably they are just not worth publishing.) Moreover, they do not square with the DTI Investment Intentions Survey published in June which predicted a 16 per cent rise in 1988 in manufacturing, measured at 1980 prices, and 10 per cent for construction, distribution and services. (**NOT TO BE USED.** The June DTI Intentions Survey was carried out before rebasing to 1985 prices. Rescaling and reweighting the Survey to 1985 prices implies a 18 per cent increase in manufacturing in 1988, and 13 per cent for construction, distribution and financial sectors.) Nor do

they square with buoyant investment prospects coming out of CBI Surveys throughout this year.

7. These figures are bound to attract press comment, perhaps embarrassing comment. But they are also likely to be disbelieved (which we should gently encourage) by informed outside commentators; they will just confirm considerable recent press comment on the unreliability of macroeconomic statistics (backed up by our own Annex to Chapter 2 of the AS). The latest such comment appeared in today's Times, copy attached, where John Banham, Director General of the CBI, is reported as commenting on the latest manufacturing output numbers (this could be used if pressed):

> "We must seriously ask ourselves whether the government figures are accurate. Revision almost always bring them into line with what our trend surveys have been predicting. If this proves to be so it will not be the first occasion this year when government figures have given a misleading picture of the economy."

Line to take

- Figures superficially disappointing. But these provisional estimates are normally highly unreliable and frequently subject to substantial upward revision.

- First provisional estimates of investment in manufacturing in second half of 1985 subsequently revised up by **14-15 per cent.** First estimates of investment by construction, distribution and financial service industries in 1987Q4 later revised up by **22 per cent.**

- Underlying investment growth still strong. Even with these unbelievably low figures, growth in first three quarters of this year compared to same period last year is 10 per cent for manufacturing and 15½ per cent for construction, distribution and financial service industries.

- DTI Investment Intentions Survey (June) points to strong growth in 1988. CBI Surveys show similar buoyant investment prospects. These have normally proved reliable in past.

- Banham quote about reliability of government statistics.

Jim Hibberd

J S HIBBERD

REVISIONS TO INVESTMENT RELATIVE TO FIRST PROVISIONAL ESTIMATE

Chart 1 Manufacturing Investment (including leased assets)

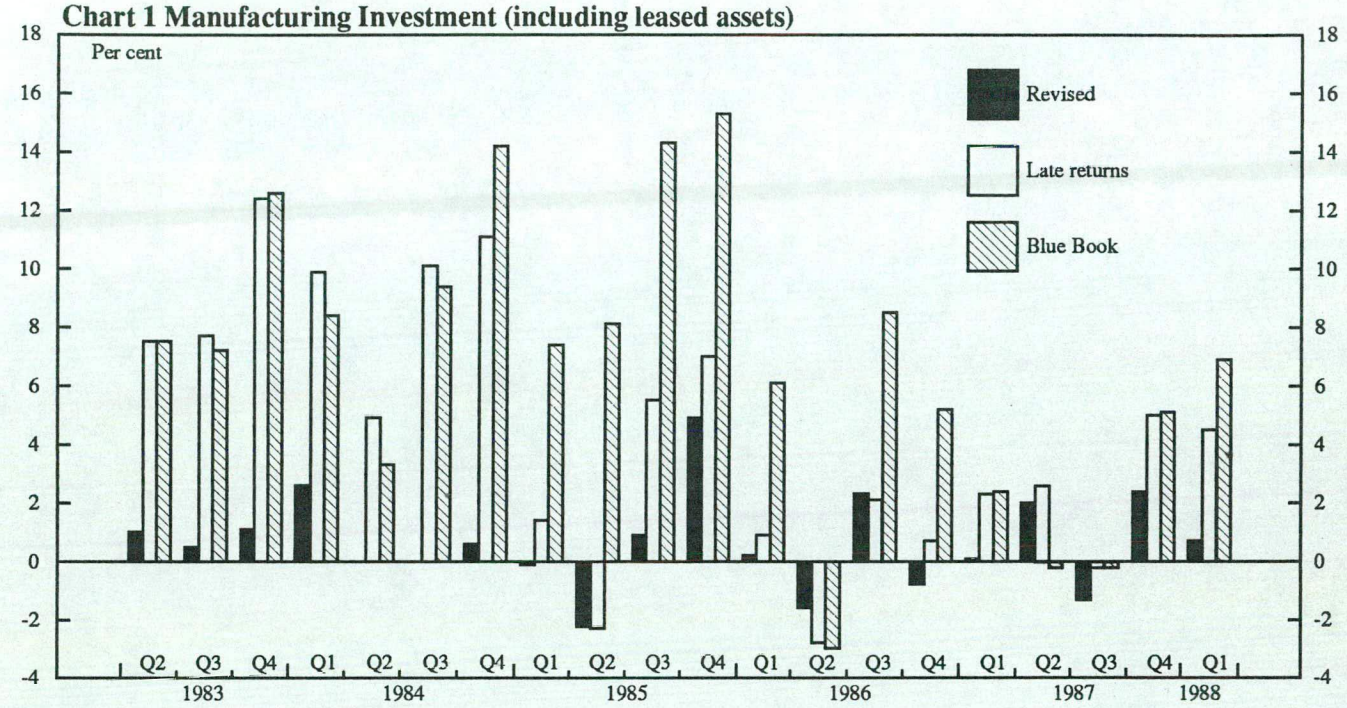
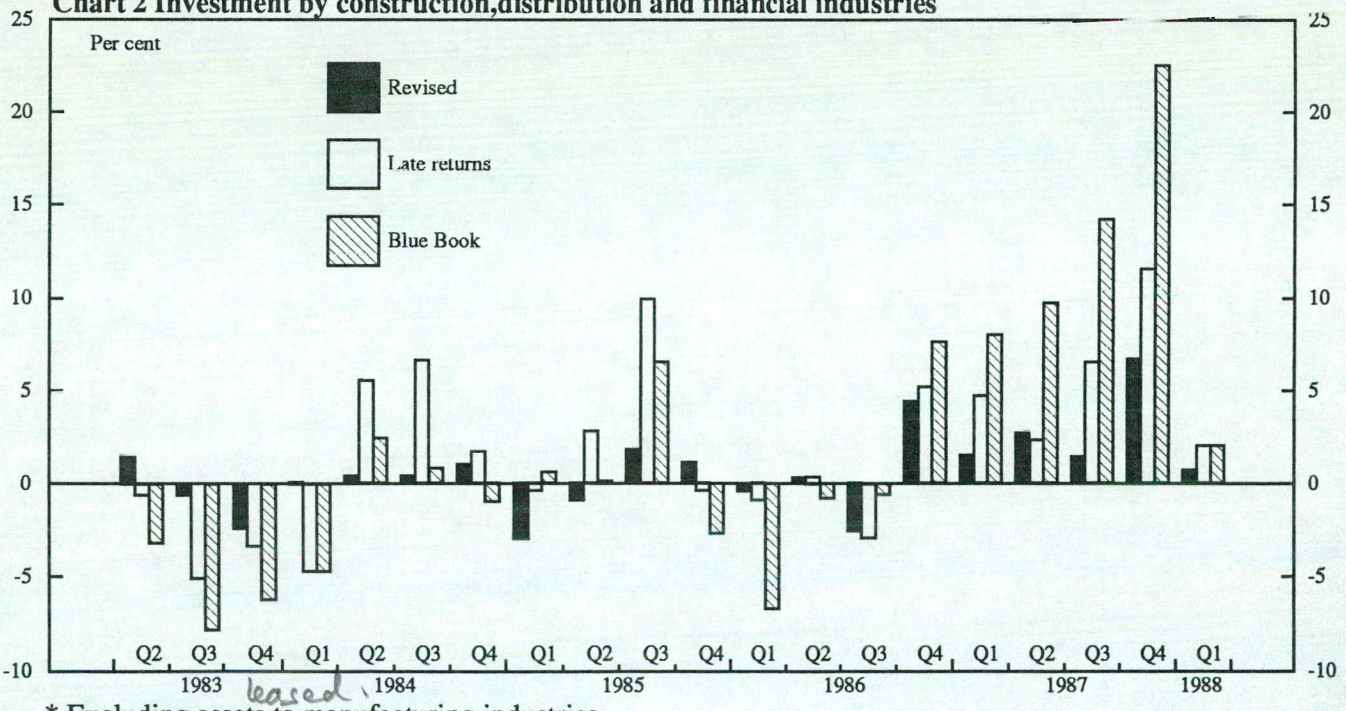


Chart 2 Investment by construction,distribution and financial industries*



* Excluding assets leased to manufacturing industries

Figures on demand and output boost trade fears

By Rodney Lord, Economics Editor

Concern is developing in the City over the combination of apparently buoyant high street demand and falling industrial output. Analysts are speculating that next week's trade figures may show a strong rise in imports.

Industrial production fell in September by 0.5 per cent, the first monthly fall since February. The Central Statistical Office has also revised down, to 0.5 per cent, the estimated rise in August.

Combined with the big rise in October's retail sales, reported on Monday, the fear is that British industry is beginning to compete less effectively with overseas producers.

But Mr John Banham, director general of the Confederation of British Industry, said: "We must seriously ask ourselves whether the government figures are accurate. Revision almost always brings them into line with what our trends surveys have been predicting. If this proves to be so it will not be the first occasion this year on which government figures have given a misleading picture of the economy."

Taking the third quarter as a whole, production was 1 per cent higher than in the previous quarter, with the September index at 110.6 (1985=100), seasonally adjusted.

Manufacturing output over the same period was up 3 per cent. The fastest-growing sectors were chemicals, up 6 per cent, and engineering and allied industries, up 4 per cent.

The strong growth in output of capital goods was reversed in September, with a 2½ per cent fall.

Mr Peter Spencer, of Shearson Lehman Hutton, the securities house, said: "This is disappointing because rapid growth of output of investment goods has been strongly correlated with growth in exports of capital goods."

The figures surprised markets, which had been expecting little change in output. The pound closed 40 points lower against the mark at DM3.1530.

Comment, page 27

'Inflation the priority'

Overcoming inflation, rather than exchange rate stability, is the overriding objective of official policy, Mr Robin Leigh-Pemberton, the Governor of the Bank of England, said yesterday (Our Economics Editor writes).

Speaking to the 1988 Forex Conference in Luxembourg he said: "While we recognise the general value of stability, it cannot be the overriding objective of our policy. For the present, that remains the reduction of inflation."

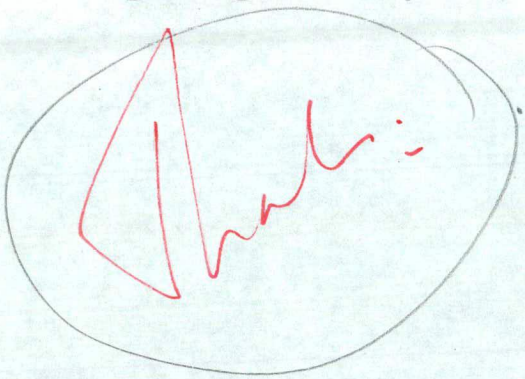
He denied that greater stability was necessary to enjoy the benefits of a freer market in 1992. But nor would freer capital movements destroy that stability. The "practical steps" which the EEC should take lay mainly in the area of removing market imperfections, he said.

FROM: T S O'BRIEN

DATE: 28 NOVEMBER 1988

CHANCELLOR 12/2

Tony D pl.



cc: Chief Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Mr Monck
Mr Scholar
Mrs Lomax
Mr Odling-Smee
Mr Peretz
Mr Riley
Mr Sedgwick
Mr Grice
Mr Hibberd
Mr O'Donnell
Mr Owen
Mr Ritchie
Mr Brooks
Mr Darlington
Ms Kosmin

BUILDING EMPLOYERS CONFEDERATION CONSTRUCTION SURVEY

Sir Terence Burns has suggested I send a note to you on the latest survey from the Building Employers Confederation (BEC) on conditions in the construction industry. The BEC, which has 9,500 members who between them carry out around ¾ of all private building industry output, has conducted this quarterly survey for several years now. The responses give an indication of employers' attitudes on future workloads, capacity of operations, tender prices, recruitment difficulties etc.

2. The survey responses and the BEC's commentary are bullish. The prediction of a 3-4 per cent rise in output next year (with most forecasts suggesting around 8-10 per cent this year, more than confirmed by the data to H1) is above the figure expected by NEDO (2 per cent) and the Building Material Producers (2½ per cent).

3. Whilst the survey responses confirm the impression of an industry operating at or close to capacity, the situation is a little better than reported in the summer survey (although there could be a seasonal dimension at work). For example, as Chart 1 shows, the percentage of firms working at full capacity is down by about five points (69 to 64) on the peak recording (88Q1), and

those reporting serious delays due to manpower shortages down from 14 to 8 per cent. Nonetheless, recruitment difficulties still seem quite severe, as Chart 2 shows, and the regional dimension to this problem, with London and the South somewhat more pressed than elsewhere, can be seen in Chart 3.

4. Tender prices are expected to rise by 63 per cent of firms, which although a high observation, is down from the peak levels recorded earlier this year. One can see in Chart 4 that the regional breakdown shows tender price expectations higher in the South and the Midlands than in the North, but the differential is less now than a year or so ago.

Tom O'Brien

T S O'BRIEN

CHART 1

CAPACITY OF OPERATIONS

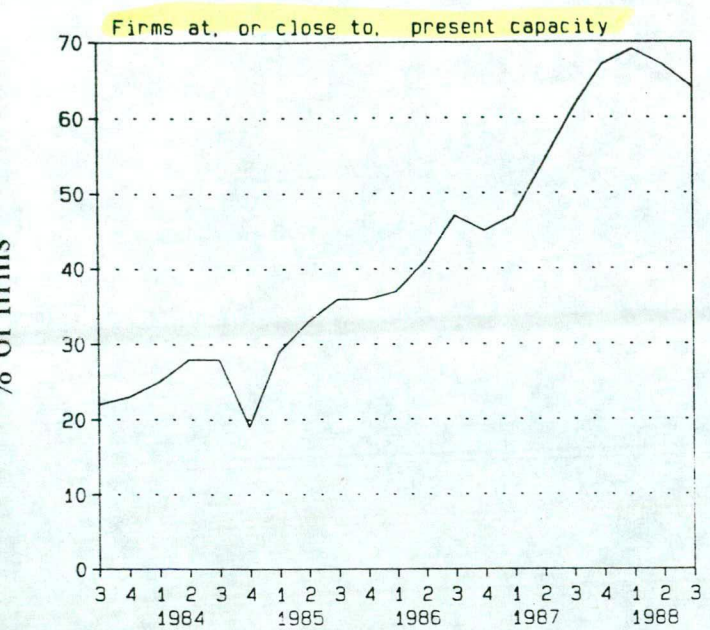


CHART 2

LABOUR AVAILABILITY

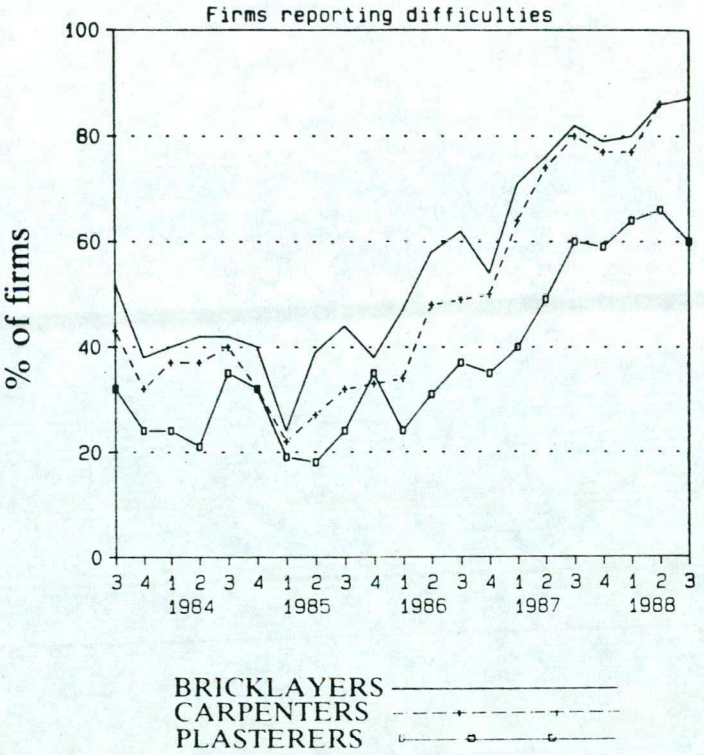
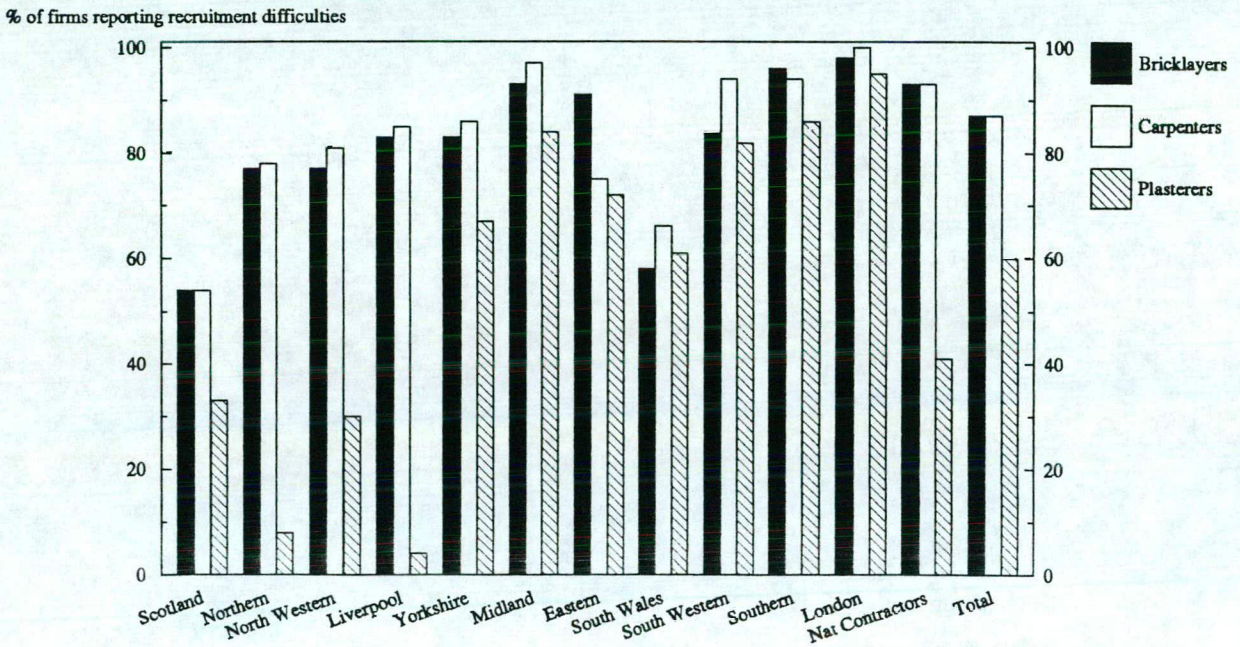


Chart 3 RECRUITMENT DIFFICULTIES IN THE BUILDING INDUSTRY (AUTUMN 1988)



SOURCE: Builders Employers Confederation Survey

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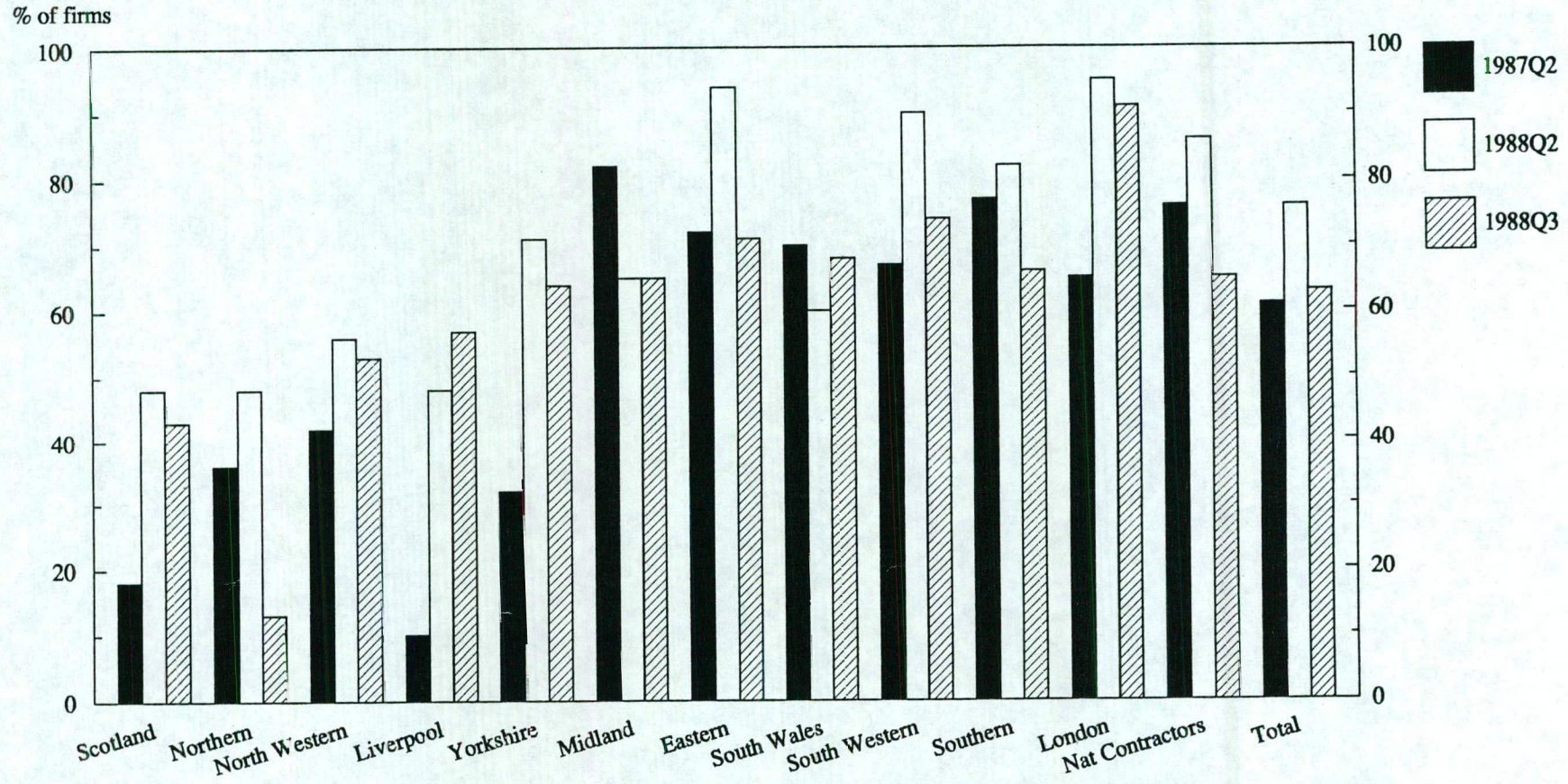
Chart 4
FIRMS EXPECTING TENDER PRICES TO RISE (%)



SOURCE:BEC State of Trade Enquiry,Autumn 1988

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FROM: R M BENT
DATE: 1 December 1988

MCU

LETTER TO LORD YOUNG FROM LORD CHELWOOD

I attach a draft reply to Lord Chelwood's letter of 23 November, commenting on a written question answered by Lord Young on behalf of the Treasury.

R M BENT
PE2 Division

pe2.la.2.1.12.bent

~~DRAFT LETTER~~

Lord Chelwood MC DL
House of Lords

Thank you for your letter of 23 November.

I am afraid that there is little I can add to my previous answer. To renationalise an industry, whether Steel or some other privately-owned company, will require that a Bill to be introduced, and enacted. ~~Depending on the precise drafting of the Bill, there may or may not be a conflict with the Treaty of Rome, as amended,~~ whether or not there is depends on the precise drafting of the Bill.

DAVID YOUNG

D465

FROM: S J DAVIES
DATE: 21st December 1988

CHANCELLOR

cc Chief Secretary
Sir P Middleton
Sir T Burns
Mr Byatt
Mr Monck
Mr Scholar
Mr H P Evans
Mr Riley
Mr Sedgwick
Mr Spackman
Mr Gieve
Mr Melliss
Mr Bennett
Mr D Savage
Mr Tyrie

RECENT UK PRODUCTIVITY PERFORMANCE

I attach a paper discussing recent UK productivity performance that has been prepared in MP1 division.

2. The early part of the paper sets out various data on the growth of productivity in the UK relative to other countries and also on the relative level of productivity in the UK. The relative productivity growth figures are all pretty familiar but the comparisons of productivity levels less so. In particular, the comparisons of GDP per man hour shown in Table 3 (after paragraph 12) are in some respects quite different from the better publicised GDP per head of population figures also shown in that table; they show that UK productivity compares more favourably with productivity in the G3 countries, for example. These GDP per man hour estimates do not have the official endorsement of one of the international organisations, and there must be some margin of error in the underlying estimate of hours worked per man-year in the countries covered. But the scholar who derived them (Professor Angus Maddison) is a very well regarded expert in the field, and they are unlikely to be seriously wide of the mark.

3. The paper goes on to discuss various estimates of relative levels of manufacturing productivity and concludes that none of them are at all reliable. It does seem reasonably clear, however, that the UK's position in the manufacturing productivity league

table is lower than its position in the overall productivity league table; and that even after the fast productivity growth of recent years, the scope for "catch-up" is some way from being exhausted.

4. The latter part of the paper discusses recent academic work on the reasons for the UK's improved productivity performance.

SJD

S J DAVIES

RECENT UK PRODUCTIVITY PERFORMANCE

This paper sets out the latest data on the UK's productivity performance relative to that of other industrial countries, and considers recent evidence on the reasons for the improvement in the UK's productivity performance in the current decade. Labour productivity is sometimes measured as output per person employed and sometimes as output per hour worked. The latter measure is more closely related to the efficiency of use of labour inputs, but data on the former is generally more reliable and more readily available. In this paper both measures are used, depending on data availability.

Relative growth in labour productivity

2. In the 1980s the rate of growth of output per person employed has been faster in the UK than in any of the other G7 countries, with the exception of Japan. For manufacturing industry alone growth in output per person employed has been faster in the UK than in all the other G7 countries. The productivity record of G7 countries since 1960 is summarised by decades in table 1. (The choice of these particular periods for comparison probably exaggerates the relative improvement in the UK, because the UK experienced an earlier and deeper recession than the other countries; the use of alternative periods would tell a qualitatively similar story but show a slightly less dramatic relative improvement.)

Table 1: Output per person employed in the major 7 industrial countries

(average annual percentage change)

	Manufacturing			Whole economy		
	1960-70	1970-80	1980-87	1960-70	1970-80	1980-87
United States	3.4	3.0	4.1	2.0	0.4	0.9
Japan	8.8	5.3	2.3	9.0	3.8	2.8
West Germany	4.1	3.2	2.0	4.3	2.9	1.7
France	6.6	3.0	2.5	5.0	3.1	1.7
UK	3.0	1.6	5.3	2.4	1.3	2.7
Italy	5.9	3.0	3.7	6.2	2.6	1.9
Canada	4.0	3.2	3.2	2.5	1.5	1.4
Average of major 7	5.2	3.3	3.4	4.1	1.7	1.7

Sources: OECD, CSO

3. The surge in UK manufacturing productivity in the early 1980s was initially dismissed by many commentators as a freakish development related to the severity of the 1980 recession. But while manufacturing productivity growth eased back for a while in the mid 1980s as output paused, the last two years have confirmed a fundamental improvement in the performance of UK manufacturing industry. There have also been clearer signs of an improved performance outside the manufacturing sector.

4. Table 2 shows the record of UK productivity in the 1980s year by year.

Table 2: Productivity growth by sector (output per person employed)

per cent per annum

	Manufacturing	Non-manufacturing	Public non trading	Whole economy	(Non North Sea)
1973-79	0.7	0.6	0.2	1.1	(0.5)
1979-87	4.1	1.5	0.1	2.1	(1.8)
1980	-3.9	-2.7	1.1	-2.2	(-2.4)
1981	3.5	0.7	0.7	2.2	(1.3)
1982	7.0	2.6	-0.3	4.3	(3.2)
1983	8.2	2.7	0.2	4.2	(3.7)
1984	5.7	-0.3	-1.5	1.1	(0.8)
1985	2.8	2.7	-0.8	2.0	(2.0)
1986	3.0	3.3	2.1	2.2	(2.4)
1987	7.3	2.9	0.1	2.9	(3.4)
1988 (forecast)	7.3	4.1	-0.3	3.8	(4.4)

Labour productivity and total factor productivity

5. Discussions of productivity often begin by breaking down total growth of output into three components:

- changes in the contribution of labour inputs

- changes in the contribution of capital inputs

- changes in the efficiency with which the capital and labour inputs are used, ie changes in output for given capital and labour inputs. This component is referred to as 'total factor productivity', and is calculated as the residual component of output growth: ie the increase in output that is left unexplained after taking account of the contributions of labour and capital inputs.

6. On certain assumptions about the nature of the production process, which may not be completely realistic but are often adopted in this sort of discussion, the contribution of labour and capital inputs to growth can be computed as follows:

- the contribution of labour to output growth is measured as the change in labour input times the share of labour income in national income;

- the contribution of the capital stock to output growth is measured as the change in capital input times the share of profits in national income.

7. On these assumptions, a forecast of the growth of total potential output can obviously be derived from projections of growth in labour and capital inputs and an estimate of the trend in total factor productivity. An equivalent use of the same framework is to account for growth in labour productivity in terms of growth in total factor productivity and a contribution from changes in the capital/labour ratio.

8. Several people, including Professor Muellbauer, Peter Spencer (when at Credit Suisse First Boston) and more recently Mark Brown of Phillips and Drew have published projections of underlying labour productivity growth for manufacturing productivity based on this sort of approach. Muellbauer's 1987 estimate projection of the future trend in manufacturing productivity is shown below:

Productivity growth in manufacturing

Underlying total factor productivity	Capital labour substitution effect	Trend labour productivity
3.15	0.25	3.4

9. This estimate of trend labour productivity is well below the recent actual rate of growth of labour productivity in manufacturing shown in table 2 above. One reason is that some of the recent increase in labour productivity is attributable to a cyclical increase in intensity of utilisation of the employed labour force - this part of the increase cannot be projected to continue indefinitely. But that is not the whole explanation. A good part of the reason for the gap between the projection of trend labour productivity growth and recent actual labour productivity growth is that substitution of capital for labour is estimated to have contributed much more to growth in total output per head over the period since 1979 than it is projected to do in future (the sharp fall in manufacturing employment in the early 1980s meant a big rise in the capital/labour ratio which is not likely to be repeated in the future). A reduction in the rate of growth of capital intensity is likely to lower the rate of growth of labour productivity unless something else changes.

10. The projected contribution of capital/labour substitution obviously depends on a forecast of investment. Investment now is turning out considerably higher than Muellbauer assumed last year, and this by itself would imply a somewhat higher projection of labour productivity. Peter Spencer, adopting a similar approach to Muellbauer, but assuming a rather higher capital labour substitution effect for the future, derived a higher estimate of trend growth in labour productivity - 4 per cent a year as against Muellbauer's 3.4 per cent.

11. Measuring the capital/labour substitution effect for the recent past and projecting it over the future is complicated by uncertainty over the current size of the capital stock. It is fairly generally accepted that the CSO's measurement of the capital stock is too high (because it takes no account of early scrapping of capacity following the oil price shocks and

subsequent recessions in the 1970s and early 1980s). But there is considerable disagreement over the extent to which the official figures overstate the capital stock. This question is discussed in more detail in annex A. We also examine there the sensitivity of Muellbauer's projection of the underlying productivity trend in manufacturing (para 8 above) to the measurement of the capital stock, and conclude that his projection could be as much as 1 percentage point too low.

International comparisons of productivity levels

12. While the UK's rate of productivity growth has improved markedly in the 1980s, the level of productivity in the UK is still somewhat below that of other industrial countries. Indeed, the potential for catching up other countries has been an important precondition for the acceleration of UK productivity. Comparisons of international productivity levels are not straightforward; output levels cannot be accurately compared using market exchange rates, and measures of relative price levels (purchasing power parities) need to be used. Going through recent literature on the subject reveals considerable disparities between different studies. The most comprehensive and thorough recent study is by Maddison (1987), but even this is already out of date in some respects. Table 3 below shows a Treasury update of Maddison's estimate of GDP per man hour for six industrial countries. The table also shows the latest figures for GDP per capita in the industrial countries published by the CSO in August: this second set of figures is relatively familiar but reflects international variation in participation rates, unemployment rates, length of working weeks, and holiday entitlements as well as differences in productivity.

Table 3: Real GDP per man hour and per head of population in 1987
(UK=100)

	GDP per man hour	GDP per head of population
US	127	149
Japan	68	107
Germany	101	109
France	115	104
Netherlands	115	101
UK	100	100

13. There are striking differences between the two columns of table 3. For example Japanese output per man hour is well behind that of the other countries, but Japan's GDP per capita is relatively high. Japan's much better position in terms of GDP per capita is due in part to the relatively high proportion of the population in employment (48% compared with 42% in the UK in 1984, according to Maddison) - this reflects low Japanese unemployment rates and low numbers of elderly people. It is due even more to high annual hours worked per person (Maddison estimates that in 1984 the average Japanese worker worked 41 per cent more hours a year than his British counterpart - largely because he worked 30 per cent more days a year).

14. The ordering of and size of gaps between France, Germany and the UK is also striking. According to Maddison's calculations, the German advantage over the UK in terms of GDP per head of population almost entirely reflects a greater number of hours worked, rather than higher output per man hour. In spite of somewhat lower German unemployment the proportion of the population in work in Germany in 1984 was marginally lower than in the UK (partly because Germans spend so long obtaining the academic and vocational qualifications admired by the National Institute and others). However, average annual hours per worker in Germany were 10 per cent higher than in the UK in 1984.

15. The international organisations do not publish purchasing power parities for sectors of output - manufacturing, construction etc - and so there is great uncertainty in international comparisons of sectoral productivity. Given the lack of specific PPPs for manufacturing output the main options in making international comparisons of manufacturing productivity are:

- expressing different countries' output in common currency using market exchange rates (which would only give the right result if the "law of one price" held absolutely for manufacturing output)

- using PPPs for total GDP (which would only give the right result if the relative price of manufactures to

non manufactures were the same in all countries - in practice it varies, with less advanced countries normally having a higher relative price of manufactures)

- calculating proxy PPPs for manufacturing output (possible, but subject to an unquantifiable and probably large degree of inaccuracy).

16. Table 4 gives a range of results available for measuring relative manufacturing output per person employed in 1987 (while the range is wide it would be much wider if freakish figures published by the National Institute last year were included):

- column (i) shows value added per worker at current prices converted into common currency by taking a centred three-year average of market exchange rates.

- column (ii) uses estimates for 1984 value added and GDP purchasing power parities (PPPs) brought forward to 1987 using indices of manufacturing production and employment

- column (iii) is as (ii) but with 1986 estimates of value added and 1986 GDP PPPs;

- column (iv) extrapolates forward to 1987 estimates by D J Roy that were published in Economic Trends, June 1987. These were constructed using proxy PPPs for manufacturing output for 1980.

Table 4: Alternative estimates of manufacturing output per worker as a percentage of UK output per worker for 1987

	(i) Market exchange rates	(ii) GDP PPPs for 1984	(iii) GDP PPPs for 1986	(iv) Manufacturing PPPs for 1980
US	191	168	159	148
Japan	161	110	111	79
Germany	151	137	124	120
France	146	110	112	117

17. Given this range of estimates it is difficult to conclude much about the level of manufacturing productivity in the UK relative to other countries. But it does seem likely that

- the UK's relative productivity standing is worse in manufacturing than in the rest of the economy

- there is still a considerable gap between the UK and the best of our competitors, so that there is room for several more years of relatively fast growth in UK manufacturing productivity before the scope for "catch-up" is exhausted.

The rest of this paper considers some of the hypotheses about why the 1980s have seen the UK starting to close the productivity gap that had opened up in the previous decades.

The "batting average" hypothesis

18. What has come to be known as the "batting average" hypothesis was widely canvassed in the early 1980s as an explanation of some or all of the rise in productivity after the trough of the 1980-81 recession. The argument was that the improved productivity performance primarily reflected the disappearance of less productive plants rather than productivity growth in surviving plants; the implication being that the improved performance would not persist. The hypothesis appeared to derive some weak support from the growth of company liquidations in the early 1980s; these reached a peak in 1985 (representing 1 per cent of total companies compared with ½ per cent in 1980) but have since fallen quite sharply. Against the hypothesis, a study by the Bank of England (1983) suggested that changes in the structure of manufacturing employment only made a very minor contribution to the gain in productivity between 1979 and 1982; and surveys by the CBI/BIM (1983) and by Wenban-Smith (1982) pointed to significant productivity improvements in surviving firms.

19. Further evidence against the "batting average" hypothesis comes from more recent work by Oulton (1987), who analyses the distribution of productivity by plant size. He shows that

closures (or partial closures) of the largest plants (those with over 1000 employees), which had a 41 per cent share in total employment in 1979, accounted for 62 per cent of the manufacturing jobs lost between 1979 and 1982*. But these plants also had a higher level of productivity than smaller plants. Thus it seems that closures were probably concentrated among high-productivity plants. Oulton suggests that this paradoxical result can be explained by the observed negative correlation between plant size and profitability. While large plants have above average productivity, they tend to be of below average profitability: possibly because in larger plants employees have relatively more success in capturing the gains from higher productivity. Support for this view comes from Millward and Stevens (1986) who show that union density rises with plant size and Prais (1981) who found that strike-proneness was positively related to plant size in the 1970s.

20. The main question mark over Oulton's work is the lack of information on the distribution of productivity within each plant size. If there are large dispersions about the average, it is still just possible that closures were in fact concentrated on below-average productivity plants. If on the other hand, Oulton is right and closures were concentrated on high-productivity firms it must be the case that other factors (such as lower trade union power, improved management efficiency) were responsible for an even greater increase in productivity than was actually observed.

21. In any case, all the time low productivity activities of one kind or another are being cut out and higher productivity activities are being expanded. The fact - if it is a fact - that this happened on a more dramatic scale in the early 1980s was more a reflection of a depth of the recession and the scale of the general trauma than of the uniqueness of that particular type of improvement in productivity. Particularly after the last two and half years of very fast productivity and output growth, the "batting average hypothesis" appears to have little to contribute.

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*A further 10 per cent of job losses are estimated to have resulted from increased productivity with unchanged output in larger plants.

The "microchip" hypothesis

22. A large number of studies, many originating from the Science Policy Research Unit at Sussex University, have considered aspects of the "IT revolution". Although much of the research is qualitative and anecdotal and not primarily directed at identifying the quantitative contribution of technological change to recent trends in productivity at the aggregate level, it nevertheless provides some useful insights.

23. Freeman and Soete (1985) characterise the current IT "revolution" as a change of "techno-economic paradigm" which makes possible a "quantum leap" in potential productivity. However, they argue that these productivity gains are typically at first only realised in a few leading sectors; it takes decades to complete the process of learning, adaption and institutional change which are required before significant productivity gains can be realised in the rest of the economy. The authors argue that significant IT-related gains in productivity are yet to be realised outside the leading (ie IT-producing) sectors.

24. A fundamental problem with using the "microchip" hypothesis to account for what has happened in the 1980s is that it cannot explain the relative improvement in the UK's performance. The new technological possibilities are open to other countries to exploit quite as much as the UK; and there is nothing in the UK's industrial record this century that would lead one to expect the UK to exploit them first. Thus it seems we must look elsewhere for an explanation of what has happened to UK productivity.

The "industrial relations" hypothesis

25. There is a large literature on the effect of unions on productivity. Metcalf (1988a) provides a useful summary of the various channels through which unions are postulated to affect productivity. The conventional argument that unionisation reduces productivity rests on an association of unionisation with restrictive work practices and industrial action and with an adversarial style of industrial relations in which trust and co-operation between the parties is low. But arguments have also

been advanced which imply that unionisation raises productivity. Freeman and Medoff (1984) suggest that the 'collective voice' provided by a union may be a source of improved communications between firm and workers and may enhance morale, motivation and co-operation, leading to lower labour turnover. Furthermore, if unions achieve a wage differential over non-union workers, firms may respond by substituting capital for labour or skilled labour for unskilled labour.

26. Nevertheless, the general consensus of the large number of studies which have used cross-section data to estimate the net effect of union presence on productivity is that the two are negatively correlated. For example, Machin's (1987) study of the British engineering industry over the period 1978-82 found that in large firms the presence of a closed shop was associated with a 17 per cent reduction in productivity while a 10 per cent rise in the index of union presence was associated with a 6.1 per cent reduction in productivity. No significant effects were present for firms with less than 1,000 employees.

27. Some preliminary work by Denny and Muellbauer (1988) provides a formal analysis of the effects of union organisation on productivity growth using data from the Workplace Industrial Relations Surveys of 1980 and 1984. They find that unions' organisational sophistication (measured by union density and the number of shop stewards) has a negative effect on productivity, perhaps because sophistication is too high in the sense that it represents unnecessary complexity, or alternatively because sophistication is itself a function of factors (eg plant size) which make organisation more difficult. The range of topics which are bargained over and the existence of joint committees of managers and employees are shown to benefit productivity; but the existence of a director with responsibility for personnel and industrial relations matters appears to have a harmful effect, although probably the dominant causal link is in the opposite direction. Even after allowing for these and other measures of organisation, union density by itself has a significantly negative effect on productivity.

28. A study by Metcalf (1988b) is the only one to have looked specifically for evidence of the effects of recent changes in industrial relations legislation on productivity. The author's claim that 'Thatcherism has worked wonders' is not however based on the estimated effects of trade union reform. If trade union reforms had made a significant contribution towards productivity growth in the 1980s, Metcalf argues that one might have expected highly unionised industries to have shown the fastest rises in productivity. Metcalf shows that this was not the case, while Denny and Muellbauer showed that, if anything, the opposite was true. It is argued instead that fear of unemployment (leading to increased effort) and firms' fear of bankruptcy (leading to an assault on over-manning and inefficiency) were the main factors explaining differences in the growth of productivity between 1980 and 1985 at industry level.

29. This evidence that industrial relations legislation may not have contributed to the improvement in productivity growth should not be dismissed out of hand. However, there are reasons for not placing too much weight on Metcalf's finding:

- the analysis stops in 1985, yet there have been cases of productivity gains following trade union weakness since then (notably in printing)

- the study is confined to manufacturing, yet some of the major productivity improvements stimulated by changes in the power of trade unions have been elsewhere (eg railways, post office and coal)

- even if industrial relations legislation has not helped unionised sectors more than non-unionised sectors, it may have helped all sectors by encouraging managers to manage more positively without fear of industrial unrest

- it may be that the weakening of the trade unions has allowed managers to make better use of their capital stock rather than their labour force, so that we would

observe a higher growth of total factor productivity in unionised than non-unionised sectors but not necessarily a higher growth of labour productivity

- the measure of the degree of unionisation used in the exercise was rather crude

- the study did not control for other factors (eg the growth of the capital stock, technological change) which cause different productivity growth rates in different sectors, and so the relationship with trade unions might have been obscured.

At all events, it seems clear that the weaker position of unions has made an important contribution to the improved productivity performance, even if this weakness owes more to macroeconomic conditions than to the government's legislation.

The "management" hypothesis

30. The hypothesis that significant beneficial effects on management effort and effectiveness have been brought about by the combination of the 'shock' effects of the 1980-81 recession and the realisation that the Government would not continue to bail out failures through micro-economic intervention or accommodating macroeconomic policies has been the subject of much debate and anecdotal evidence. Examples are Metcalf (1988b), referred to above and McWilliams (1988) who argues that an additional contributing factor was the increased sophistication and globalisation of financial markets following the abolition of exchange controls which made it impossible for firms to survive with a return below the international rate.

31. Anecdotal evidence on the role of management deficiencies in the poor performance of the 1973-79 period (eg Nichols (1988)) at least indicates that there was significant room for improvement in management efficiency in the 1970s. It would not be surprising if the change within elite educational institutions from training future empire builders on their playing fields to training future businessmen on their computers were leading to an increased supply

of good managers. If the traditional bad managers were the ones who were most likely to go to the wall in the 1980-81 recession, there could have been a step improvement in the quality of management in the early 1980s.

Inflation and productivity

32. High rates of inflation are often argued to have harmful effects on investment and hence the level of labour productivity through two types of effect. First, institutional reluctance to grant indexed loans leads to cash-flow problems at the beginning of the repayment period (front-end loading) which are greater the higher is the rate of inflation. The associated rise in the risk of bankruptcy may discourage investment directly and has also been shown (Wadhwani 1984) to be reflected in a rise in the premium on equity finance. Further reasons why stock market valuations may be adversely affected by inflation have been advanced by Modigliani and Cohn (1979). Their argument is essentially that accounting conventions erroneously fail to count reductions, due to inflation, in the real value of outstanding debt as contributing to an increase in profits. Wadhwani provides empirical evidence to support the importance of these effects.

33. A second channel through which inflation may harm investment arises if the rate of inflation is associated with uncertainty about inflation and thus raises the riskiness of investment projects. A number of studies have established a positive correlation betwen the level of inflation and variability in inflation and relative prices. It seems likely that lower inflation will have contributed to the productivity improvement through the mechanism of higher and better directed investment. However, it is difficult to quantify these sorts of effects; and they seem unlikely to be as important as the labour market effects discussed above.

Conclusions

34. For many years the level of productivity in the UK has been lower than in other industrial countries and until the 1980s the gap had been widening. The existence of this gap has made it

easier for the UK to achieve relatively fast productivity growth in the 1980s. But why did the UK start to realise the potential for improvement in the 1980s when it had failed to do so in previous decades?

35. It seems reasonable to suppose that there have been importance changes on both sides of industry:

- unions have become weaker and have been less able to resist the introduction of more efficient ways of using labour (although, as noted above, there is some argument over to what extent this is due to the government's labour legislation rather than other influences such as high unemployment)

- management has improved: it may have become more competent technically and also got better at managing its relations with its labour force.

36. As the manufacturing productivity gap with other countries closes there will be less scope for easy productivity improvements. In the long run the rate of growth of productivity in the UK will be constrained by the technological progress in world industries, so that productivity is unlikely to grow faster in the UK than in other industrial countries indefinitely. But one cannot rule out the possibility that, having got onto a high productivity and investment growth track, UK productivity could overshoot the levels of some other industrial countries. Outside manufacturing, there may be areas where UK productivity is currently ahead of some other industrial countries - this is certainly the case in agriculture.

37. It is likely that the more stable macroeconomic environment (of which lower inflation is an important element) has also contributed to the improved productivity performance. Firms' investment decisions are likely to be more productive in the sort

of conditions that have prevailed in the UK in the 1980s than in the volatile conditions of the previous decade. On the assumption of continued macroeconomic stability over the medium term, we would expect a continuation of at least the 2½ per cent a year labour productivity growth recorded in the non-oil economy over the 5 years to 1988.

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ANNEX A

SCRAPPING AND THE CAPITAL STOCK

This annex considers the implications of two recent papers (Wadhwani and Wall (1986) and Smith (1987)) which attempt to measure the extent of early scrapping using data from company accounts. Both studies make use of current cost accounts (which were published by 70 per cent of companies in 1981 and 1982) in order to obtain estimates of the true level of the capital stock. The key difference between data obtained from this source and the official data is that the latter refer to assets which the CSO assume to be still in place on the basis of postulated average asset lives, while current cost accounts relate only to assets which companies have recorded as actually still in existence. The Smith study attempts to measure the level of companies' capital stock (excluding buildings) in 1983 while Wadhwani and Wall are more ambitious in attempting to derive an annual time-series from 1972 to 1982.

2. Smith estimates that only 74 per cent of the manufacturing capital stock shown in the official statistics in 1983 actually existed; for non-manufacturing and the whole economy the figures are 86 per cent and 81 per cent respectively. As noted above, these figures do not include buildings, and so cover only about 44 per cent of the recorded gross capital stock excluding dwellings. If, as an extreme assumption, there was no early scrapping of buildings, Smith's results imply that early scrapping in manufacturing and in the whole economy amounted to 17 per cent and 8 per cent respectively of the recorded capital stock in 1983.

3. Wadhwani and Wall (1986) use the accounts of a sample of 333 large manufacturing companies to derive a series for the current replacement value of their capital stock over the period from 1972 to 1982. They estimate the capital stock in manufacturing to have been 9.5 per cent below the official series in 1981-82. The time profile of their alternative capital stock series suggests that early scrapping was concentrated in the years 1977-78 to 1979-80.

4. Two criticisms of the company accounts approach to determining the capital stock have been made. First, as Wadhwani and Wall acknowledge, their sample of firms only includes those who survived and excludes those that went under. This is likely to have caused them to underestimate scrapping. The second criticism, which applies to Smith as well, was made by Muellbauer. He has suggested that the firms which produced current cost accounts may not have been representative: these firms which chose to present current cost accounts may have been those whose asset position looked relatively favourable on this basis. Thus use of the accounts could lead to an underestimate of scrapping. On the other hand company accountants are thought to write off capital assets too quickly because they are averse to the risk of accumulating insufficient depreciation balances. If true this would have lead Smith to overestimate scrapping.

5. To get some idea of the implication of Smith's results, MP1 has computed a time series of the gross capital stock for recent years, in which we have adopted Smith's estimates for the stock of equipment, and have (quite arbitrarily) assumed that the rate of early scrapping of buildings was one quarter that for equipment. Figures for the capital stock thus computed are shown below:

Table A1: Gross capital stock based on Smith's estimates*
(end years £bn, 1980 prices)

	1983	1984	1985	1986	1987
Manufacturing (including leased assets)	159.2	162.2	166	169	172
Non-North Sea	684.3	703.9	725	743.2	762.9
Whole economy	705.5	727	749.6	768.9	789.1
Memo: CSO series for:					
Manufacturing (including leased assets)	205.4	207.2	209.5	211.2	
Whole economy	805	822.9	841.7	858	

* Excluding dwellings: CSO series is taken from the 1987 Blue Book.

6. The "Smith-based" estimates show a lower level but a faster recent growth of the capital stock than the official series. The gross capital stock in manufacturing is computed to have been growing at around 2 per cent a year, as against 1 per cent in the official statistics. The whole economy capital stock is computed to have been rising at a rate of over 2¾ per cent a year, as compared with under 2¼ per cent in the official statistics. The latest Treasury forecasts would imply growth in the manufacturing capital stock over the next two years of between 2½ and 3 per cent a year, with growth in the whole economy capital stock of around 3¼-3½ per cent a year. Obviously, if Smith has overstated the extent of the early scrapping of the 1970s and early 1980s the estimates shown in table 3 will tend to overstate the recent rate of growth of the capital stock.

7. In terms of the approach to projecting labour productivity and potential output discussed in paragraphs 5ff of the main paper, using "Smith-based" estimates of the capital stock would raise both the estimated recent contribution and projected future contribution of capital/labour substitution to growth in labour productivity as compared with estimates based on the official statistics (see table A2 for alternative estimates of trends in the capital/labour ratio).

Table A2: Changes in the capital labour ratio

(per cent per year)

	Manufacturing		Whole economy	
	CSO estimate	Smith-based estimate	CSO estimate	Smith-based estimate
1983-1987	2½	3½	¾	1½
1987-1989 (forecast)	2¼	3¼	1¼	2

8. Multiplying these capital labour ratio changes by one third (roughly the share of profits in national income) gives the estimated contribution of capital/labour substitution to growth in labour productivity. On the Smith-based estimate, the current

contribution of capital/labour substitution to growth in labour productivity in manufacturing is marginally above 1 per cent a year; for the economy as a whole it is about 2/3 per cent a year.

9. In manufacturing, the computed contribution is fractionally lower over the immediate future than it has been in the recent past (because although the rate of growth of the capital stock has increased this is outweighed by a decrease in the rate of decline of employment). For the economy as a whole the contribution of capital/labour substitution to productivity growth is marginally higher over the immediate future than over the recent past. The estimated changes between the recent past and immediate future are not sensitive to the choice of capital stock measure.

10. Finally, it may be interesting to return to Muellbauer's projections of the trend in productivity in manufacturing, which were based on an analysis of the period 1980-85, in order to see how sensitive the estimate is to the use of an alternative estimate of the capital stock.

11. Muellbauer's estimates imply that over the period 1980-85, out of a total of 5.5 per cent a year growth of labour productivity, 1.6 per cent could be attributed to capital/labour substitution, 0.7 per cent to cyclical factors and the remaining 3.2 per cent to total factor productivity. This estimate is based on the CSO measure of the capital stock.

12. On the basis of Smith's estimates of scrapping the true capital stock might have grown by only a little under 1 per cent between 1980 and 1985, compared with measured growth of 4 per cent. This implies that about 0.3 percentage points should be subtracted from the factor substitution effect and a corresponding amount added to total factor productivity growth. This is summarised in the table below:

Table A3: Breakdown of manufacturing labour productivity growth
1980-85 annual averages

	CSO capital stock series	Smith series
Factor substitution	1.6	1.3
Cyclical effect	0.7	0.7
Total factor productivity	3.2	3.5
Total	5.5	5.5

13. As shown above, on Smith-based estimates of the capital stock the contribution to productivity growth of capital/labour substitution comes out at about 1 per cent a year over the near future. Adding this to the 3.5 per cent annual growth in total factor productivity estimated for 1980-85 would imply an underlying trend of 4.5 per cent a year in labour productivity. This is about 1 percentage point higher than Muellbauer's estimate.

eb.ph/rl/1

PERSONAL AND CONFIDENTIAL
until 11.30am on 19 JANUARY 1989
then UNCLASSIFIED

"S[illegible] easing in output in the last two months, but probably a reaction to the very fast growth recorded in the summer."

FROM: ROBERT LIND
DATE: 18 January 1989

1. **MR PICKFORD** ✓ [handwritten initials] 19/1
2. **CHANCELLOR**
(+ 1 for No.10)

Thanks. The lack @ X of wording. These fluctuations may well relate not to what happens, but are simply statistical 'noise'. M.

cc
Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Monck
Mr Scholar
Mr Burgner
Mr Riley
Mr Sedgwick
Mr Burr
Mr Gieve
Mr Hibberd
Mr Peretz
Mr Bush
Mr Darlington
Mr Dyer
Mr Hudson
Mr Owen
Ms Turk
Mr Tyrie
Mr Call
Mr Stirling - CSO
Mr Kingaby - CSO
HB/002

INDEX OF OUTPUT OF THE PRODUCTION INDUSTRIES - NOVEMBER

This will be published at 11.30am on Thursday 19 January.

2. Latest estimates are:

	Industrial production	**Manufacturing output**	**Energy and water**
<u>**Index numbers**</u> (1985=100)			
1986	102.3	101.0	105.4
1987	106.2	106.7	105.0
1987 Q3	106.8	107.8	104.4
Q4	108.4	109.5	105.8
1988 Q1	108.4	111.0	102.5
Q2	110.1	112.8	104.0
Q3	111.2	116.3	99.9
Jun	110.5	113.3	104.4
Jul	110.8	115.6	100.0
Aug	111.1	116.4	99.4
Sep	111.7	116.8	100.4
Oct	111.1	116.5	99.0
Nov	111.0	116.4	98.7
<u>Percentage changes</u>			
1987 on 1986	3.8	5.6	-0.4
Latest 3 months on:			
a) previous 3 months	0.4	1.3	-1.8
b) a year earlier	3.4	7.2	-5.3
c) 1979H1	12.5	9.7	22.2

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then UNCLASSIFIED

COMMENT

3. The index of production figures for November show manufacturing output broadly unchanged since August, although the growth rates to the latest 3 months suggest continued expansion. Energy output, abstracting from the effects of Piper Alpha, has been broadly flat.

4. Manufacturing output in the 3 months to November was 1½ per cent higher than in the previous 3 months, and 7 per cent higher than a year earlier. The levels of the index show a flat profile over the past four months, but the CSO say that this is not necessarily an indication of any slow-down in growth. The October and November figures are highly provisional and may be revised on receipt of quarterly data. The CSO also point out that with exceptionally high output in the third quarter, reflecting distortions in the seasonal adjustment, the latest figures probably reflect some consolidation. The CSO's estimate of the trend rate of growth in manufacturing in recent months is 7 per cent. Although this is the same as last month, on unrounded figures the trend in October was nearer 7¼ per cent, but in November it is nearer 6¾ per cent.

5. A number of revisions have been made to the data this month. The most marked is that to the 1987Q3 index which has been revised down by 0.5 index points. The CSO say that this is a result of receipt of late information.

6. Piper Alpha, and other problems with oil production, continue to depress energy output; in the 3 months to November it fell by 2 per cent on the previous 3 months, and by 5½ per cent on a year earlier. The CSO say that, had production in the affected fields carried on at the rate immediately before the disaster, the recorded 4 per cent fall in output for the extraction of mineral oil and natural gas between the two latest 3 month periods would have been zero. As a result, total energy output in the latest 3 months would have risen by ½ per cent; and the index of production would have risen by 1 per cent, on the previous 3 months (it actually rose by 0.4 per cent).

PERSONAL AND CONFIDENTIAL
until 11.30am on 19 JANUARY 1989
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7. The recorded index of production fell in November, reflecting the fall in energy and manufacturing output. In the 3 months to November it rose by ½ per cent on the previous 3 months and was 3½ per cent higher than in the same period a year earlier. After allowing for the effects of Piper Alpha, the CSO estimate underlying trend growth in industrial production at 5 per cent.

Line to take:

- Manufacturing output growth remains strong.

- Some consolidation is to be expected after abnormally high levels of output in July and August.

Robert Lind

ROBERT LIND

sh2

CONFIDENTIAL

FROM: STEPHEN HANKS
DATE: 27 January 1989

1. **MR MELLISS**
2. **CHANCELLOR**

cc PPS
Sir T Burns
Mr Sedgwick
Mr Pickford
Mr Hurst
Mr Ramsden

BUSINESS INVESTMENT

1. You requested a table showing business investment in each of the G7 countries (a) over the 1980s as a whole and (b) since 1983 - both including and excluding the forecast growth for 1989. We have used numbers taken from the December OECD Economic Outlook for 1989 since these are in the public domain.

Growth in business investment in G7 countries

Average annual percentage change	1980-1988	1980-1989	1983-1988	1983-1989
United States	3¼	3¼	6¼	6
Japan	8	8½	11	11
W. Germany	2¼	2¾	4¼	4¾
France	1½	2¼	3¾	4½
Italy	1¾	2	6¼	6¼
Canada	4	4½	8	8
United Kingdom	**6¼**	**6½**	**10**	**9¾**
G7	4.3	4.4	7.3	7.3

Percentage cumulative growth	1980 to 1988	1980 to 1989	1983 to 1988	1983 to 1989
United States	29	34	35	41
Japan	86	107	68	86
W. Germany	19	27	23	31
France	13	21	21	30
Italy	14	20	36	43
Canada	37	48	46	58
United Kingdom	**62**	**76**	**61**	**74**
G7	41	51	42	52

CONFIDENTIAL

2. Cumulative growth investment is not, of course, a good proxy for the rate of growth of productive capital since it takes no account of depreciation and scrapping.

3. The figures for the UK in Table 3 of the WEP Report were wrong. The correct figures are shown below:

Business Investment

Percentage change on year earlier	**UK**	**G7**
1987	8½	5
1988	17½	12
1989	10¼	8½

Stephen Hanks

STEPHEN HANKS

mh3

FROM: MARTIN HURST
DATE: 27 January 1989

MR ALLAN

BUSINESS INVESTMENT

1. You asked Mr Hanks to provide figures for the UK consistent with those in his note of 27 January from the internal forecast, rather than from the OECD. These are as follows:

Growth in business investment, annual average percentage change

1980-88	1980-89	1983-88	1983-89
7.6	7.9	12.0	11.7

Percentage cumulated growth

1980-88	1980-89	1983-88	1983-89
80.1	97.9	76.4	93.9

Higher than Japan

2. There are a number of possible definitions of private business investment on the Treasury model. It has not proved possible to reproduce the OECD definition precisely for the UK, so we have chosen a series which is broadly compatible. You will see that these figures are significantly higher than those obtained using the OECD series, but the reasons for this are not clear. I therefore think it preferable to use the OECD figures in any international comparisons.

3. The figures presented include investment by British Steel over the whole of the period, but, as in the published data, there remain discontinuities associated with the privatisation of British Gas and British Telecom.

Martin Hurst

MARTIN HURST

worth chasing this down, since it affects whether we're 2nd or 1st on 83-88 (& 89) comparison.

AA

mh4

RESTRICTED

FROM: MARTIN HURST
DATE: 31 January 1989

PS/CHANCELLOR

cc Sir T Burns
Mr Sedgwick
Mr Melliss
Mr Pickford
Mr Darlington
Mr Hanks
Mr Ramsden

BUSINESS INVESTMENT

1. You asked me to investigate further the difference between the internal forecast numbers for growth of business investment from 1983 to 1988 and 1989 and those available from OECD sources.

2. Some of the difference between the numbers quoted in my minute of 29 January and the OECD numbers is attributable to differences in coverage, notably in the treatment of investment in land and existing dwellings, which is included in the OECD's figures, and in the treatment of British Steel. With Mr Darlington's help we have now eliminated these discrepancies and produced a series from the internal forecast on the same definitions used by the OECD. These are presented in table 1.

Table 1: Business Investment % growth over year earlier

	UK	**OECD**	**HMT**	
1987		10.5	10.8	
1988		13.3	18.8	
1989		8.5	11.8	
Cumulated				**[Japan]**
1983-1988		61	69	68
1983-1989		74	89	86

3. The remaining difference between the internal figures and the OECD figures is attributable to the adjustments to the data made by the forecasters. These were particularly pronounced in 1988Q3 and, implicitly, for 1988Q4. The new figures show that on our internal estimates UK growth in business investment marginally exceed that in Japan, the country with the most rapid growth in the remainder of the G7.

4. Provisional UK data for 1988Q4 and revisions to data for 1988Q3 are not yet available but will be published by the time of the Budget. There is no necessary reason why we should take these fully on board, certainly if the investment data are anything like the provisional 1988Q3 data we will ignore them. But the new data may lead EA division to revise their adjustments to the national accounts and to investment. The figures for the UK and Japan are so close that such revisions might alter the relative position of the two countries. However, the adjusted data will almost certainly support a line placing the UK roughly on a par with Japan over this period, well ahead of other major competitors.

Martin Hurst

MARTIN HURST

sh4

FROM: STEPHEN HANKS
DATE: 31 January 1989

PS/CHANCELLOR

cc Sir T Burns
Mr Sedgwick
Mr Melliss
Mr Pickford
Mr Hurst
Mr Ramsden

BUSINESS INVESTMENT

1. In your minute of 30 January you asked about growth in United Kingdom business investment relative to that in other EC countries. The OECD provides historical data on this series for all EC countries except, Ireland, Luxembourg and Portugal.

Growth in business investment in 9 EC countries

Average annual percentage change	1980 - 1987	1983 - 1987
W. Germany	1.5	3.5
France	0.5	2.5
Italy	0.9	6.1
Belgium	2.5	6.5
Denmark	5.4	8.9
Greece	-3.6	-3.2
Holland	3.3	8.6
Spain	2.0	6.4
United Kingdom	5.3	9.1

Percentage cumulative growth	1980 to 1987	1983 to 1987
W. Germany	11	15
France	3	11
Italy	6	27
Belgium	19	28
Denmark	45	41
Greece	-23	-12
Holland	25	39
Spain	15	28
United Kingdom	43	42

2. The OECD does not provide forecasts for business investment for non G7 countries, therefore it is not possible to provide figures for comparisons including 1988 or 1989. Published national sources are also unable to provide such information.

3. The figures shown above for members of the G7 are significantly lower than those shown in my minute of 27 January. This is due to the fact that they do not include 1988 which was a boom year for investment. On the basis of unpublished national forecasts it is clear that if 1988 were included that the United Kingdom would head the business investment league for the nine EC countries covered. Within the EC as a whole it is possible that the United Kingdom would be second to Portugal.

4. The EC provide historical data and forecast for investment in all its member countries. It does not however provide figures for business investment. Total investment, including both public and private, is divided into two categories, construction and equipment. Taking the period 1983 - 1989, the United Kingdom is sixth in the EC equipment investment league table.

Stephen Hanks

STEPHEN HANKS

35/3 typ3.jb/ea1/jb.11.7.2

FROM: T S O'BRIEN
DATE: 7 February 1989

1. SIR TERENCE BURNS
2. CHANCELLOR

cc Chief Secretary
Sir P Middleton
Mr Anson
Mr Monck
Mr Scholar
Mrs Lomax
Mr Odling-Smee
Mr Peretz
Mr Riley
Mr Sedgwick
Mr Grice
Mr Hibberd
Mr O'Donnell
Mr Owen
Mr Ritchie
Mr Brooks
Mr Darlington
Ms Kosmin
Mr Cress

BUILDING EMPLOYERS CONFEDERATION CONSTRUCTION SURVEY

The latest survey from the Building Employers Confederation (BEC), conducted in December of last year and released yesterday, remains optimistic in tone. Around three-quarters of the sample are expecting an increase in workload in the year ahead. As chart 1 shows, this is a touch down from the summer peak, but still high.

2. Nearly half of the firms are reporting an increase in new enquiries. These enquiries are, however, spread unevenly across sectors. There has been a sharp downturn in enquiries for private new housing (although a slight upward movement in the indicator for public new housing). This tends to confirm other evidence of a slowing housing market. Enquiries for private industrial and commercial work continue to be strong, which is interpreted by the BEC as evidence that in the short term at least, clients in these sectors are relatively insensitive to high interest rates.

3. The overall capacity indicator, shown in Chart 2, moved up a little from the previous quarter, and now comes close to its peak level. There is evidence that this capacity working has become more widespread across the regions. Recruitment difficulties have

eased a little, with shortages of bricklayers, carpenters and plasterers reported by fewer firms now than one quarter ago. The regional dimension to this is shown in chart 3. Only five per cent of firms report serious delays as a result of manpower shortages (again down from the previous quarter, when the figure was eight per cent).

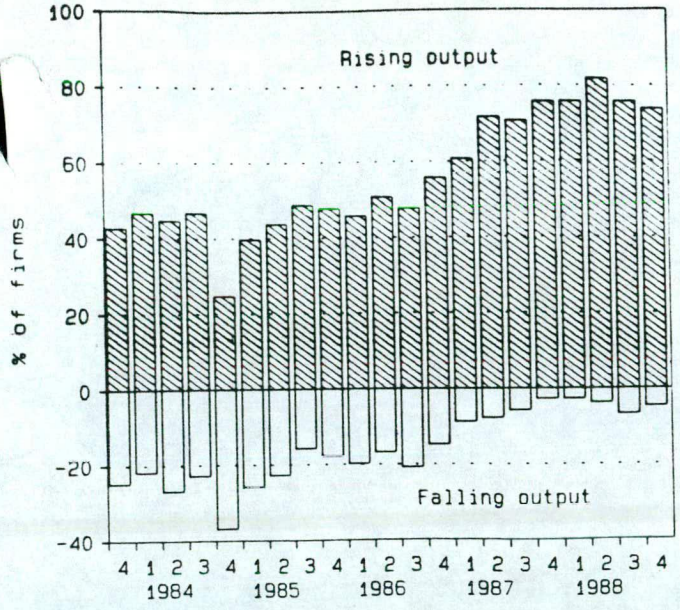
4. Finally, expectations on tender prices show a slight upward movement from the previous quarter (chart 4). Two-thirds of firms expect their tender prices to rise, but this percentage is a little below the peak recording in the summer of last year (75 per cent). Within this, there has been a significant fall in expected tender price rises for private new housing. The balance of firms expecting to increase prices in this sector was at 80 per cent last summer, and now stands at a little over 50 per cent. Tender price expectations in other sectors have moved in line with the aggregate indicator.

Tom O'Brien

T S O'BRIEN

ANTICIPATED WORKLOAD IN THE YEAR AHEAD

1



CAPACITY OF OPERATIONS

2

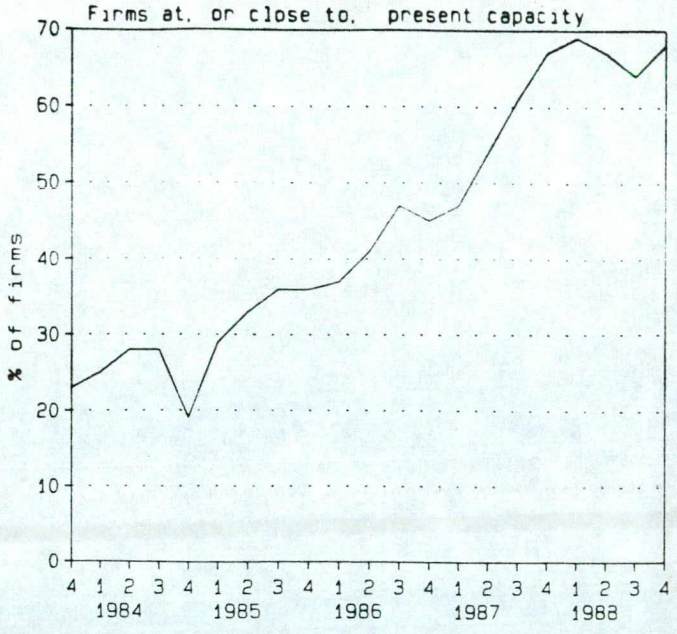
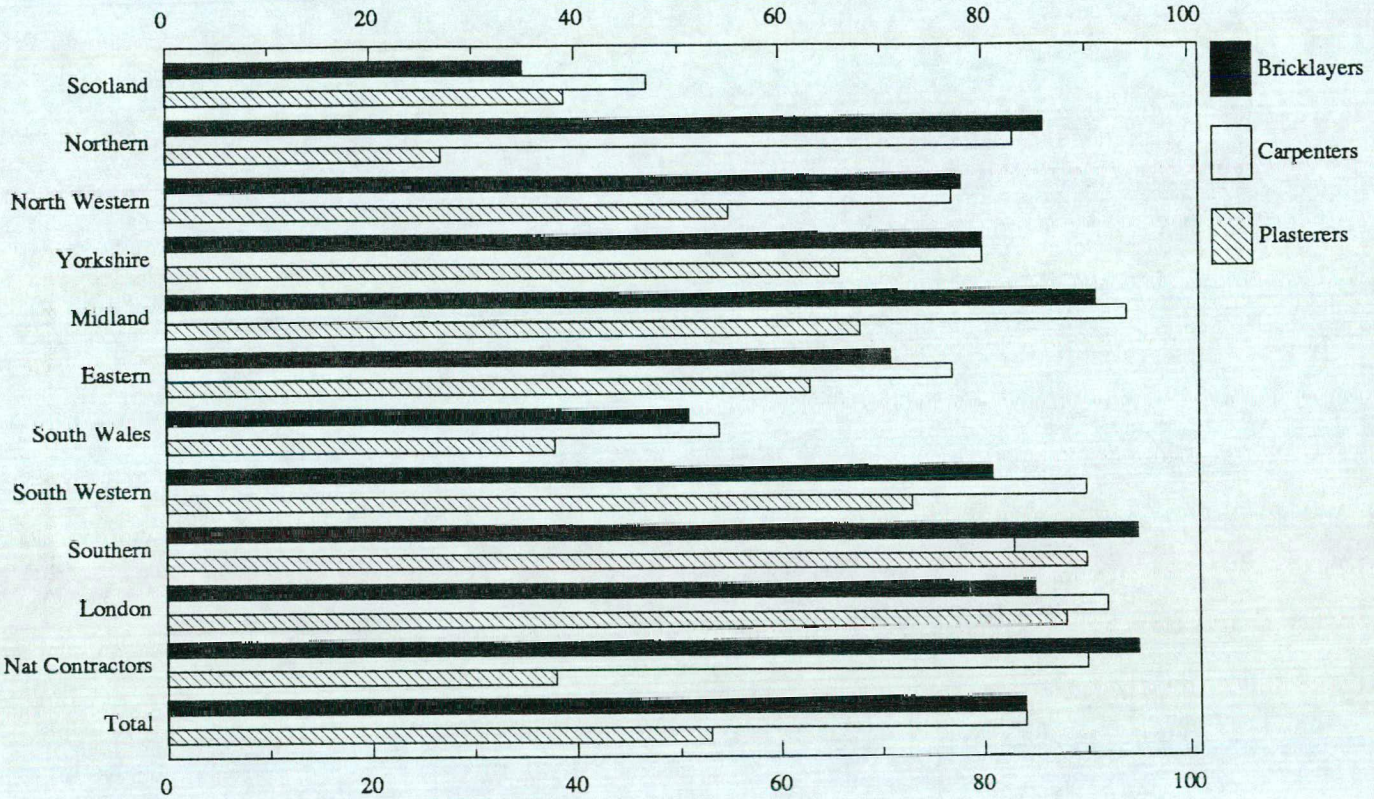


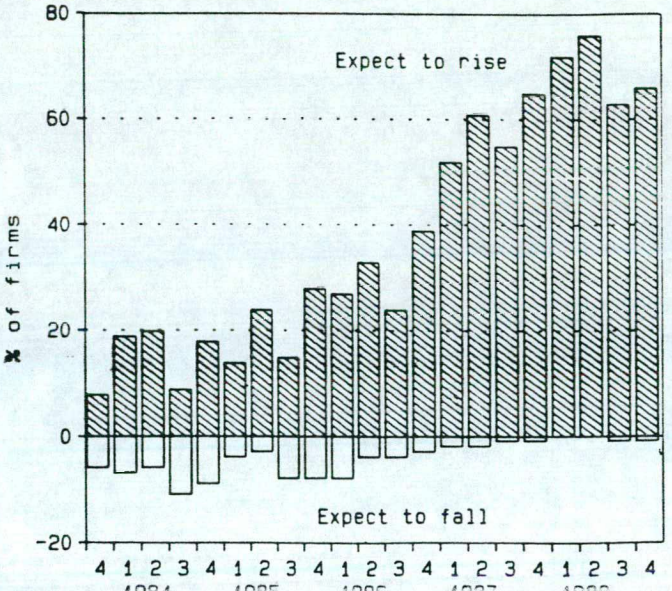
Chart 3 Recruitment difficulties in the building industry (winter 1988)

3



EXPECTED CHANGE IN TENDER PRICES

4



SOURCE: Builders Employers Confederation Survey

sh5

FROM: STEPHEN HANKS
DATE: 10 February 1989

1. MR MELLISS
2. PPS/CHANCELLOR

cc Sir T Burns
Mr Evans
Mr Sedgwick
Mr Mowl
Mr Pickford
Mr Hurst
Mr Ramsden

BUSINESS INVESTMENT

1. In your minute of 2nd February you asked for business investment tables covering the G7 plus Belgium and Holland, for the 1960s, 1970s and the 1980s. There are no consistent figures available prior to 1967. Spain has also been included in the comparison as it has the fifth largest economy in Europe.

Business Investment in the G7 plus Belgium, Holland and Spain

Average annual percentage change	1967-1970	1967-1980	1970-1980	1980-1987	1980-1988
United States	2.5	3.4	3.7	2.3	3.2
Japan	22.4	7.0	2.8	7.0	8.1
W. Germany	13.3	4.3	1.8	1.5	2.2
France	8.2	3.7	2.4	0.5	1.5
Italy	7.1	3.2	2.0	0.9	1.7
Canada	1.7	6.1	7.5	2.0	4.1
United Kingdom	7.2	3.4	2.3	5.3	6.9
G7	8.6	4.4	3.3	3.2	4.2
Belgium	3.4	2.8	2.6	2.5	n.a
Holland	6.5	1.8	0.4	3.3	n.a
Spain	11.7	5.5	3.7	2.0	n.a

Percentage cumulative growth	1967to1970	1967to1980	1970to1980	1980to1987	1980to1988
United States	8	55	44	17	29
Japan	83	141	32	60	86
W. Germany	45	73	19	11	19
France	27	61	27	3	13
Italy	23	50	22	6	14
Canada	5	116	106	15	37
United Kingdom	23	55	26	44	71
G7	30	79	39	26	41
Belgium	11	42	29	19	n.a
Holland	21	26	4	25	n.a
Spain	40	100	44	15	n.a

2. The figures are taken from the December 1988 OECD Economic Outlook with the exception of the Treasury adjusted United Kingdom figures for 1987 and 1988.

3. An annex shows figures for total gross domestic fixed capital formation, the only investment series that enables comparisons to be made back to 1960.

4. You should be aware that the OECD figures for business investment are constructed in such a way that investment by a privatised company counts as business investment only after privatisation. Therefore the 1980-1987 and 1980-1988 figures for the United Kingdom are inflated by the privatisation of British Gas and British Telecom and other nationalised industries. Their investment is in the terminal year but not the base. One way to deal with this problem is to construct an adjusted business investment series that includes the investment of the British Gas and British Telecom throughout the 1980s. We do not have figures for other privatised companies but the effect is likely to be smaller. The comparison between a series adjusted on this basis and the unadjusted series is as follows:

sh5

United Kingdom Business Investment

	Unadjusted (OECD)		Adjusted	
	Total	Average	Total	Average
1980-1987	44	5.3	36	4.4
1980-1988	71	6.9	61	6.1

5. Although the adjustment makes a significant difference to the absolute figures, the position of the United Kingdom in the business investment league table is unaffected.

6. PSF division have confirmed that the privatisation adjustment figures are in the public domain. But it might still be thought advisable to use the unadjusted series in public given their consistency with the OECD. Mr Pickford may like to comment.

7. The Japanese figures may be inflated in similar fashion due to the privatisation of NTT, their equivalent of British Telecom. A request has been sent to the United Kingdom Embassy in Tokyo for the information that will enable a privatisation adjusted series to be constructed for japan. You will be informed if such a series is available. This problem does not affect the figures presented in the annex.

Stephen Hanks

STEPHEN HANKS

GROSS DOMESTIC FIXED CAPITAL FORMATION — ANNEX

1. This annex presents international comparisons of gross domestic fixed capital formation since 1960.

GDFCF growth in the EC and G7 countries

Average annual percentage growth	1960-1970	1970-1980	1980-1988
United States	3.8	2.5	3.9
Japan	15.7	3.5	5.3
W. Germany	4.4	1.4	0.7
France	7.9	2.5	0.7
Italy	5.1	1.1	1.4
Canada	4.9	6.1	4.4
United Kingdom	5.2	0.4	4.1
G7	7.3	2.6	3.5
Belgium	5.8	2.2	-0.1
Denmark	7.0	-0.8	1.6
Greece	9.3	2.8	-1.4
Holland	6.7	0.2	1.7
Ireland	9.8	5.9	-1.6
Luxembourg	3.4	2.7	0.1
Portugal	6.9	3.7	2.4
Spain	11.2	1.6	3.7
EC	6.2	1.5	1.6

Percentage cumulative growth	1960 to 1970	1970 to 1980	1980 to 1988
United States	45	27	36
Japan	329	41	51
W. Germany	54	15	6
France	112	28	6
Italy	64	12	13
Canada	60	82	41
United Kingdom	66	4	38
G7	123	30	34
Belgium	76	24	-1
Denmark	96	-8	13
Greece	143	31	-11
Holland	91	2	14
Ireland	154	78	-12
Luxembourg	40	30	1
Portugal	94	44	21
Spain	190	17	34
EC	86	16	14

2. These figures are taken from the Annual OECD National Accounts Volume 1 and the December 1988 OECD Economic Outlook. The G7 and EC aggregates were calculated using 1982 weights.

3. In the 1980's the United Kingdom heads the EC league table for gross domestic fixed capital formation and is third amongst the G7 nations.

1.15pm

CONFIDENTIAL

FROM: P N SEDGWICK
DATE: 15 MARCH 1989

SIR P MIDDLETON

cc PPS
Sir T Burns
Mr Gieve
Mr Hibberd
Mr Pickford
Mr Darlington

GSS PRESS NOTICES ON CAPITAL EXPENDITURE AND GDP

Our problems with the statistics are not yet over.

2. I attach a copy of the DTI's press notice on capital expenditure by manufacturing, construction, distribution, and financial services. This is due out at 11.30 tomorrow. (NB this is not a draft press notice, but the version that DTI/BSO intend to publish.) The numbers are not consistent with those we have used in the FSBR or those that the CSO will use in the national accounts press notice to be released on Friday: they are lower in 1987 and 1988.

3. The adjustments that the CSO have made are apparently not available in the detail required for this press notice. The intention is (see cover note to the press notice and first note for editors) to make "any necessary revisions.... later this year when final results are available from annual enquiries for 1987".

4. This seems wholly unsatisfactory. I have contacted the CSO who will be in touch today to say what if anything they intend to do. The options seem to me to be

(i) delay this press notice (and say why);

(ii) put in at the very least figures for the total that are consistent with the CSO figures;

(iii) explain clearly in the text that the detailed figures are regarded as underestimates.

Some combination of (ii) and (iii) is the most likely outturn.

Phoned PNS 15/3.
P.N.S

P N SEDGWICK

Reference.....

To:

cc Mr Liesner
Mr Ward

PS/PRIME MINISTER
PS/SECRETARY OF STATE
PS/MINISTERS OF STATE
PS/PARLIAMENTARY UNDER SECRETARIES OF STATE
PS/PERMANENT SECRETARY

From:

R WILLIAMS
Head Branch 2
BSO
Newport
GTN 1211 2252

14 March 1989

CAPITAL EXPENDITURE PRESS NOTICE

A press notice giving revised figures for the fourth quarter of 1988 is attached for information. The notice will be published at 11.30 am on Thursday 16 March. As usual, the contents should be treated as confidential until then.

The revised figures for the fourth quarter are, overall, almost 5 per cent higher than at the provisional stage, with the figures for manufacturing revised marginally upwards and those for construction, distribution and financial industries revised upwards by nearly 8 per cent.

The figures for 1986-8 are not fully consistent with the figures of total fixed investment in the Financial Statement and Budget Report 1989-90. The latter figures incorporate upward revisions to take account of additional information, for which no industrial detail is yet available. Any necessary revisions to the quarterly series will be made later this year when final results are available from annual inquiries for 1987.

X

R WILLIAMS

302/89

CODE 18-78

dti

press notice

89/182

16 March 1989

CAPITAL EXPENDITURE IN THE FOURTH QUARTER OF 1988: REVISED ESTIMATES

The revised estimate of capital expenditure by the manufacturing, construction, distribution and financial industries* in the fourth quarter of 1988 is £7616 million, at 1985 prices and seasonally adjusted; over 1 per cent lower than in the preceding quarter, but almost 2 per cent higher than in the fourth quarter of 1987.

The volume of investment in 1988 was nearly 11 per cent higher than in 1987.

The most recent trends in capital expenditure are shown in the following table:-

INVESTMENT IN THE MANUFACTURING, CONSTRUCTION, DISTRIBUTION AND FINANCIAL INDUSTRIES*

£ million at 1985 prices and seasonally adjusted

	Manufacturing industries** (including leased assetsØ)	Construction, distribution and financial industries*** (excluding assets leased to manufacturers)	Total
1985	10259	14797	25056
1986	9576	15121	24697
1987	10050	17554	27604
1988	10990 (36%)	19575 (64%)	30565
1985 Q1	2713	4189	6902
Q2	2484	3402	5886
Q3	2498	3659	6157
Q4	2564	3548	6112
1986 Q1	2655	3598	6253
Q2	2278	3681	5959
Q3	2378	3878	6256
Q4	2265	3964	6229
1987 Q1	2330	4026	6356
Q2	2554	4287	6841
Q3	2592	4339	6931
Q4	2574	4901	7475
1988 Q1	2638	4647	7285
Q2	2822	5126	7948
Q3	2819	4897	7716
Q4 (r)	2711	4905	7616

* Divisions 2, 3, 4, 5, 6 and 8 of the Standard Industrial Classification (Revised 1980)
** Divisions 2, 3 and 4
*** Divisions 5, 6 and 8
Ø Assets leased from owners in the financial industries. The effect of leasing on manufacturing investment is described in Note 2.
r Revised

Department of Trade and Industry 1 Victoria Street London SW1H 0ET Out of Hours Tel 01-215 7877 Fax 01-222 4382

Prepared by the Government Statistical Service

MANUFACTURING INDUSTRIES

The revised estimate of manufacturers' direct expenditure in the fourth quarter of 1988 is £2506 million, at 1985 prices and seasonally adjusted. In addition, it is important to take account of the leasing of assets to manufacturers from the financial industries. This is taken to amount to £205 million in the fourth quarter, at 1985 prices and seasonally adjusted, giving a total investment in the manufacturing industries of £2711 million; nearly 4 per cent lower than in the previous quarter, but almost 5½ per cent higher than in the fourth quarter of 1987.

The volume of investment (including leased assets) in 1988 was almost 9½ per cent higher than in 1987. On the same annual basis of comparison, expenditure (including leasing) on individual assets increased by 18 per cent for vehicles, by almost 10½ per cent for plant and machinery but fell by over 2 per cent for new building work.

On the same annual basis, the more notable changes by industry (excluding leasing - see Note 3) were rises in investment of almost 27½ per cent in paper, printing and publishing, of 25 per cent in vehicles, of over 15½ per cent in metal manufacture, and of nearly 14 per cent in food. There were decreases in investment of over 16½ per cent in textiles, leather and clothing, of 8½ per cent in drink and tobacco, and of over 5 per cent in mechanical engineering.

CONSTRUCTION, DISTRIBUTION AND FINANCIAL INDUSTRIES

The revised estimate of investment by these industries (excluding leasing to manufacturers) in the fourth quarter of 1988 is £4905 million, at 1985 prices and seasonally adjusted; marginally higher than the preceding quarter, and virtually equal to expenditure in the fourth quarter of 1987.

The volume of investment (excluding leasing to manufacturers) in 1988 was 11½ per cent higher than in 1987. On the same annual basis of comparison, expenditure (excluding leasing to manufacturers) on individual assets rose by over 13½ per cent for plant and machinery, by 13 per cent for new building work and by 3½ per cent for vehicles.

On the same annual basis, the more notable changes by industry (including leasing - see Note 3) were rises in investment of over 22½ per cent in banking, insurance and other finance, of over 19 per cent in finance leasing, and of almost 6½ per cent in wholesale and business services and construction.

TOTAL INVESTMENT Ø

Capital expenditure estimates for Division 0 (Agriculture, Forestry and Fishing), certain industries in Division 1 (Energy and Water Supply), Division 7 (Transport and Communication) and Division 9 (Other Miscellaneous Services) for the fourth quarter of 1988 are not yet available. Consequently, the analysis of investment in this section is confined to trends up to and including the third quarter of 1988.

In the third quarter of 1988, total capital expenditure in Divisions 0 to 9 was £12576 million, at 1985 prices and seasonally adjusted; over 1 per cent lower than in the previous quarter, but more than 6 per cent higher than expenditure in the same quarter a year ago. In the last twelve months, expenditure was almost 9 per cent higher than expenditure in the preceding twelve months.

Expenditure in Division 0 in the third quarter of 1988 was £119 million, at 1985 prices and seasonally adjusted; 4 per cent lower than in the previous quarter, and 30½ per cent lower than in the same quarter a year ago. In the last twelve months, expenditure in Division 0 was 22 per cent below expenditure in the preceding twelve months.

Expenditure in Division 1 in the third quarter of 1988 was £1364 million, at 1985 prices and seasonally adjusted; nearly 3½ per cent higher than in the previous quarter, but 2½ per cent lower than in the same quarter a year ago. In the last twelve months, expenditure in Division 1 was over 4 per cent below expenditure in the preceding twelve months.

Expenditure in Division 7 in the third quarter of 1988 was £1323 million, at 1985 prices and seasonally adjusted; nearly 1½ per cent lower than in the previous quarter, and almost 1 per cent lower than in the same quarter a year ago. In the last twelve months, expenditure in Division 7 was 4½ per cent higher than expenditure in the preceding twelve months.

Expenditure in Division 9 in the third quarter of 1988 was £2052 million, at 1985 prices and seasonally adjusted; over 3 per cent higher than in the previous quarter, and over 2 per cent higher than in the same quarter a year ago. In the last twelve months, expenditure in Division 9 was over 2 per cent higher than expenditure in the preceding twelve months.

Ø Divisions 0 to 9 of the Standard Industrial Classification (Revised 1980)

Press Inquiries: 01 215 4471/4472/4475
Public Inquiries: 0633 81 2149/2215

NOTES FOR EDITORS

1. REVISIONS TO SERIES

The figures for 1986-8 are not fully consistent with the figures of total fixed investment in the Financial Statement and Budget Report 1989-90. The latter figures incorporate upward revisions to take account of additional information, for which no industrial detail is yet available. Any necessary revisions to the quarterly series will be made later this year when final results are available from annual inquiries for 1987.

2. EFFECT OF LEASING ON MANUFACTURING INVESTMENT

Assets have traditionally been classified to the industries of their ownership. Since capital goods acquired for leasing out are mainly bought by the service industries, leasing to manufacturers produces an apparent switch in investment to the service industries from the manufacturing industries. The following table illustrates the effect of leasing from the financial industries. In 1988 assets leased from owners in the financial industries represented an addition of over 10 per cent of manufacturers' capital expenditure. Assets leased from owners in other industries outside manufacturing are not included in this analysis.

INVESTMENT BY MANUFACTURING INDUSTRIES

£ million at 1985 prices

	Capital Expenditure	Estimated Volume of assets leased from financial industries	Total Expenditure
1977	9162	666	9828
1978	9767	950	10717
1979	10138	1019	11157
1980	8763	1158	9920
1981	6581	1155	7735
1982	6362	1241	7603
1983	6463	1078	7541
1984	7810	1112	8922
1985	8726	1533	10259
1986	8479	1098	9576
1987	9087	963	10050
1988	9970	1020	10990

3. An analysis of leased assets by user industry within manufacturing is not available.

4. ASSET COVERAGE OF THE CAPITAL EXPENDITURE ESTIMATES

The net figures given in the Press Notice cover acquisitions less disposals of vehicles and of plant and machinery, and expenditure on new building work. Spending on land and existing buildings is excluded from the figures.

5. The industrial coverage of the capital expenditure estimates is as follows:-

i. The latest quarter's estimates relate to Divisions 2 to 4 (Manufacturing Industries), Division 5 (Construction), Division 6 (Distribution etc), and Division 8 (Finance and Business Services).

ii. The previous quarter's figures cover those Divisions listed in (i) plus Division 0 (Agriculture, Forestry and Fishing), Division 1 (Energy and Water Supply), Division 7 (Transport and Communication) and Division 9 (Other Miscellaneous Services). Figures for the fourth quarter of 1988 in respect of Divisions 0, 1, 7 and 9 will be published in the first quarter 1989 provisional press notice on 18 May 1989.

6. More detailed estimates of capital expenditure in the fourth quarter of 1988, together with current price data, will be published in British Business on 17 March 1989.

TABLE 1a: FIXED CAPITAL EXPENDITURE AT 1985 PRICES: £m seasonally adjusted

		Analysis by ownership										Analysis by type of asset		
	Total	Agriculture forestry and fishing	Energy and water supply	Mineral extraction metal,mineral and chemical industries	Metal goods engineering and vehicles industries	Other manufacturing industries	Construction	Distribution etc	Transport and communication	Financial and business services etc	Other services	New building work	Vehicles	Plant and machinery
Divisions	0-9	0	1	2	3	4	5	6	7	8	9	0-9		
Period														
1980	38,833	1,218	7,101	2,482	3,228	3,058	611	4,089	5,071	6,430	5,952	13,079	6,299	19,670
1981	35,651	1,054	7,480	1,787	2,447	2,351	538	3,750	3,977	6,825	5,563	12,516	4,905	18,290
1982	37,326	1,248	7,545	1,646	2,310	2,410	607	4,017	3,634	7,538	6,384	13,713	5,036	18,522
1983	38,481	1,338	7,512	1,683	2,364	2,416	658	4,149	4,182	7,482	6,697	13,877	5,176	19,429
1984	42,523	1,242	7,071	1,831	2,972	3,007	553	4,802	4,854	8,892	7,299	15,163	6,111	21,249
1985	45,373	981	6,631	2,240	3,245	3,240	532	5,173	5,086	10,625	7,518	15,198	6,441	23,735
1986	44,852	865	6,535	2,158	3,114	3,207	520	5,429	4,835	10,269	7,919	15,251	5,616	23,984
1987	47,394	650	5,950	2,433	2,861	3,793	508	6,329	5,079	11,680	8,112	15,739	6,094	25,560
1988	N/A	N/A	N/A	2,688	3,078	4,203	720	6,553	N/A	13,322	N/A	N/A	N/A	N/A
1985 Q1	12,157	264	1,662	545	852	793	155	1,331	1,546	3,226	1,784	3,770	2,146	6,241
Q2	10,999	258	1,657	536	807	832	135	1,270	1,266	2,306	1,933	3,908	1,462	5,629
Q3	11,171	239	1,686	573	770	815	123	1,300	1,164	2,576	1,925	3,759	1,474	5,938
Q4	11,046	220	1,627	587	816	800	120	1,272	1,111	2,517	1,976	3,760	1,359	5,927
1986 Q1	11,237	241	1,660	518	839	819	142	1,234	1,181	2,700	1,901	3,798	1,422	6,017
Q2	11,000	227	1,601	535	707	759	124	1,356	1,228	2,478	1,985	3,747	1,372	5,881
Q3	11,382	201	1,664	553	779	851	127	1,378	1,247	2,569	2,014	3,887	1,413	6,082
Q4	11,233	196	1,610	553	788	777	127	1,462	1,179	2,522	2,019	3,819	1,409	6,005
1987 Q1	11,300	164	1,580	592	637	845	118	1,407	1,143	2,756	2,058	3,871	1,413	6,016
Q2	11,729	166	1,402	602	737	962	121	1,563	1,355	2,856	1,965	3,770	1,528	6,431
Q3	11,845	171	1,400	604	758	971	152	1,645	1,335	2,800	2,007	3,860	1,560	6,425
Q4	12,520	149	1,568	634	729	1,015	117	1,713	1,246	3,268	2,082	4,239	1,593	6,689
1988 Q1	12,358	151	1,487	659	733	993	138	1,566	1,328	3,194	2,106	4,131	1,473	6,753
Q2	12,723	124	1,321	626	787	1,145	188	1,748	1,341	3,455	1,989	4,117	1,581	7,024
Q3	12,576	119	1,364	703	802	1,016	161	1,570	1,323	3,465	2,052	3,905	1,731	6,940
Q4	N/A	N/A	N/A	701	757	1,048	232	1,669	N/A	3,209	N/A	N/A	N/A	N/A

The estimates are shown to the nearest £ million but should not be regarded as accurate to this degree.

Figures in the table have been rounded to the nearest final digit where necessary and, in these instances, the sum of the constituent items may not always agree exactly with the total shown.

N/A - not available

TABLE 1b: FIXED CAPITAL EXPENDITURE AT 1985 PRICES: £m seasonally adjusted

	Analysis by ownership				Analysis by type of asset Divisions 1-8			Analysis by user			
Divisions	Total for Divisions 1-8	Production and construction industries 1-5	Manufacturing industries (revised definition) 2-4	Distribution and financial services, transport etc. 6-8	New building work	Vehicles	Plant and machinery	Assets leased to manufac-turers	Divisions 2-4 (Manufacturing) including assets leased to manufacturers	Divisions 5,6 and 8 excluding assets leased to manufacturers	Divisions 5,6,7 and 8 excluding assets leased to manufacturers
Period											
1980	31,717	16,474	8,763	15,590	8,312	5,759	17,801	1,158	9,920	9,972	14,875
1981	29,081	14,598	6,581	14,552	8,099	4,399	16,591	1,155	7,735	9,958	13,910
1982	29,704	14,514	6,362	15,189	8,527	4,477	16,657	1,241	7,603	10,921	14,565
1983	30,447	14,633	6,463	15,813	8,542	4,627	17,278	1,078	7,541	11,211	15,393
1984	33,982	15,435	7,810	18,548	9,243	5,572	19,168	1,112	8,922	13,135	17,989
1985	36,774	15,889	8,726	20,885	9,332	5,935	21,507	1,533	10,259	14,797	19,884
1986	36,068	15,534	8,479	20,534	9,329	5,132	21,607	1,098	9,576	15,121	19,956
1987	38,632	15,544	9,087	23,088	9,833	5,641	23,158	963	10,050	17,554	22,632
1988	N/A	N/A	9,970	N/A	N/A	N/A	N/A	1,020	10,990	19,575	N/A
1985 Q1	10,109	4,007	2,190	6,103	2,347	2,021	5,741	523	2,713	4,189	5,735
Q2	8,808	3,966	2,175	4,842	2,425	1,311	5,072	309	2,484	3,402	4,667
Q3	9,006	3,966	2,158	5,040	2,283	1,364	5,359	340	2,498	3,659	4,822
Q4	8,850	3,950	2,203	4,900	2,277	1,238	5,334	360	2,564	3,548	4,659
1986 Q1	9,095	3,979	2,177	5,116	2,347	1,292	5,455	478	2,655	3,598	4,779
Q2	8,788	3,726	2,000	5,062	2,272	1,245	5,270	278	2,278	3,681	4,909
Q3	9,167	3,974	2,183	5,193	2,394	1,291	5,482	195	2,378	3,878	5,125
Q4	9,018	3,855	2,118	5,163	2,316	1,303	5,399	147	2,265	3,964	5,143
1987 Q1	9,079	3,772	2,075	5,306	2,333	1,297	5,449	255	2,330	4,026	5,169
Q2	9,598	3,824	2,302	5,774	2,338	1,423	5,836	253	2,554	4,287	5,642
Q3	9,666	3,886	2,333	5,781	2,424	1,433	5,809	258	2,592	4,339	5,674
Q4	10,289	4,062	2,377	6,227	2,737	1,486	6,065	196	2,574	4,901	6,147
1988 Q1	10,100	4,011	2,385	6,089	2,540	1,364	6,197	252	2,638	4,647	5,975
Q2	10,610	4,066	2,558	6,543	2,728	1,471	6,410	265	2,822	5,126	6,466
Q3	10,404	4,047	2,521	6,357	2,482	1,578	6,344	298	2,819	4,897	6,221
Q4	N/A	N/A	2,506	N/A	N/A	N/A	N/A	205	2,711	4,905	N/A

The estimates are shown to the nearest £ million but should not be regarded as accurate to this degree.

Figures in the table have been rounded to the nearest final digit where necessary and, in these instances, the sum of the constituent items may not always agree exactly with the total shown.

N/A - not available

FROM: KEVIN DARLINGTON
DATE: 16 MARCH 1989

CHANCELLOR OF THE EXCHEQUER

cc PS/Chief Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Odling-Smee
Mr Sedgwick
Mr Gieve
Mr Hibberd
Mr Pickford
Mr Owen
Mr Bush
Ms Cutler
Mrs Chaplin
Mr Tyrie
Mr Call

a
DTI wouldn't budge & needs added a footnote referring to the relevant Notes & Editors.

INVESTMENT IN 1988

The Department of Trade and Industry publish today at 11.30 revised estimates of investment by manufacturing industries and by construction, distribution, and financial industries for 1988 (copy attached).

2. These are uncomfortable presentationally as they do not incorporate the upward adjustments made recently by the CSO to the official investment statistics. The CSO adjustments to total capital expenditure in 1986, 1987 and 1988 were included in the FSBR and will appear in the CSO's Press Notice on GDP published tomorrow, 17 March. The upward adjustments amount to £300 million in 1986, £1700 million in 1987 and £4700 million in 1988.

3. The revisions to capital expenditure in 1986 and 1987 have been derived by the BSO from a preliminary view of its own 1987 benchmark inquiries. This expenditure will eventually find its way into the categories of industrial investment reported in the press notice (most probably in construction, distribution and financial industries).

4. The revision for 1988 is a CSO initiative and, as yet, there is no clear indication of how it will be allocated by sector, although the likelihood is that the vast majority will end up in construction, distribution and financial industries.

5. The table below compares total investment by manufacturing, construction, distribution and financial industries as it appears in the press notice with a revised series to which the whole of the upward adjustments have been added.

Investment in the manufacturing, construction, distribution and financial industries

£million at 1985 prices

	Published today	Revised	Difference (per cent in brackets)
1985	25056	25056	
1986	24697	24997	300 (1.2)
1987	27604	29304	1700 (6.2)
1988	30565	35265	4700 (15.4)
percentage change on year earlier			
1986	-1.4	-0.2	
1987	11.8	17.2	
1988	10.7	20.3	

6. The DTI/BSO press notice does not make great play of the fact that it does not include the significant upward revisions. It includes a footnote pointing readers to the Notes for Editors where the following paragraph appears:

> "Initial indications from benchmark inquiries are that total investment for these industries will be revised upwards. Allowances of £300 million for 1986 and £1700 million for 1987 are included in the Financial Statement and Budget Report and in the CSO's Press Notice on GDP to be issued tomorrow. There is an adjustment of total capital expenditure in 1988 in these publications but the contribution from the manufacturing, construction, distribution and financial industries cannot be identified."

7. There is an air of insouciance about this press notice which may give commentators the impression that the significant upward revision to capital expenditure in 1988 has been foisted on an unwilling BSO by the CSO. Given the recent press commentary on relations between the CSO and HMT, it might be suggested that the CSO were only acting under pressure from the Treasury. This can be emphatically denied.

Lines to take

- DTI press notice acknowledges in Notes to Editors that these latest estimates will be revised upwards.
- Numbers in FSBR, to be confirmed by CSO GDP press notice, give more accurate indication of total investment and business investment since 1986.

Defensive

- **Conflict between CSO and BSO?**

  No, BSO acknowledge that estimates will be revised up when full analysis of benchmark inquiries completed.

- **CSO only to publish higher numbers because of Treasury pressure**

  Nonsense. CSO, prompted by very large discrepancies between the expenditure measure of GDP and other measures, have looked hard at likely weaknesses in initial estimates of expenditure. Preliminary assessment of 1987 benchmark inquiries point to significant understatement of industrial investment in 1987. Likely to continue into 1988. But this was CSO initiative, not Treasury pressure. Still large, but not abnormally large, gap between expenditure and other GDP measures.

- CSO press briefing (attached) points out several considerations that underlie their revisions.

Kevin Darlington

KEVIN DARLINGTON

dti

press notice

89/182 16 March 1989

CAPITAL EXPENDITURE IN THE FOURTH QUARTER OF 1988: REVISED ESTIMATES

The revised estimate of capital expenditure by the manufacturing, construction, distribution and financial industries* in the fourth quarter of 1988 is £7616 million, at 1985 prices and seasonally adjusted; over 1 per cent lower than in the preceding quarter, but almost 2 per cent higher than in the fourth quarter of 1987.

The volume of investment in 1988 was nearly 11 per cent higher than in 1987.

The most recent trends in capital expenditure are shown in the following table:-

INVESTMENT IN THE MANUFACTURING, CONSTRUCTION, DISTRIBUTION AND FINANCIAL INDUSTRIES*

£ million at 1985 prices and seasonally adjusted

	Manufacturing industries** (including leased assetsØ)	Construction, distribution and financial industries*** (excluding assets leased to manufacturers)	Total
1985	10259	14797	25056
1986	9576	15121	24697(n)
1987	10050	17554	27604(n)
1988	10990 (36%)	19575 (64%)	30565(n)
1985 Q1	2713	4189	6902
Q2	2484	3402	5886
Q3	2498	3659	6157
Q4	2564	3548	6112
1986 Q1	2655	3598	6253(n)
Q2	2278	3681	5959(n)
Q3	2378	3878	6256(n)
Q4	2265	3964	6229(n)
1987 Q1	2330	4026	6356(n)
Q2	2554	4287	6841(n)
Q3	2592	4339	6931(n)
Q4	2574	4901	7475(n)
1988 Q1	2638	4647	7285(n)
Q2	2822	5126	7948(n)
Q3	2819	4897	7716(n)
Q4 (r)	2711	4905	7616(n)

* Divisions 2, 3, 4, 5, 6 and 8 of the Standard Industrial Classification (Revised 1980)
** Divisions 2, 3 and 4
*** Divisions 5, 6 and 8
Ø Assets leased from owners in the financial industries. The effect of leasing on manufacturing investment is described in Note 2.
r Revised
(n) See Note 1

Department of Trade and Industry 1 Victoria Street London SW1H 0ET Out of Hours Tel 01-215 7877 Fax 01-222 4382

Prepared by the Government Statistical Service

MANUFACTURING INDUSTRIES

The revised estimate of manufacturers' direct expenditure in the fourth quarter of 1988 is £2506 million, at 1985 prices and seasonally adjusted. In addition, it is important to take account of the leasing of assets to manufacturers from the financial industries. This is taken to amount to £205 million in the fourth quarter, at 1985 prices and seasonally adjusted, giving a total investment in the manufacturing industries of £2711 million; nearly 4 per cent lower than in the previous quarter, but almost 5½ per cent higher than in the fourth quarter of 1987.

The volume of investment (including leased assets) in 1988 was almost 9½ per cent higher than in 1987. On the same annual basis of comparison, expenditure (including leasing) on individual assets increased by 18 per cent for vehicles, by almost 10½ per cent for plant and machinery but fell by over 2 per cent for new building work.

On the same annual basis, the more notable changes by industry (excluding leasing - see Note 3) were rises in investment of almost 27½ per cent in paper, printing and publishing, of 25 per cent in vehicles, of over 15½ per cent in metal manufacture, and of nearly 14 per cent in food. There were decreases in investment of over 16½ per cent in textiles, leather and clothing, of 8½ per cent in drink and tobacco, and of over 5 per cent in mechanical engineering.

CONSTRUCTION, DISTRIBUTION AND FINANCIAL INDUSTRIES

The revised estimate of investment by these industries (excluding leasing to manufacturers) in the fourth quarter of 1988 is £4905 million, at 1985 prices and seasonally adjusted; marginally higher than the preceding quarter, and virtually equal to expenditure in the fourth quarter of 1987.

The volume of investment (excluding leasing to manufacturers) in 1988 was 11½ per cent higher than in 1987. On the same annual basis of comparison, expenditure (excluding leasing to manufacturers) on individual assets rose by over 13½ per cent for plant and machinery, by 13 per cent for new building work and by 3½ per cent for vehicles.

On the same annual basis, the more notable changes by industry (including leasing - see Note 3) were rises in investment of over 22½ per cent in banking, insurance and other finance, of over 19 per cent in finance leasing, and of almost 6½ per cent in wholesale and business services and construction.

TOTAL INVESTMENT Ø

Capital expenditure estimates for Division 0 (Agriculture, Forestry and Fishing), certain industries in Division 1 (Energy and Water Supply), Division 7 (Transport and Communication) and Division 9 (Other Miscellaneous Services) for the fourth quarter of 1988 are not yet available. Consequently, the analysis of investment in this section is confined to trends up to and including the third quarter of 1988.

In the third quarter of 1988, total capital expenditure in Divisions 0 to 9 was £12576 million, at 1985 prices and seasonally adjusted; over 1 per cent lower than in the previous quarter, but more than 6 per cent higher than expenditure in the same quarter a year ago. In the last twelve months, expenditure was almost 9 per cent higher than expenditure in the preceding twelve months.

Expenditure in Division 0 in the third quarter of 1988 was £119 million, at 1985 prices and seasonally adjusted; 4 per cent lower than in the previous quarter, and 30½ per cent lower than in the same quarter a year ago. In the last twelve months, expenditure in Division 0 was 22 per cent below expenditure in the preceding twelve months.

Expenditure in Division 1 in the third quarter of 1988 was £1364 million, at 1985 prices and seasonally adjusted; nearly 3½ per cent higher than in the previous quarter, but 2½ per cent lower than in the same quarter a year ago. In the last twelve months, expenditure in Division 1 was over 4 per cent below expenditure in the preceding twelve months.

Expenditure in Division 7 in the third quarter of 1988 was £1323 million, at 1985 prices and seasonally adjusted; nearly 1½ per cent lower than in the previous quarter, and almost 1 per cent lower than in the same quarter a year ago. In the last twelve months, expenditure in Division 7 was 4½ per cent higher than expenditure in the preceding twelve months.

Expenditure in Division 9 in the third quarter of 1988 was £2052 million, at 1985 prices and seasonally adjusted; over 3 per cent higher than in the previous quarter, and over 2 per cent higher than in the same quarter a year ago. In the last twelve months, expenditure in Division 9 was over 2 per cent higher than expenditure in the preceding twelve months.

Ø Divisions 0 to 9 of the Standard Industrial Classification (Revised 1980)

Press Inquiries: 01 215 4471/4472/4475
Public Inquiries: 0633 81 2149/2215

NOTES FOR EDITORS

1. REVISIONS TO SERIES

Initial indications from benchmark inquiries are that total investment for these industries will be revised upwards. Allowances of £300 million for 1986 and £1700 million for 1987 are included in the FSBR and in the CSO press notice on GDP to be issued tomorrow. There is an adjustment to total capital expenditure in 1988 in these publications but the contribution from manufacturing, construction, distribution and finance cannot be identified.

2. EFFECT OF LEASING ON MANUFACTURING INVESTMENT

Assets have traditionally been classified to the industries of their ownership. Since capital goods acquired for leasing out are mainly bought by the service industries, leasing to manufacturers produces an apparent switch in investment to the service industries from the manufacturing industries. The following table illustrates the effect of leasing from the financial industries. In 1988 assets leased from owners in the financial industries represented an addition of over 10 per cent of manufacturers' capital expenditure. Assets leased from owners in other industries outside manufacturing are not included in this analysis.

INVESTMENT BY MANUFACTURING INDUSTRIES

£ million at 1985 prices

	Capital Expenditure	Estimated Volume of assets leased from financial industries	Total Expenditure
1977	9162	666	9828
1978	9767	950	10717
1979	10138	1019	11157
1980	8763	1158	9920
1981	6581	1155	7735
1982	6362	1241	7603
1983	6463	1078	7541
1984	7810	1112	8922
1985	8726	1533	10259
1986	8479	1098	9576
1987	9087	963	10050
1988	9970	1020	10990

3. An analysis of leased assets by user industry within manufacturing is not available.

4. ASSET COVERAGE OF THE CAPITAL EXPENDITURE ESTIMATES

The net figures given in the Press Notice cover acquisitions less disposals of vehicles and of plant and machinery, and expenditure on new building work. Spending on land and existing buildings is excluded from the figures.

5. The industrial coverage of the capital expenditure estimates is as follows:-

i. The latest quarter's estimates relate to Divisions 2 to 4 (Manufacturing Industries), Division 5 (Construction), Division 6 (Distribution etc), and Division 8 (Finance and Business Services).

ii. The previous quarter's figures cover those Divisions listed in (i) plus Division 0 (Agriculture, Forestry and Fishing), Division 1 (Energy and Water Supply), Division 7 (Transport and Communication) and Division 9 (Other Miscellaneous Services). Figures for the fourth quarter of 1988 in respect of Divisions 0, 1, 7 and 9 will be published in the first quarter 1989 provisional press notice on 18 May 1989.

6. More detailed estimates of capital expenditure in the fourth quarter of 1988, together with current price data, will be published in British Business on 17 March 1989.

TABLE 1a: FIXED CAPITAL EXPENDITURE AT 1985 PRICES: £m seasonally adjusted

		Analysis by ownership										Analysis by type of asset		
	Total	Agriculture forestry and fishing	Energy and water supply	Mineral extraction metal,mineral and chemical industries	Metal goods engineering and vehicles industries	Other manufacturing industries	Construction	Distribution etc	Transport and communication	Financial and business services etc	Other services	New building work	Vehicles	Plant and machinery
Divisions	0-9	0	1	2	3	4	5	6	7	8	9	0-9		
Period														
1980	38,833	1,218	7,101	2,482	3,228	3,058	611	4,089	5,071	6,430	5,952	13,079	6,299	19,670
1981	35,651	1,054	7,480	1,787	2,447	2,351	538	3,750	3,977	6,825	5,563	12,516	4,905	18,290
1982	37,326	1,248	7,545	1,646	2,310	2,410	607	4,017	3,634	7,538	6,384	13,713	5,036	18,522
1983	38,481	1,338	7,512	1,683	2,364	2,416	658	4,149	4,182	7,482	6,697	13,877	5,176	19,429
1984	42,523	1,242	7,071	1,831	2,972	3,007	553	4,802	4,854	8,892	7,299	15,163	6,111	21,249
1985	45,373	981	6,631	2,240	3,245	3,240	532	5,173	5,086	10,625	7,618	15,198	6,441	23,735
1986	44,852	865	6,535	2,158	3,114	3,207	520	5,429	4,835	10,269	7,919	15,251	5,616	23,984
1987	47,394	650	5,950	2,433	2,861	3,793	508	6,329	5,079	11,680	8,112	15,739	6,094	25,560
1988	N/A	N/A	N/A	2,688	3,078	4,203	720	6,553	N/A	13,322	N/A	N/A	N/A	N/A
1985 Q1	12,157	264	1,662	545	852	793	155	1,331	1,546	3,226	1,784	3,770	2,146	6,241
Q2	10,999	258	1,657	536	807	832	135	1,270	1,266	2,306	1,933	3,908	1,462	5,629
Q3	11,171	239	1,686	573	770	815	123	1,300	1,164	2,576	1,925	3,759	1,474	5,938
Q4	11,046	220	1,627	587	816	800	120	1,272	1,111	2,517	1,976	3,760	1,359	5,927
1986 Q1	11,237	241	1,660	518	839	819	142	1,234	1,181	2,700	1,901	3,798	1,422	6,017
Q2	11,000	227	1,601	535	707	759	124	1,356	1,228	2,478	1,985	3,747	1,372	5,881
Q3	11,382	201	1,664	553	779	851	127	1,378	1,247	2,569	2,014	3,887	1,413	6,082
Q4	11,233	196	1,610	553	788	777	127	1,462	1,179	2,522	2,019	3,819	1,409	6,005
1987 Q1	11,300	164	1,580	592	637	845	118	1,407	1,143	2,756	2,058	3,871	1,413	6,016
Q2	11,729	166	1,402	602	737	962	121	1,563	1,355	2,856	1,965	3,770	1,528	6,431
Q3	11,845	171	1,400	604	758	971	152	1,645	1,335	2,800	2,007	3,860	1,560	6,425
Q4	12,520	149	1,568	634	729	1,015	117	1,713	1,246	3,268	2,082	4,239	1,593	6,689
1988 Q1	12,358	151	1,487	659	733	993	138	1,566	1,328	3,194	2,106	4,131	1,473	6,753
Q2	12,723	124	1,321	626	787	1,145	188	1,748	1,341	3,455	1,989	4,117	1,581	7,024
Q3	12,576	119	1,364	703	802	1,016	161	1,570	1,323	3,465	2,052	3,905	1,731	6,940
Q4	N/A	N/A	N/A	701	757	1,048	232	1,669	N/A	3,209	N/A	N/A	N/A	N/A

The estimates are shown to the nearest £ million but should not be regarded as accurate to this degree.

Figures in the table have been rounded to the nearest final digit where necessary and, in these instances, the sum of the constituent items may not always agree exactly with the total shown.

N/A - not available

TABLE 1b: FIXED CAPITAL EXPENDITURE AT 1985 PRICES: £m seasonally adjusted

	Analysis by ownership				Analysis by type of asset Divisions 1-8			Analysis by user			
Divisions	Total for Divisions 1-8	Production and construction industries 1-5	Manufacturing industries (revised definition) 2-4	Distribution and financial services, transport etc. 6-8	New building work	Vehicles	Plant and machinery	Assets leased to manufac-turers	Divisions 2-4 (Manufacturing) including assets leased to manufacturers	Divisions 5,6 and 8 excluding assets leased to manufacturers	Divisions 5,6,7 and 8 excluding assets leased to manufacturers
Period											
1980	31,717	16,474	8,763	15,590	8,312	5,759	17,801	1,158	9,920	9,972	14,875
1981	29,081	14,598	6,581	14,552	8,099	4,399	16,591	1,155	7,735	9,958	13,910
1982	29,704	14,514	6,362	15,189	8,527	4,477	16,657	1,241	7,603	10,921	14,565
1983	30,447	14,633	6,463	15,813	8,542	4,627	17,278	1,078	7,541	11,211	15,393
1984	33,982	15,435	7,810	18,548	9,243	5,572	19,168	1,112	8,922	13,135	17,989
1985	36,774	15,889	8,726	20,885	9,332	5,935	21,507	1,533	10,259	14,797	19,884
1986	36,068	15,534	8,479	20,534	9,329	5,132	21,607	1,098	9,576	15,121	19,956
1987	38,632	15,544	9,087	23,088	9,833	5,641	23,158	963	10,050	17,554	22,632
1988	N/A	N/A	9,970	N/A	N/A	N/A	N/A	1,020	10,990	19,575	N/A
1985 Q1	10,109	4,007	2,190	6,103	2,347	2,021	5,741	523	2,713	4,189	5,735
Q2	8,808	3,966	2,175	4,842	2,425	1,311	5,072	309	2,484	3,402	4,667
Q3	9,006	3,966	2,158	5,040	2,283	1,364	5,359	340	2,498	3,659	4,822
Q4	8,850	3,950	2,203	4,900	2,277	1,238	5,334	360	2,564	3,548	4,659
1986 Q1	9,095	3,979	2,177	5,116	2,347	1,292	5,455	478	2,655	3,598	4,779
Q2	8,788	3,726	2,000	5,062	2,272	1,245	5,270	278	2,278	3,681	4,909
Q3	9,167	3,974	2,183	5,193	2,394	1,291	5,482	195	2,378	3,878	5,125
Q4	9,018	3,855	2,118	5,163	2,316	1,303	5,399	147	2,265	3,964	5,143
1987 Q1	9,079	3,772	2,075	5,306	2,333	1,297	5,449	255	2,330	4,026	5,169
Q2	9,598	3,824	2,302	5,774	2,338	1,423	5,836	253	2,554	4,287	5,642
Q3	9,666	3,886	2,333	5,781	2,424	1,433	5,809	258	2,592	4,339	5,674
Q4	10,289	4,062	2,377	6,227	2,737	1,486	6,065	196	2,574	4,901	6,147
1988 Q1	10,100	4,011	2,385	6,089	2,540	1,364	6,197	252	2,638	4,647	5,975
Q2	10,610	4,066	2,558	6,543	2,728	1,471	6,410	265	2,822	5,126	6,466
Q3	10,404	4,047	2,521	6,357	2,482	1,578	6,344	298	2,819	4,897	6,221
Q4	N/A	N/A	2,506	N/A	N/A	N/A	N/A	205	2,711	4,905	N/A

The estimates are shown to the nearest £ million but should not be regarded as accurate to this degree.

Figures in the table have been rounded to the nearest final digit where necessary and, in these instances, the sum of the constituent items may not always agree exactly with the total shown.

N/A - not available

CSO BRIEFING ON DTI CAPITAL EXPENDITURE PRESS NOTICE

What does DTI Press Notice say?

"Initial indications from benchmark inquiries are that total investment for these industries will be revised upwards. Allowances of £300 million for 1986 and £1700 million for 1987 are included in the Financial Statement and Budget Report and in the Central Statistical Office's Press Notice on GDP to be issued tomorrow. There is an adjustment to total capital expenditure in 1988 in these publications but the contribution from the manufacturing, construction, distribution and financial industries cannot be identified."

Why are CSO figures different?

Figures to be issued tomorrow by CSO will include special adjustments to fixed investment estimates to bring them closer to the final figures expected when full information is available. The adjustments are based on preliminary results from BSO annual inquiries for 1987; a modified adjustment in the deflation process allowing for divergences between import and domestic prices; and a special study of the apparent shortfall of fixed investment estimates compared with production and trade data for capital goods.

The CSO's figures cover total fixed capital formation, not solely manufacturing, construction, distribution and financial industries.

Are Treasury figures in the FSBR the same as CSO's?

Yes.

Do you think DTI figures are wrong?

DTI's estimates are based on a voluntary quarterly inquiry into businesses' capital expenditure with more comprehensive annual data collected in arrears. The quarterly data collection system is known to suffer coverage problems and preliminary results for BSO annual inquiries for 1987 indicate that the quarterly inquiry significantly underestimated the growth of expenditure in that year. Production and trade data suggest this understatement may have continued into 1988.

DTI have not included special adjustments in their figures because at this stage it is not possible to allocate these adjustments between industries. They will revise their figures as soon as firm and full information is available.

Central Statistical Office
16 March 1989

1.7

CONFIDENTIAL

FROM: P N SEDGWICK (EA)
DATE: 7 JUNE 1989
(x 4459)

CHANCELLOR

cc Chief Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Mr Monck
Mrs Case
Mrs Lomax
Mr Moore
Mr Peretz
Mr Riley
Mr Hibberd
Mr Meyrick
Mr Mowl
Mr Pickford
Mr Revolta
Mr S Wood
Mr Owen
Mr Cornelius
Mr Coulton
Mr Guy
Mr Judge
Mrs Chaplin
Mr Tyrie
Mr Call

(PEM may put up a note on this).

THE CONSTRUCTION INDUSTRY

I attach a paper by Brian Coulton that assesses the performance of the construction industry, and in particular the evidence on capacity constraints and inflationary pressures.

2. The currently available evidence on future trends in construction does not present a clear message. On balance it suggests lower growth of output and private sector construction investment in the next two years, and the continuation of relatively high inflation in the industry. We will be examining prospects again after our current forecasting exercise, by which time we will have assessed further the implications for the industry of the latest survey of the private sector's investment intentions. We will at the same time be working with expenditure groups to assess the implications of public expenditure bids with a high construction content. This work will help in the preparation of briefing for the public expenditure Cabinet on July 13 and later on for bilaterals.

P.N.S

P N SEDGWICK

CONFIDENTIAL

7/7/89.

RECENT DEVELOPMENTS AND PROSPECTS FOR THE CONSTRUCTION INDUSTRY

Summary

1.1 **Output** - the construction industry has enjoyed a boom over the last two years, growing faster than both the economy as a whole and manufacturing. In 1987 the level of construction output passed its previous peak in 1973. Although the recent growth has been partly related to the private housing boom, the non-housing sector has also been very buoyant.

1.2 **Capacity utilisation** - the industry has clearly been working close to full capacity.

1.3 **Labour market** - employment growth has been strong in the last two years and reports have emerged of widespread shortages of skilled labour. The result has been construction earnings increasing at a faster rate than in the economy as a whole.

1.4 **Materials supply** - there have been some bottlenecks in the supply of materials, but these have been less serious than the skill shortages.

1.5 **Prices and costs** - construction output prices have been rising rapidly, 6½ points faster than the retail price index in 1988. Material costs in construction rose only marginally faster than in manufacturing.

1.6 **Prospects** - recent data on construction new orders and the forecasts of industry specialists, suggest that output will grow further, though at a slower rate, this year, before levelling off in 1990. More recently available private sector investment intentions suggest more buoyant output. The available assessments of prospects do not take account of the possibility of a further surge in public sector construction orders.

ea1
pns12.5

A Recent Developments

i) Output

2. Total output of the construction industry (GB) rose by 7 per cent in 1988†. This followed growth of 7¾ per cent in 1987, and took construction output to its highest ever post-war level, 11½ per cent above the previous peak in 1973 (see chart 1 and table 1). The recent boom compares with an average annual growth rate between 1980 and 1988 of 3½ per cent.

3. Virtually all of the increase in new work in 1988 (and a large part in 1987) came from the private sector. The extremely buoyant housing market in 1988 saw **private new housing** output rise by 12½ per cent, following growth of 11 per cent in 1987. However, output fell in the second half of 1988 as the housing market slowed down.

4. In the non-housing sector, construction for the **private industrial**[1] sector rose by almost 15 per cent in 1988, only slightly below the growth rate of 15½ per cent in 1987. This sector includes the Channel Tunnel project which started to contribute to output in the latter half of 1987. Excluding this project, output of this sector would have grown by about 8 per cent in 1988, continuing an upward trend since mid-1986.

5. Construction for the **private commercial**[2] sector grew by 13½ per cent in 1988, following 18 per cent growth in the year before. This sector incorporates Canary Wharf as well as other mega office projects such as Broadgate and the numerous 'retail park' projects which have blossomed in the last 2-3 years.

6. Public sector construction work, on the other hand, showed little growth in the past year. **Public new housing** output fell in 1988, reflecting the large decline in local authority house

---

† Figures for the fourth quarter are provisional.

1 Private industrial work covers (amongst other things) factories, warehouses, oil refineries, all other buildings and works for the purpose of industrial production.

2 Private commercial work covers (amongst other things) offices, retail developments and construction for the leisure industry.

TABLE 1 : CONSTRUCTION OUTPUT BY SECTOR

£1985 Billion

	-------NEW HOUSING-------				-------OTHER NEW WORK---------						REPAIRS AND MAINTENANCE		TOTAL	
	Private		Public		Private Industrial		Private Commercial		Public Works					
		% *		%		%		%		%		%		%
1985	3.85	-4.7	0.92	-17.1	2.85	16.6	3.52	6.2	3.79	-5.3	12.93	2.4	27.85	1.1
1986	4.29	11.6	0.82	-11.2	2.61	-8.4	3.98	13.2	3.80	0.3	13.25	2.5	28.76	3.3
1987	4.77	11.1	0.87	6.5	3.02	15.7	4.71	18.1	3.60	-5.2	14.05	6.0	31.02	7.9
1988	5.37	12.5	0.78	-9.7	3.47	14.8	5.34	13.5	3.63	0.6	14.65	4.2	33.24	7.1
1987q1	1.13	14.0	0.21	2.9	0.73	11.4	1.13	21.4	0.91	-3.2	3.55	12.6	7.66	11.4
q2	1.18	7.2	0.22	2.3	0.72	12.8	1.12	16.4	0.88	-11.2	3.43	4.4	7.55	5.0
q3	1.25	14.8	0.22	10.7	0.79	23.9	1.16	12.3	0.88	-6.6	3.48	3.2	7.78	7.0
q4	1.22	9.0	0.22	10.6	0.78	15.1	1.30	22.3	0.93	0.5	3.59	4.4	8.04	8.3
1988q1	1.42	25.9	0.21	1.0	0.80	9.8	1.26	11.4	0.94	3.6	3.81	7.2	8.44	10.2
q2	1.46	24.2	0.21	-5.9	0.86	18.7	1.27	13.2	0.87	-1.4	3.62	5.4	8.28	9.7
q3	1.27	1.5	0.19	-12.9	0.86	9.0	1.35	16.8	0.89	0.5	3.59	3.0	8.15	4.7
q4	1.22	0.1	0.17	-20.9	0.95	22.0	1.47	12.7	0.93	-0.4	3.64	1.3	8.37	4.1

* Per cent change on year earlier

Chart 1 Construction output

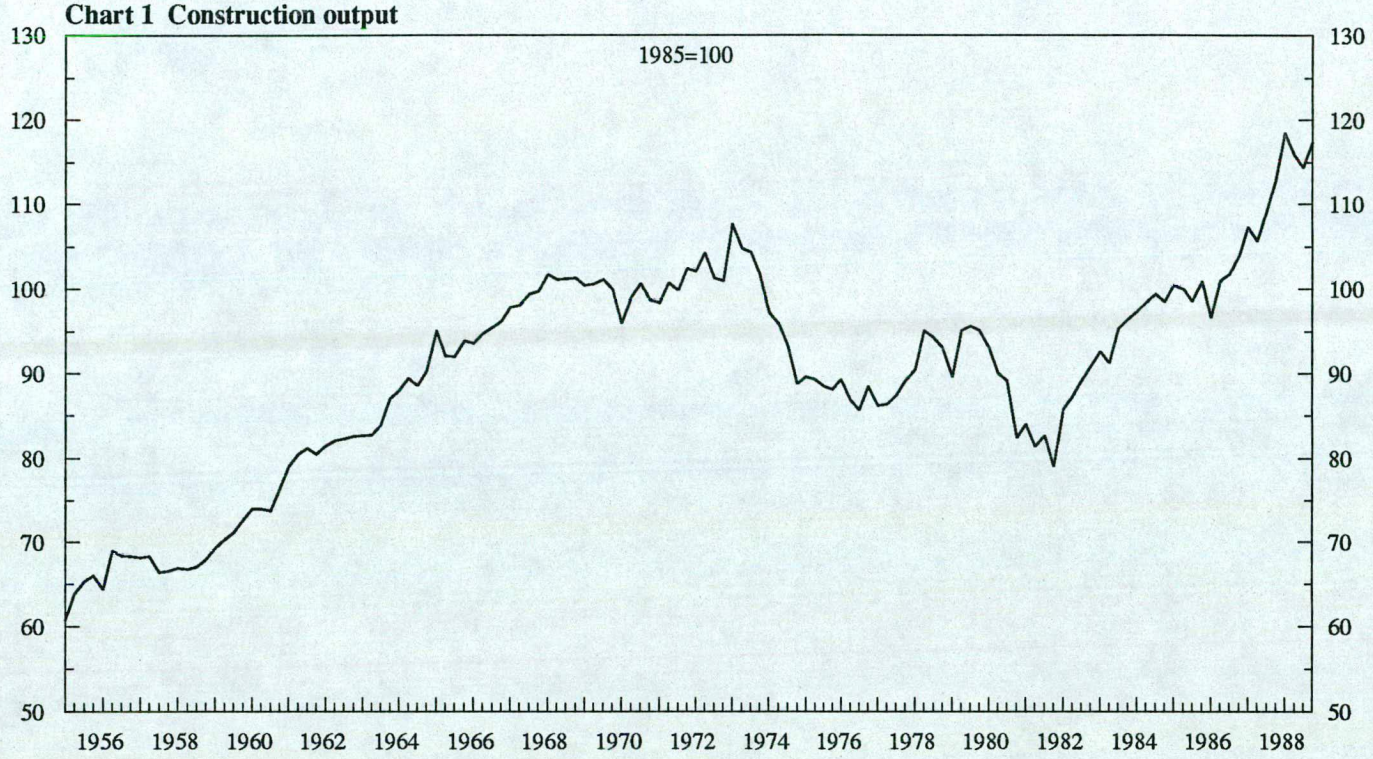
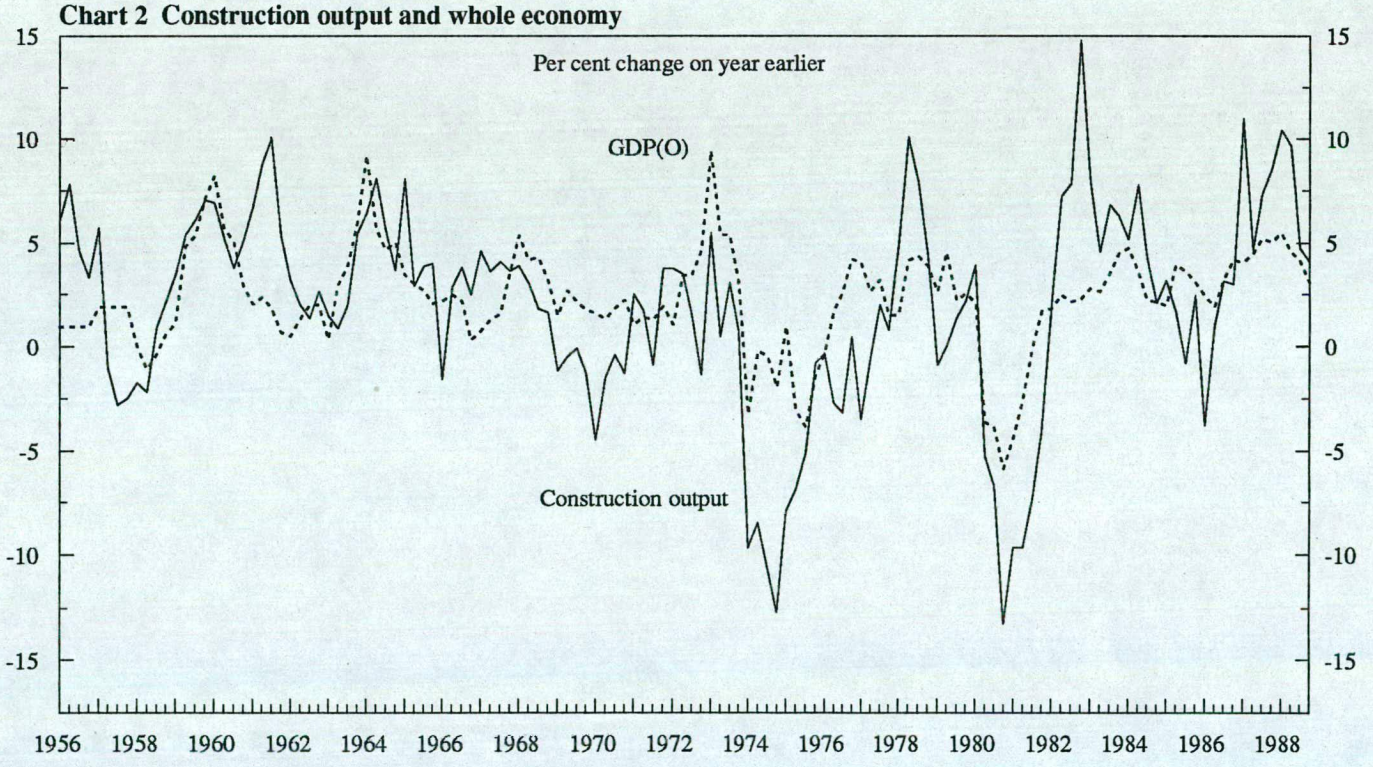


Chart 2 Construction output and whole economy



building which has not been offset by the rise in housebuilding activity by housing associations. **Public non-housing** output grew marginally last year, following a fall in 1987.

7. Associated with the boom in new work there has been healthy growth in the **repair and maintenance** sector, most markedly in the housing sector.

8. There may well be some under-recording in the official data due to the black economy and DIY work, though this is more likely to disort the level of rather than the change in output.

9. The latest **Building Employers Confederation** (BEC) survey (May) indicates continued growth of output in the first quarter of 1989 although at a slightly lower rate. Most of the growth has been in work for the private industrial and commercial sectors (where enquiries[1] are at a high level) which has compensated for the slowdown in private housebuilding. This is in line with the projection of 2½ per cent growth in construction output used by the CSO in their preliminary estimate of GDP(O) for the first quarter of 1989. (This figure is not published.)

ii) Labour market

10. The rapid rise in output over the last two years generated **employment** growth of almost 5 per cent in both 1987 and 1988, compared with employment growth in the whole economy of 2¼ and 3 per cent respectively. (See table 2 and chart 3).

(1) These are similar to new orders but include some enquiries which are not actually firm, agreed contracts. They should in principle move together with the new orders data.

Table 2: Employed Labour Force (UK)

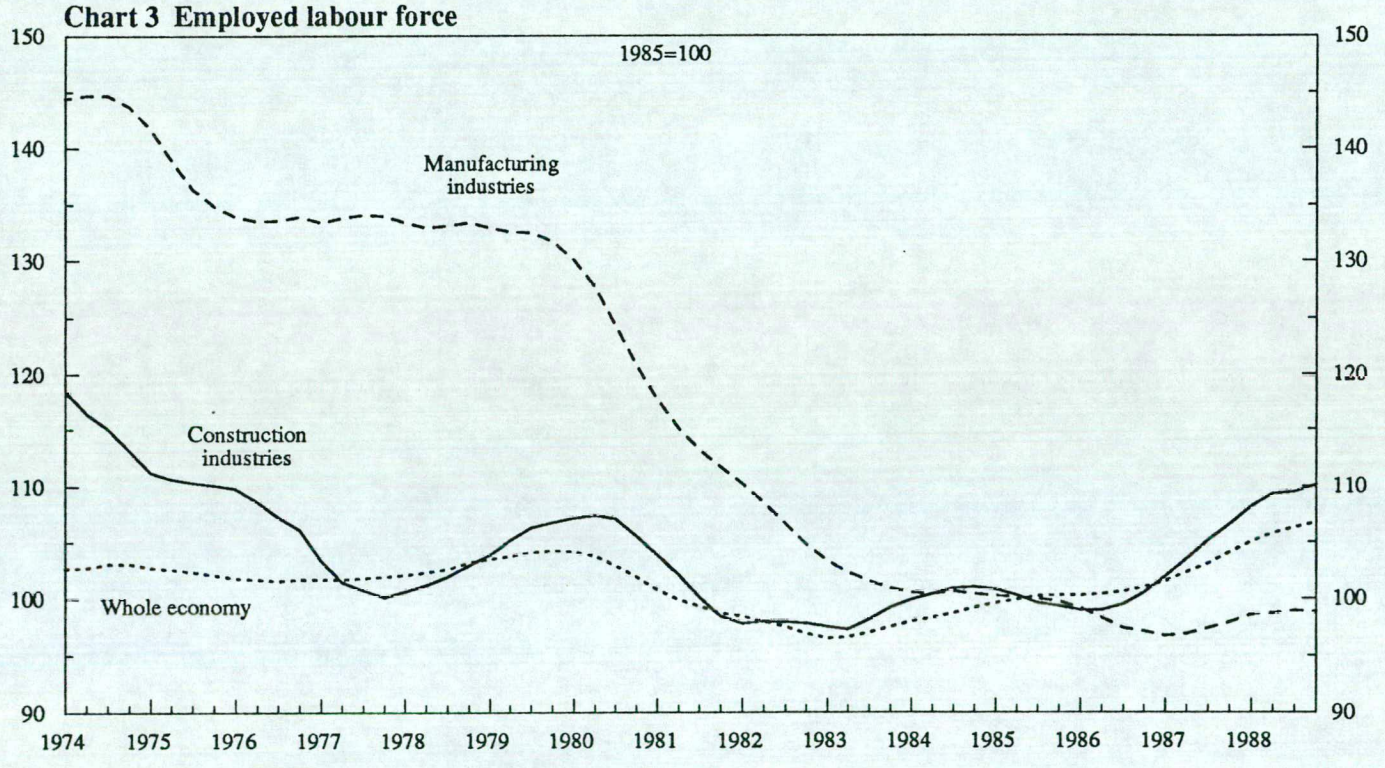
Millions

	Whole Economy	%*	Manufacturing Industry	%	Construction Industry	%
1985	24.42	1.4	5.58	-0.5	1.50	-0.5
86	25.66	0.6	5.47	-2.0	1.50	-0.5
87	25.10	2.2	5.43	-0.8	1.57	4.8
88	25.88	3.1	5.51	1.5	1.64	4.8
88Q1	25.67	3.5	5.50	2.0	1.60	6.1
2	25.82	3.4	5.51	1.9	1.61	5.7
3	25.95	3.1	5.52	1.5	1.62	4.1
4	26.07	2.6	5.52	0.9	1.63	3.3

* Per cent change on a year earlier

11. The average annual growth rate of construction employment between 1981 and 1988 was 1 per cent, so these figures represent a significant tightening of the labour market in this sector. The annual growth rate fell through 1988, standing at 3½ per cent in the fourth quarter.

Chart 3 Employed labour force



12. Table 3 shows the regional pattern of employment growth. These figures do not cover self employed workers, who in 1988 probably made up over one third of all construction industry employment (GB). (This segment of the workforce has been growing

considerably in recent years:- of the growth of 3.3 per cent in employed labour force (GB) between December 1987 and December 1988, 2.5 per cent came from growth in self employment (see Table 4).) This may go some way to explaining the slightly unexpected regional pattern of employment growth shown.

13. The largest increases in employment in 1988 were in East Anglia, the Midlands, Scotland and the North West. Employment in the South East showed no growth in the year to December 1988, after rising moderately in 1987, and the number of employees in Greater London has been falling.

Table 3: Employees in employment, construction industry, by region

	Thousands	Per cent changes	
	Dec 88	Dec 87 on Dec 86	Dec 88 on Dec 87
S East	294	2.5	0.0
G London	120	0.7	-2.4
E Anglia	43	6.8	4.9
S West	64	2.0	-1.5
W Midlands	97	5.0	3.2
E Midlands	66	5.8	3.1
Yorks & Humb	92	3.4	1.1
N West	117	3.7	1.7
North	58	3.6	0.0
Wales	43	1.9	0.0
Scotland	146	4.9	2.8
GB	1020	3.8	1.2

Table 4: Self employment in construction

Great Britain

	Thousands	Percent change on same period a year earlier
Dec 83	436	
Dec 84	467	7.0
Dec 85	479	2.5
Dec 86	514	7.4
Dec 87	568	10.4
Dec 88	608	7.0

14. The rising demand for labour has been associated with increasing reports of labour shortages in the industry. The December 1988 report by the NEDO Joint Forecasting Committee quoted that

'reports of serious shortages of skilled manpower ..... have become widespread'.

In the private office building sector in particular, the skill shortages were reported to have worsened in London (between the June and December 1988 reports) and to have spread to other cities. The April 1989 workload survey of the **Federation of Civil Engineering Contractors** (FCEC) also reports a continuation of the trend in 1988 towards increasing concern amongst firms over the availability of certain skills. In the latest survey the difference between the percentage of respondents reporting the situation as 'satisfactory' and those reporting it to be 'unsatisfactory' (the 'balance') worsened among the larger firms. The main reason given was worries over prospects for recruiting young engineers.

15. However the latest state of trade enquiry by the BEC reports a slight improvement in labour availability at the start of 1989. The proportion of members reporting difficulties recruiting bricklayers and carpenters fell by 9 percentage points to 75 per cent, although the situation with regard to plasterers has worsened slightly. In addition there was a small fall in the number of firms reporting manpower shortages as a factor causing delays to work. (See table A1 in Annex A.)

16. The tightening of the labour market in the construction sector has led to an increase in **earnings growth** which was higher in 1988 than in the rest of the economy. Table 5 shows that between 1983 and 1987 earnings growth in the construction sector was in line with the rest of the economy. In 1988 however construction earnings rose 10¾ per cent compared with 8¾ per cent in the whole economy. The figures for growth through the year show a worrying upward trend in the second half of 1988 which has been sustained in the first three months of 1989.

Table 5: Earnings growth

(per cent change on year earlier)

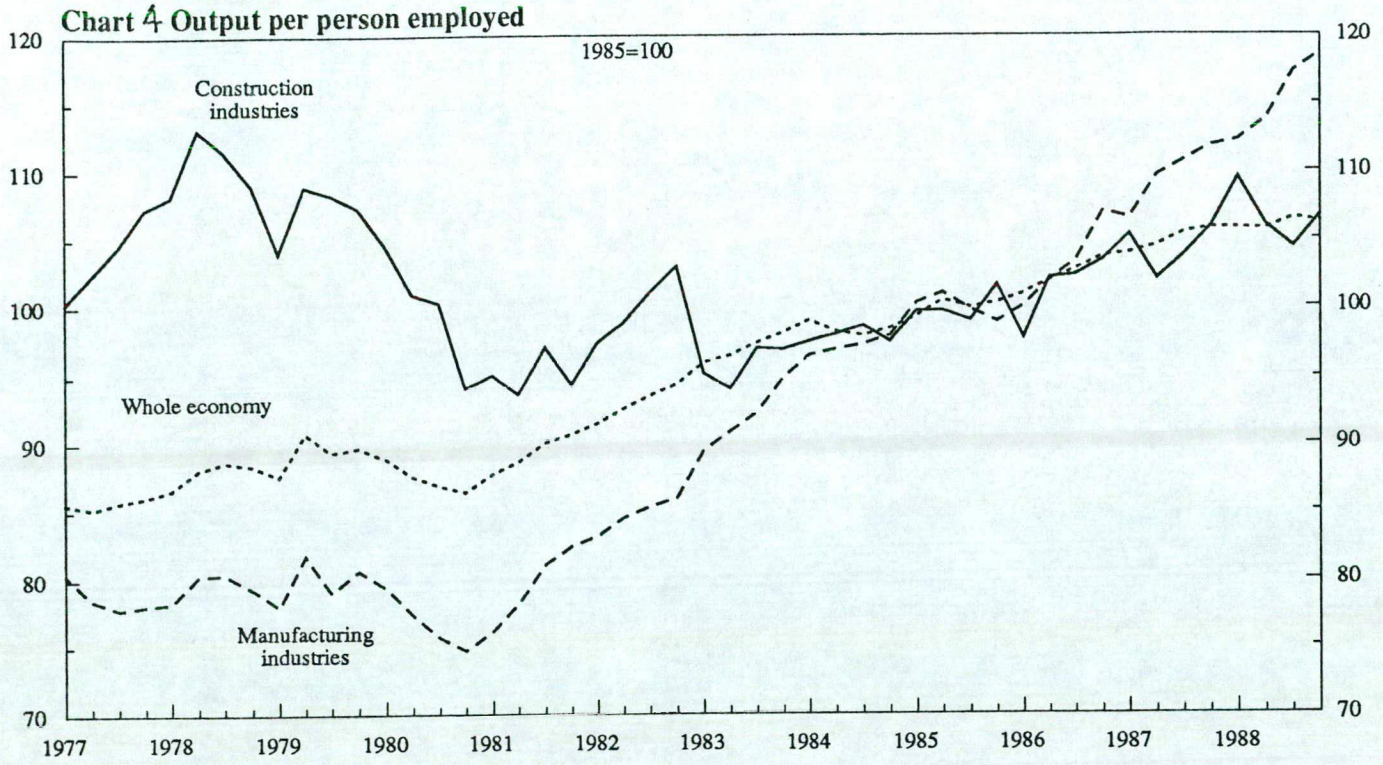
		Construction	Manufacturing	Services	Whole economy
1983		7.5	9.0	8.7	8.5
1984		5.8	8.6	6.3	6.0
1985		8.2	9.1	6.4	8.5
1986		7.9	7.7	7.7	7.9
1987		8.0	8.0	7.7	7.8
1988		10.8	8.5	8.8	8.7
1986	Sep	6.5	7.0	5.5	6.3
	Dec	8.5	8.2	6.7	7.4
1987	Mar	8.7	7.6	5.8	6.6
	June	7.6	7.9	7.6	7.7
	Sep	7.6	8.4	7.6	7.9
	Dec	8.5	8.3	9.3	8.8
1988	Mar	10.4	8.8	9.3	9.1
	June	10.2	8.0	8.2	8.1
	Sep	10.8	8.0	8.7	8.7
	Dec	12.0	9.1	12.4	11.0
1989	Jan	11.6	9.4	9.3	9.4
	Feb	12.2	10.0	8.9	9.7
	Mar	11.3	8.4	8.6	8.9

17. Recorded **productivity** in the construction sector has increased by 11½ per cent since 1983 compared with 9½ per cent for the economy as a whole. However this performance is less impressive when compared to the increase for all production industries (22¾ percent) and particularly manufacturing (25½ per cent). (See Chart 4 and Table 6).

Table 6: Output per person employed 1985=100

	Construction	Whole economy	Total production industries	Manufacturing
	Per cent change on year earlier			
1986	2.3	5.0	3.0	1.3
87	2.5	4.9	6.5	2.9
88	1.1	2.6	5.3	2.4

Chart 4 Output per person employed



iii) **Materials supply**

18. The evidence on materials shortages as a factor constraining firms is somewhat mixed, but on balance it seems that shortages have had only a moderate influence and may even have eased slightly in recent months.

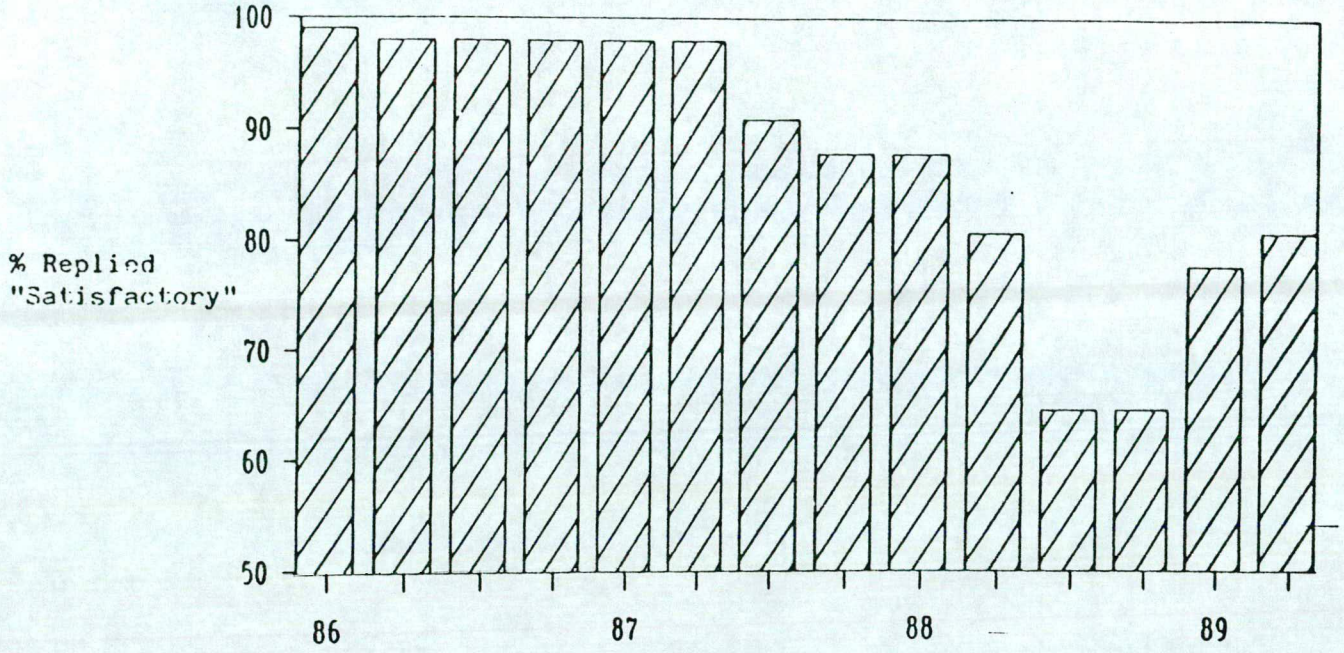
19. The December **NEDO** report concluded that

> 'the industry has succeeded in avoiding major shortages of building materials and components.... (in contrast to the shortages of skills)'.

In addition the May **FCEC** survey describes an improvement since mid 1988 when the matter was a cause of growing concern -

> "since July (1988) the number of firms reporting difficulties in obtaining materials has fallen back by more than half" (see Chart 5).

Chart 5: Federation of Civil Engineering Contractors Survey: General Supply position*



* % responding that materials supply satisfactory

20. However the latest BEC survey reports few signs of improvement in the bottlenecks of the supply of materials. In particular, facing bricks remain in short supply and the majority of respondents had experienced delays of over 2 months on deliveries of structural steel. Nevertheless the actual effect of material shortages on output seems to have been fairly limited with only 2 per cent of contractors citing materials delays as a serious problem disrupting work on existing contracts. (See table A1 in Annex A.)

21. A warning on the danger of potential bottlenecks in the industry was recently given by the Chairman of NEDC's Construction Industry Sector Group - Sir Christopher Foster. Speaking in the context of recent announcements by the Department of Transport on road building he said ...

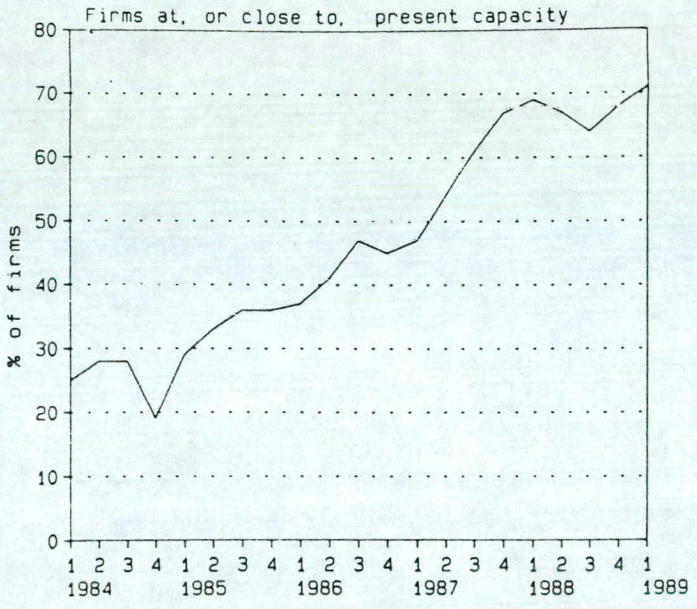
"The opportunity is enormous, but also the danger. If twice the money is going to result in twice the output, rather than in steeply rising prices, urgent steps are needed to overcome obstacles."

iv) **Capacity utilization**

22. With regards to the level of utilization of present capacity, the BEC survey reports a slightly worsening position in the first quarter. The balance of respondents working at or close to full capacity rose to 71% (the highest balance since the survey began in 1980) compared to an average of 67 per cent in 1988 as a whole (see chart 6 and table A2). The reason for the recent increase is attributed to the rise in construction activity in areas outside south and east England. Between the 1988Q3 and 1989Q1 nearly all of the increase in full capacity working has occurred in regions such as the Midlands, the North West, Liverpool, the Northern Counties and Scotland - areas where considerable surplus capacity used to exist.

Chart 6: Building Employers Confederation Survey - May 1989

CAPACITY OF OPERATIONS

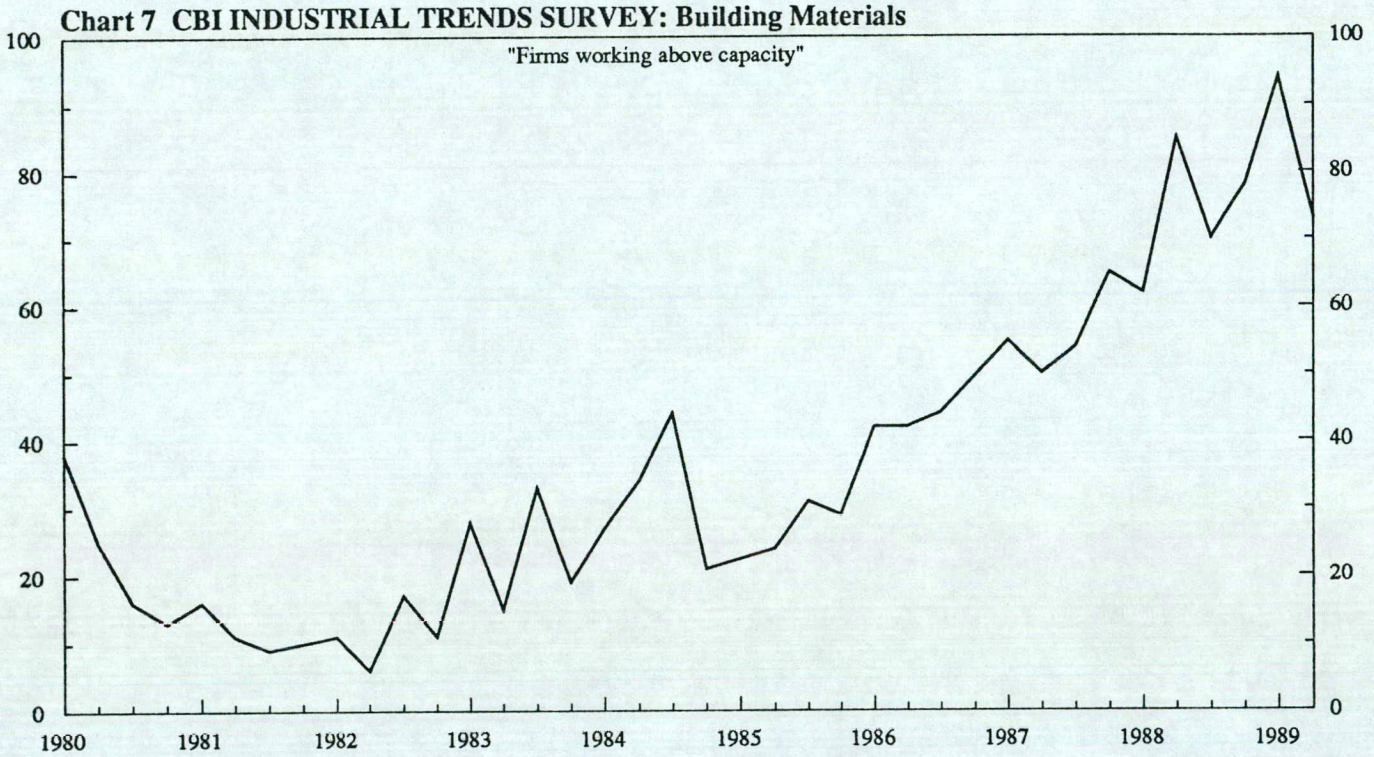


23. This regional dimension is also noted by the **National Council of Building Material Producers** (BMP) in their April forecast which

notes a spread of demand in the office market across Great Britain resulting in acute shortages. Leeds, Manchester and Birmingham are cited as areas where over-supply has been transformed into excess demand.

24. The **CBI Industrial Trends** survey for April recorded 73 per cent of respondents in the Building Materials industry reporting that output was at or above full capacity. This represented a fall from the high January result and was slightly below the average for 1988. However it was still above the response for manufacturing as a whole. As the chart shows, the number of respondents reporting that they are working at or above capacity has been on a marked upward trend since 1982.

Chart 7 CBI INDUSTRIAL TRENDS SURVEY: Building Materials



25. A slightly different pattern is described in the May **FCEC** survey which outlines a picture of emerging spare capacity in some regions in response to a easing off in civil engineering workload. Nevertheless, the general picture is clearly one of an industry operating fairly near to full capacity, and this is borne out by the evidence on costs and prices.

v) **Costs**

26. Construction **material costs** rose by 5½ per cent in 1988, ¾ per cent faster than manufacturers' input prices (see table 7). The growth rate has picked up in early 1989 to 7¼ per cent, but this is not significantly greater than for manufacturers' costs. Chart 8 shows that this growth rate does not represent a significant departure from the rate of cost inflation in the last 7-8 years, and moreover is substantially below the rates witnessed in the previous booms of construction activity in the early and late seventies. This picture is consistent with the survey evidence on material shortages, discussed earlier, which indicates that the bottlenecks in the supply of materials have not been too much of a problem.

Table 7: Construction Material Costs

(Per cent change on year earlier)

	Manufacturers input prices	Construction material costs		
		Total	New housing	Non housing
1983	7.9	6.8	7.7	6.0
1984	9.2	7.2	6.3	7.3
1985	3.0	6.0	6.0	6.8
1986	-10.5	3.6	3.8	3.4
1987	5.0	5.5	6.1	4.8
1988	4.8	5.6	5.6	5.4
1987 Q4	5.1	6.5	6.9	5.1
1988 Q1	3.6	5.8	5.4	5.2
Q2	6.3	5.3	5.4	5.2
Q3	4.2	5.3	5.2	5.3
Q4	5.1	6.1	6.0	6.3
1989 Q1	7.0	7.3	7.3	7.7

27. Chart 9 shows **unit wage costs**. The figure for construction in 1988 is an estimate - calculated using the earnings and productivity numbers (it has not been published).

28. The estimate of 8½ per cent inflation of construction unit wage costs in 1988 represents an upward movement from the trend in the 1980s and could be indicative of the increase in earnings not being accompanied by significant productivity growth. The comparison with manufacturing industry is particularly poor. However, unit wage costs were rising significantly more rapidly in this sector in both the previous cyclical peaks.

Chart 8 Construction material costs and manufacturers input prices

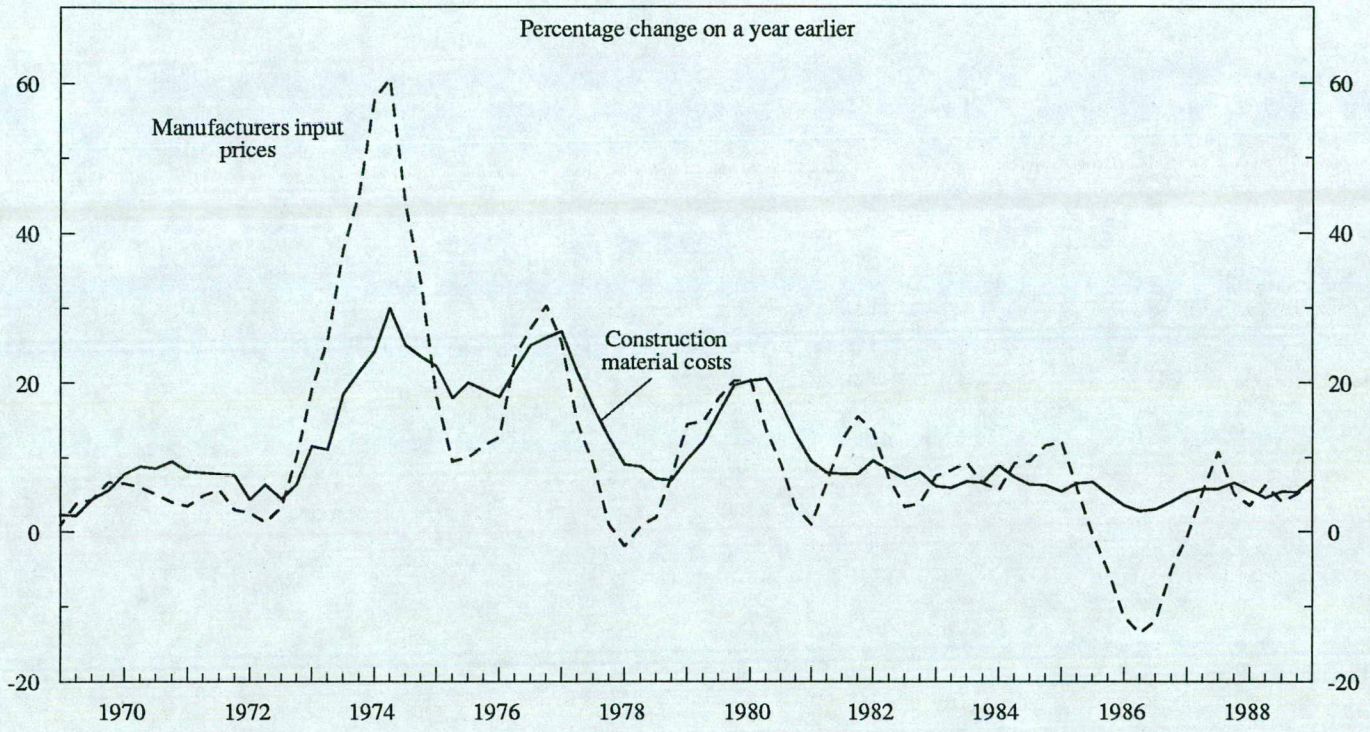
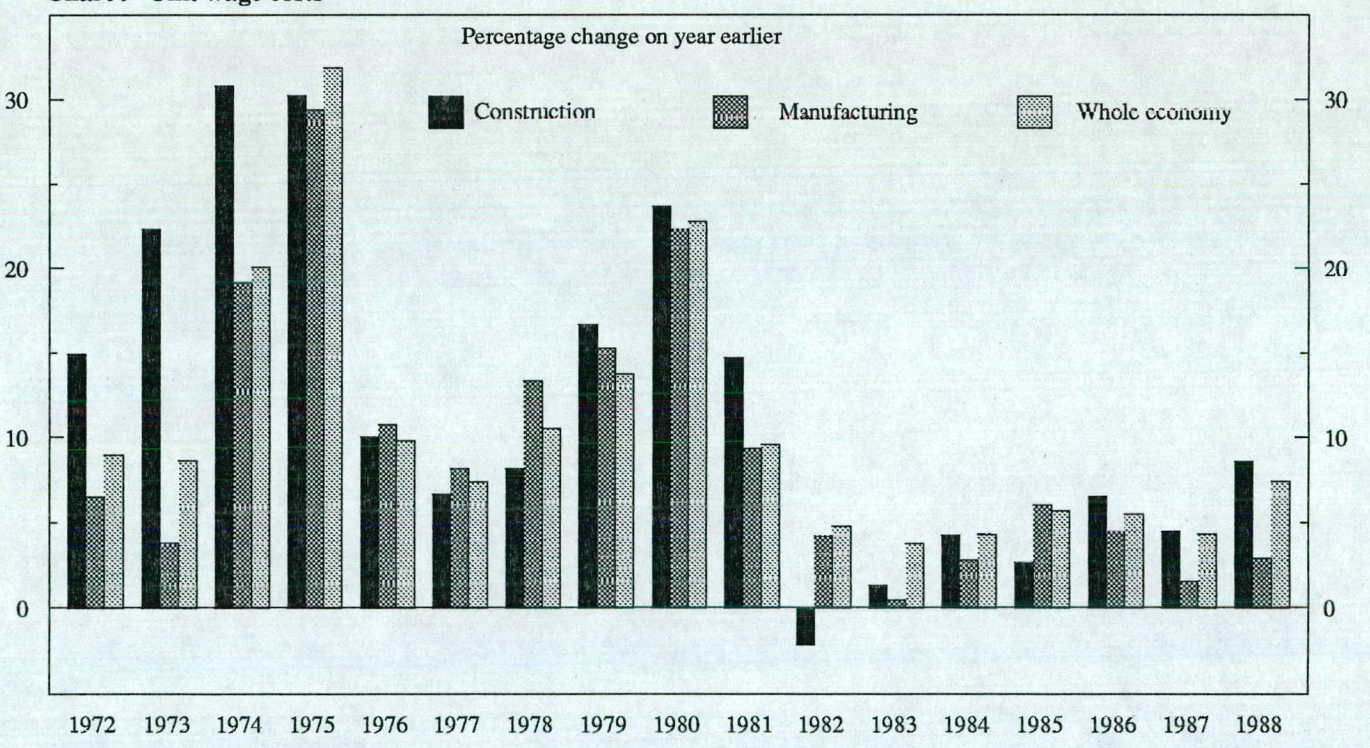


Chart 9 Unit wage costs



vi) **Prices**

29. Construction output prices rose by 11½ per cent in 1988 following growth of 6½ per cent in 1987 (see table 8).

Table 8: Construction output prices

(Per cent change on year earlier)

	Manufacturers output prices	Construction					
		Total	Housing		Non Housing		
			Private	Public	Public	Priv Ind	Priv Comm
1985	5.5	4.6	5.7	2.5	4.8	6.1	5.1
1986	4.1	5.0	9.0	3.0	2.0	1.0	6.0
1987	4.4	6.7	11.9	3.9	4.9	5.0	3.8
1988	4.8	11.6	17.2	10.3	12.1	8.5	10.9
1987Q4	4.8	8.5	13.3	5.8	8.8	10.1	4.6
1988Q1	4.7	10.2	14.7	7.6	10.6	9.9	6.4
Q2	4.7	11.8	16.8	9.4	11.3	7.6	10.1
Q3	4.8	12.4	18.7	10.2	13.0	7.4	12.7
Q4	5.0	13.9	18.8	10.9	12.6	9.2	13.3

30. Chart 10 shows the path of construction output prices and manufacturers output prices since the early 1970s. It is clear that prices in this sector are much more cyclical than those in manufacturing. In the light of past experience it is therefore not too surprising that inflation in this sector has been increasing a good deal more rapidly than in manufacturing since the beginning of 1987. The rate of increase in prices on a year earlier has escalated continuously since 1987Q1 from 3.8 per cent to 13.9 per cent in 1988Q4. However, once again, comparisons with the previous cyclical peaks remain favourable - inflation was running at over 30 per cent in the 1973-74 boom, and over 25 per cent at the end of the seventies.

31. Although much of the recent acceleration in prices has come from the house price boom, the non-housing construction sector has also seen rapid inflation - particularly in the private commercial and public works sectors. Chart 11 shows non-housing construction output prices against manufacturers' output prices. The pattern is very similar to that for the industry as a whole, indicating that neither the housing nor the non-housing sector has - so far - been mainly responsible for the rise in inflation.

Chart 10 Construction output prices and manufacturers output prices

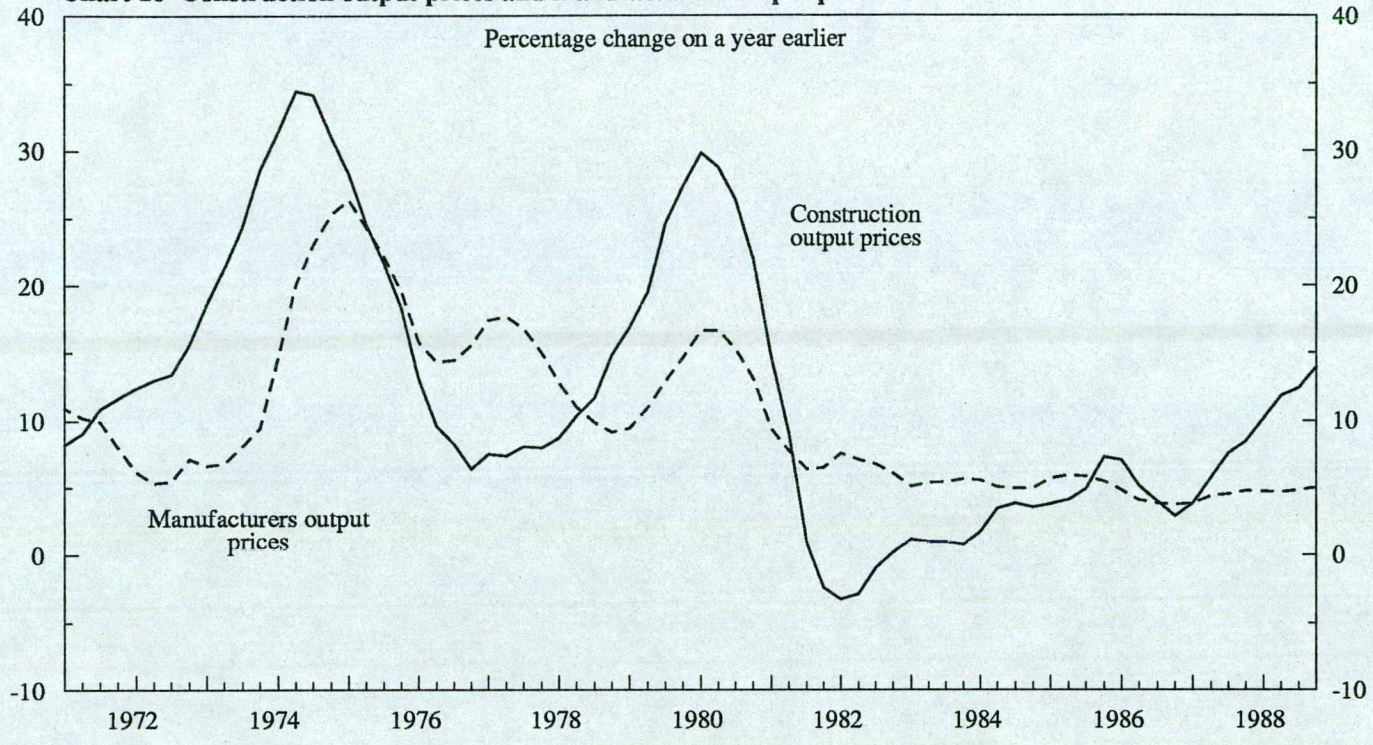
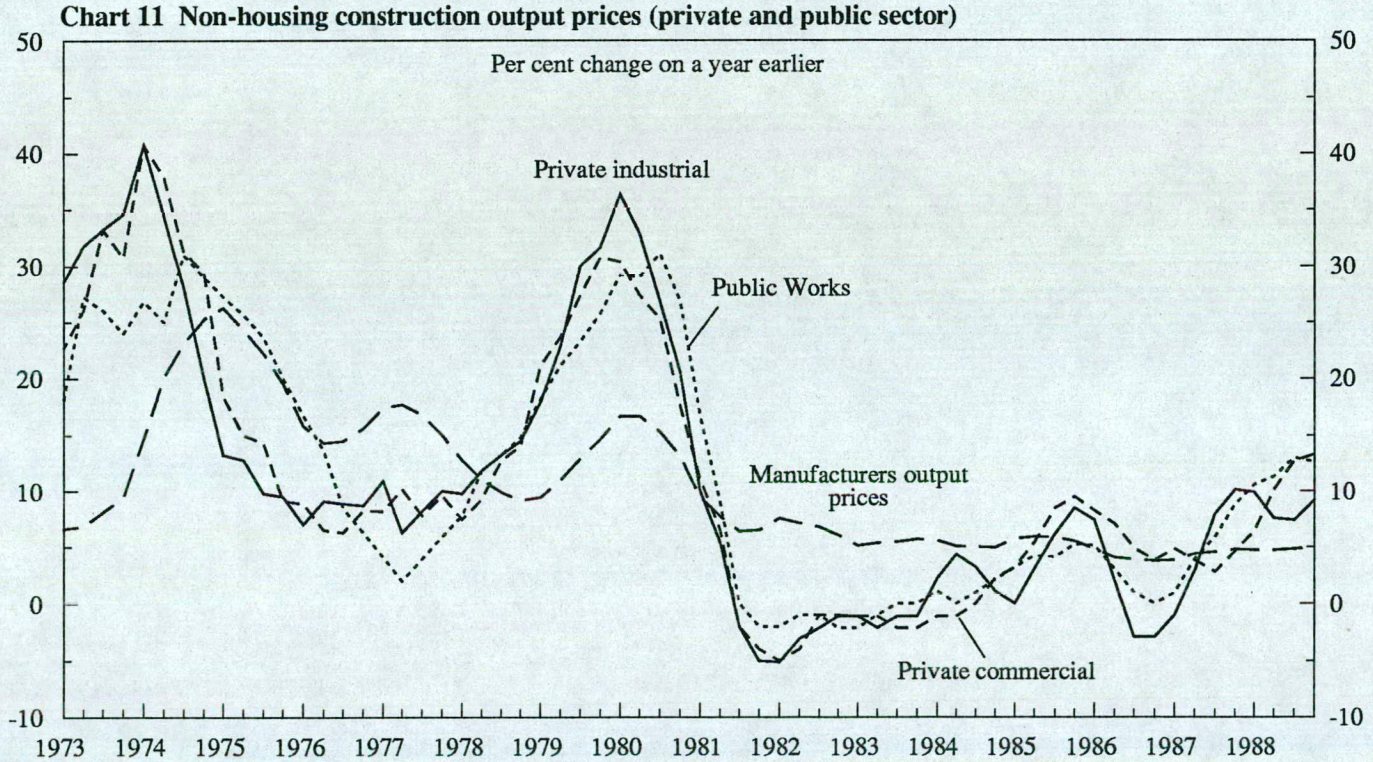
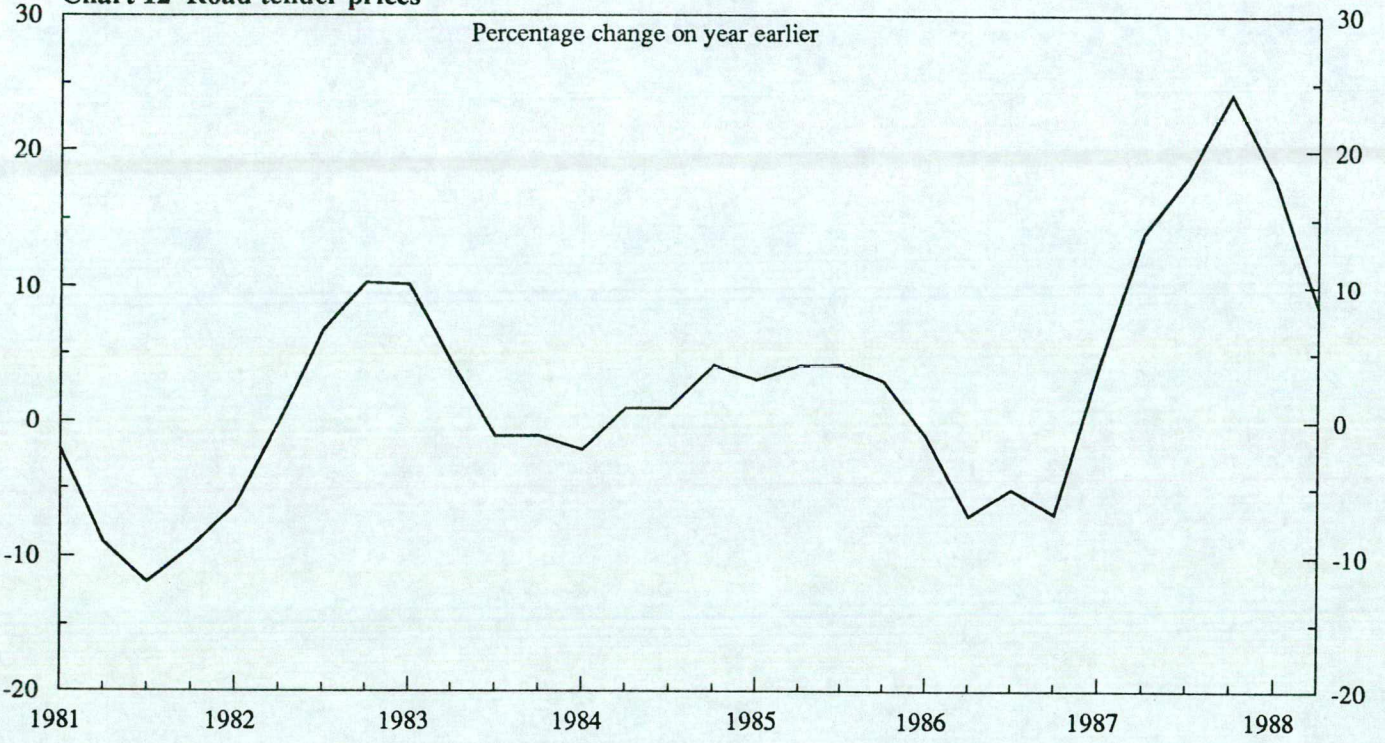


Chart 11 Non-housing construction output prices (private and public sector)



32. Chart 12 shows tender prices for road construction (part of public works). These rose 14¾ per cent in 1987 - the highest annual rate of increase since 1980 - and by 13 per cent between the first half of 1987 and the first half of 1988 (the latest available data period).

Chart 12 Road tender prices



B Prospects

33. This section analyses some of the available material on prospects for the construction industry. We will be assessing the position again after the June (internal) forecast is complete.

34. The general consensus of outside bodies on prospects for the construction sector seems to be for further growth this year in the region of 3 per cent, followed by a levelling off of output in 1990. A slight recovery is predicted for 1991. The short term outlook for prices remains fairly pessimistic given the recent rise in cost inflation and the current high level of capacity utilisation.

35. It should be noted that forecasting bodies - including those with representatives of construction companies on them - have in

general underestimated the rise in construction output over the past two years, though their record before that was reasonable. (See table B1 in Annex.)

i) **Output**

36. Analysis of the prospects for output leans heavily on the recent developments in **new orders** for construction which should, in principle, lead output with varying time lags according to the type of work. The relationship is not however always particularly stable in the short term - variations in the structure of output between sectors and of projects within sectors lead to variations in the average time lags between output and orders. Table 9 summarises recent figures for new orders by sector.

37. Total **new orders received** for new construction grew by 4 per cent in 1988, following a peak year in 1987 when orders for the Channel Tunnel and Canary Wharf projects entered the figures for the first time. However latest figures from the DoE show a drop in new orders in the first quarter, particularly in the private housing and private industrial sectors.

38. Within the private sector, orders for **new housing** rose by 4¼ per cent in 1988. This represented slight slowdown on 1986 and 1987 when orders rose substantially, preceding the housing market boom (the average lag between housing starts (orders) and completions (output) is 18 months). Latest figures from the DOE show a sharp drop in private housing starts in the first quarter of 1989.

39. New orders by the **private industrial** sector fell in 1988, but this was due to the 1987 figure being boosted by the Channel Tunnel order - the level of new orders in 1988 was still 27 per cent higher than in 1986.

40. New orders by the **private commercial** sector continued to rise at a very rapid rate in 1988, although slightly lower than the 31 per cent growth rate in 1987. The order for the first phase of Canary Wharf was included in the first quarter of 1988. Because

TABLE 9 : CONSTRUCTION ORDERS BY SECTOR

£1985 Billion

	-------NEW HOUSING-------				-------OTHER NEW WORK---------				TOTAL	
	Private		Public		Private Industrial		Private Commercial		Public Works			
		%		%		%		%		%		%
1985	4.56	6.1	0.73	-19.9	2.15	-9.9	4.03	9.3	3.88	-11.0	15.34	-2.4
1986	4.90	7.5	0.75	1.6	2.09	-2.8	4.62	14.8	4.24	9.4	16.59	8.1
1987	5.20	6.3	0.81	8.3	3.46	65.9	6.05	30.9	4.23	-0.2	19.76	19.1
1988	5.43	4.4	0.71	-11.9	2.65	-23.4	7.50	23.9	4.26	0.8	20.56	4.0
1987q1	1.32	19.3	0.21	35.3	0.64	34.3	1.21	5.7	1.06	11.7	4.45	15.6
q2	1.22	-2.4	0.23	19.9	0.58	26.4	1.47	39.6	1.01	-5.1	4.51	13.2
q3	1.34	9.4	0.16	-18.3	1.72 *	192.7	1.93	44.3	1.21	23.1	6.36	47.3
q4	1.32	6.4	0.21	13.9	0.53	9.2	1.45	34.0	0.95	11.9	4.45	10.0
1988q1	1.38	3.9	0.18	-15.0	0.66	4.2	1.97	62.7	1.14	6.7	5.32	19.7
q2	1.29	5.9	0.18	-21.1	0.63	8.3	1.76	19.5	0.96	-4.4	4.82	7.0
q3	1.37	1.9	0.16	-2.5	0.63	-63.4	1.85	-4.2	1.00	-17.8	5.00	-21.4
q4	1.40	6.0	0.19	-6.3	0.73	39.4	1.93	33.1	1.17	23.3	5.42	21.9
1989q1	1.21	-12.3	0.2	-7.7	0.60	-9.0	2.08	6.0	1.02	-10.5	5.08	-4.6
Per cent change :												
Latest 3 months on												
Previous 3 mths		-13.7				-17.6		8.0		-13.2		-6.4

of the size of many of the projects in this sector, the lag between output and orders tends to be fairly long, often up to 2 or 3 years.

41. The pattern of orders in the private sector contrasts with that in the **public sector** where **housing** orders fell by 12 per cent in 1988, and non-housing orders grew by a mere 1 per cent.

42. The general pattern of recent orders would seem to imply some further growth in total output this year, albeit at a slower rate followed by a levelling off in 1990, with likely reductions in output occurring in the private housing and private industrial sectors. This is borne out in the picture given by both NEDO and the BMPC (see table 10), and is consistent with the fall in orders in the first quarter of this year.

43. With regard to **housing output** the BMPC forecast a sharp fall this year followed by a further small reduction in 1990, whereafter a healthy recovery is predicted. This forecast is based upon more up to date information than the NEDO outlook which sees the main contraction coming in 1990.

44. On the non housing side, both organisations predict 1989 to be another year of very strong growth in **private commercial** construction, but NEDO are less optimistic on the outlook for the **private industrial** sector.

Table 10: Forecasts of Construction Output

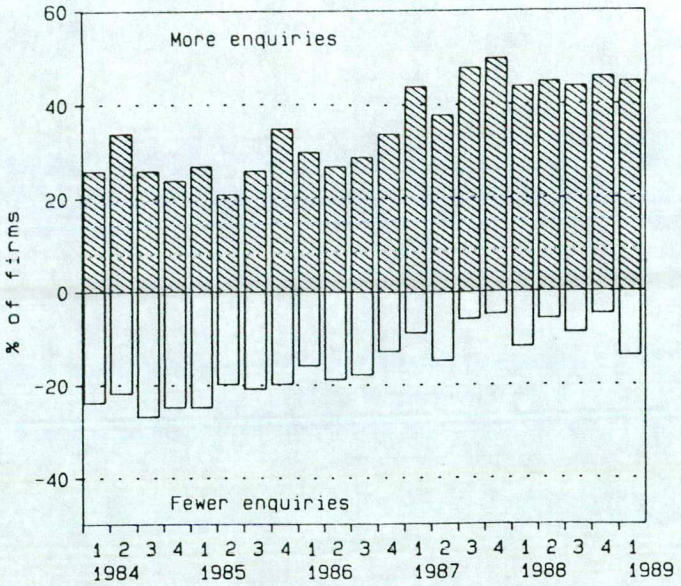
		1989	1990	1991	1992
Total output	NEDO(1)	3.0	0.0		
	BMPC(2)	2.0	1.5	2.5	
	OEF (3)	2.4	1.1	3.5	2.9
Total new work	NEDO	3.5	-2.0		
	BMPC	2.5	1.0	3.0	
Housing	NEDO	-3.8	-5.9		
	BMPC	-10.5	-2.0	6.5	
Public	NEDO	-11.0	-3.0		
	BMPC	-8.0	0.0	0.0	
Private	NEDO	-3.0	-6.0		
	BMPC	-10.5	-2.0	7.5	
Non-housing	NEDO	7.3	-0.2		
	BMPC	8.5	2.5	1.5	
Public	NEDO	2.0	1.0		
	BMPC	2.0	1.0	2.0	
Priv ind	NEDO	4.0	-7.0		
	BMPC	10.0	0.0	3.0	
Priv comm	NEDO	13.0	3.0		
	BMPC	12.0	5.0	0.0	
Repair and maintenance	NEDO	3.0	2.0		
	BMPC	2.0	1.5	2.0	

(1) NEDO - JFC Dec 1988 (2) Building Materials Producers Council - April 1989

(3) Oxford Industry Forecast - May 1989

45. The May BEC survey also points to buoyant short term prospects for the industry, quoting an expected growth rate this year of 3-4 per cent. This is based upon a maintained high positive balance between respondents reporting more and fewer enquiries (see table A3 and chart 13). Although the balance fell slightly in the first quarter, this was mainly confined to the private housing sector. The private industrial and commercial sectors remained strong, possibly reflecting some pressure to complete contracts before the imposition of VAT on non-housing construction in April 1989.

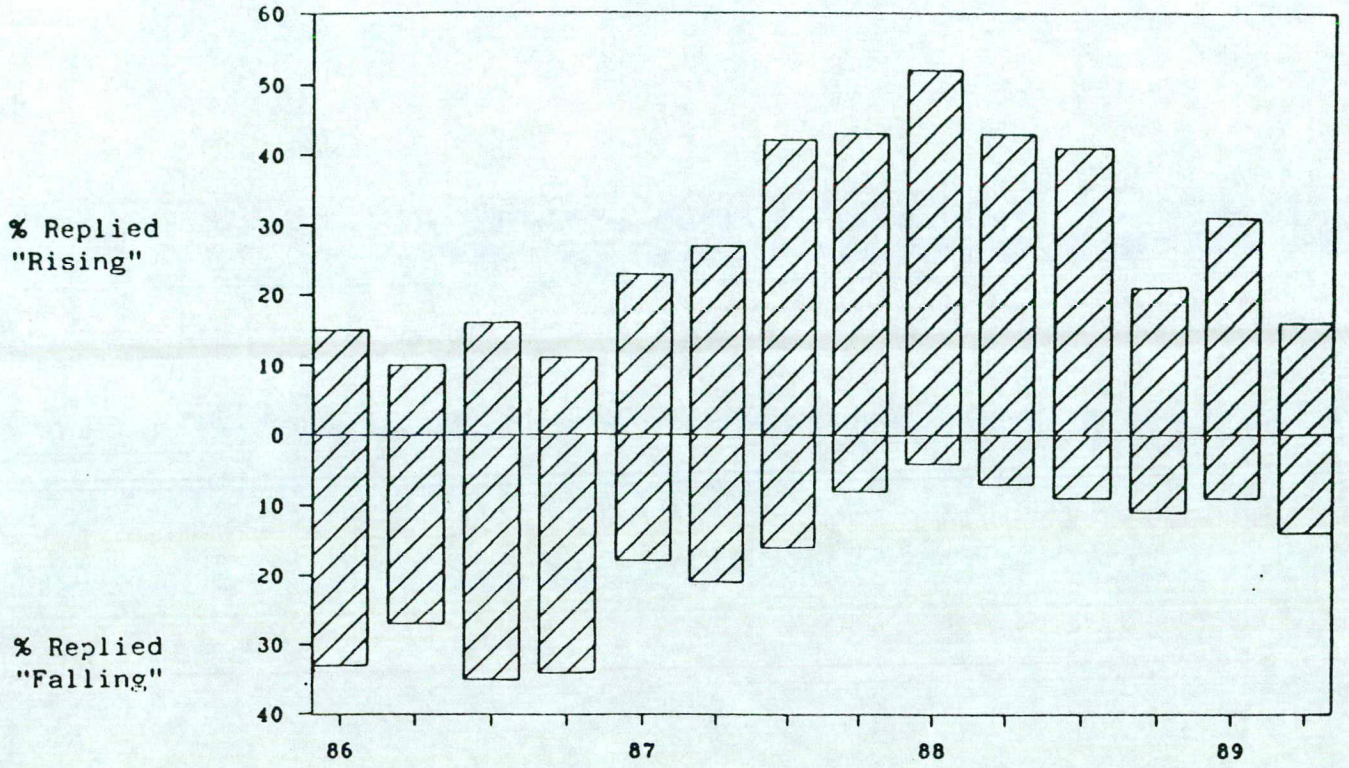
Chart 13: Building Employers Confederation: Change in new enquiries



46. The proportion of respondents anticipating an increasing workload in the year ahead dropped marginally in the first quarter to 72 per cent, still at a high level, although below that for 1988. Over the longer term the survey is a little less optimistic, with a halving in the percentage of firms reporting work in hand stretching forward more than 12 months (see table A4).

47. Other evidence on prospects for output comes from the **Federation of Civil Engineers April Workload Survey**, which reports a fall in the proportion of firms expecting a rising trend in orders for new work - from 31 per cent in January to 16 per cent. This fall in optimism is most marked amongst larger firms where nearly half expect a fall in orders for new work in the coming year (Chart 14).

Chart 14: Federation of Civil Engineering Contractors: Expectations for new work



48. The **DTI investment intentions survey** (June 1989)[1] would appear to indicate very strong growth in non-housing construction output in 1989, with investment in new buildings and works forecast to rise by 27 per cent.

Table 11: DTI: Investment in other new buildings and works

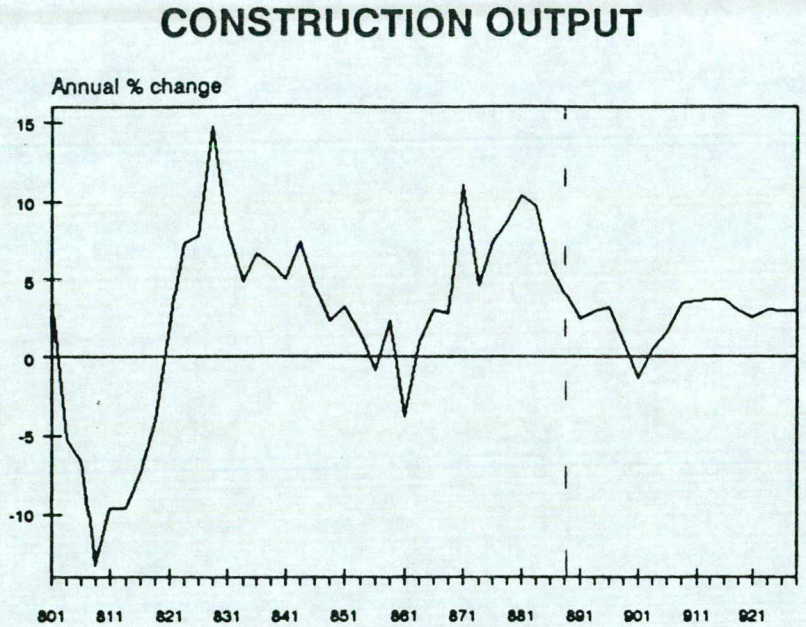
£1985m	By Manufacturers (excl leased assets)	%	By construction distribution and services	%	Total	%
1988	1227	7.2	7965	21.3	8922	15.7
1989	1665	35.7	9673	21.4	11338	27.1
1990	1341	-19.5	10329	6.7	11670	2.9

49. Finally a forecast for construction was included in the recently published Industrial forecast produced by **Oxford Economic Forecasting**. Using a highly disaggregated model of the economy they predict a decline in construction industry output growth to 1 per cent in 1990, whereafter output picks up again to grow in line with the rest of the economy up until 1992 (see table 10).

(1) Not yet published

The slowdown is mainly attributed to the slowdown in the housing market and in output for the private industrial sector (which they find to be strongly correlated with growth in general manufacturing output). Output for the commercial sector and of repairs and maintenance are assumed to respond more sluggishly to the downturn in the economy.

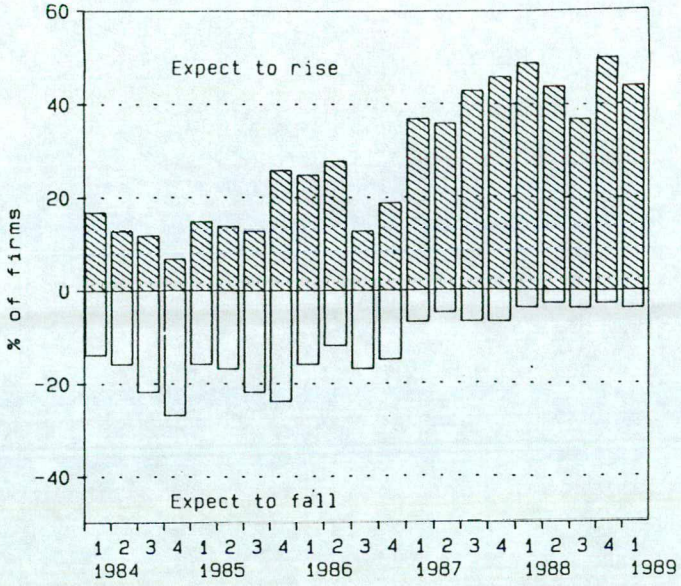
Chart 15: Oxford Economic Forecast - May 1989



(ii) Employment

50. According to the BEC the number of operatives in the industry should continue to rise. Over two fifths of members plan to increase employment on their sites during the second quarter of 1989 whereas just four per cent intend to cut back (see chart 15 and table A5). A less buoyant outlook is suggested by the FCEC for the short term, with a levelling off in employment as workload flattens out.

Chart 16: Building Employers Confederation
Employment of Operatives on Site



(iii) Prices

51. The only survey evidence on prospects for prices comes from the BEC survey. Expectations of tender price movements vary from sector to sector. The anticipated increases in prices of new private housing work and public non-housing work have shown a downturn in the first quarter, whereas the expectations of tender price inflation in the private commercial and industrial sectors remain bullish (see charts 16 and 17). Taking the industry as a whole the survey suggests 'little prospect of an imminent slowdown in .... inflation'.

52. The evidence presented here would seem to confirm this view. Given that the industry is clearly at or near full capacity, and that output is expected to continue rising, albeit at a slower rate than recently, it seems likely that there will be a further rise in construction output prices relative to the general price level in 1989. If output flattens out in 1990 pressure on prices could ease.

B COULTON
EA1

7 June 1989

Chart 17: Building Employers Confederation

EXPECTED CHANGE IN TENDER PRICES

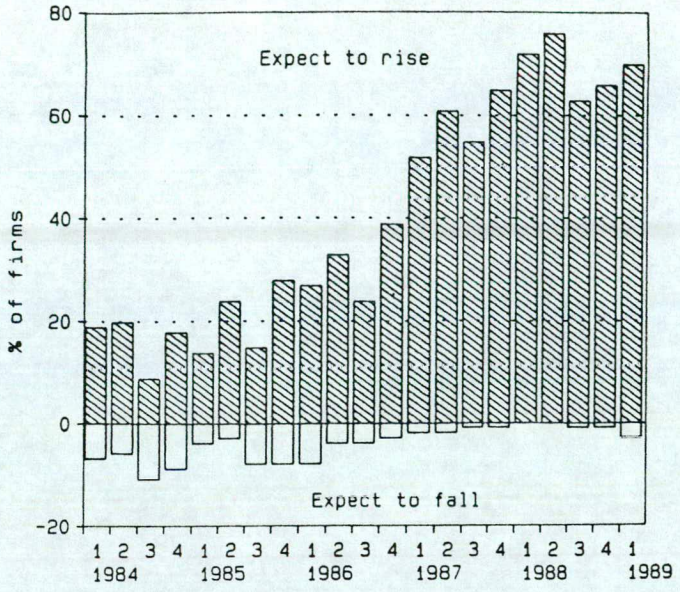
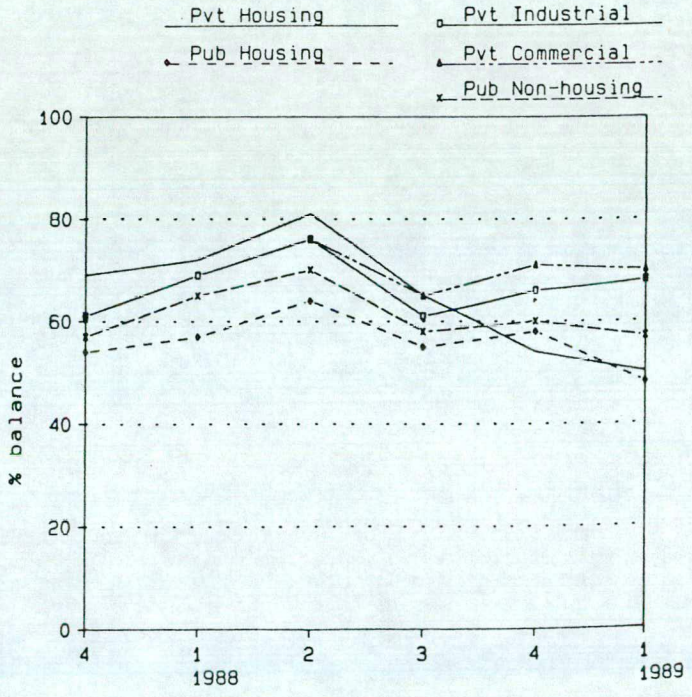


Chart 18: Building Employers Confederation

% BALANCE BETWEEN FIRMS EXPECTING RISING AND FALLING TENDER PRICES



ANNEX A

Tables from May 1989 Building Employers Confederation Survey.

Table A1:

MANPOWER, MATERIALS AND DELAYS
(Latest quarter)

% OF FIRMS REPORTING SERIOUS DELAYS TO WORK

	FACTOR CAUSING DELAYS			
	Materials shortages	Manpower shortages	Non-availability of sub-contractor input	Non-availability of plant
Scotland	12	29	5	0
Northern	4	8	0	0
North Western[1]	18	6	0	0
Yorkshire	0	0	11	0
Midlands	2	0	0	0
Eastern	0	4	0	0
South Wales	0	5	0	0
South Western	4	4	4	4
Southern	0	0	0	0
London	0	0	8	0
Nat. Contractors	0	0	0	0
Total	2	3	2	0
Total Preceding Quarter	8	5	5	0

% OF FIRMS REPORTING DIFFICULTIES IN SECURING

	Brick-layers	Carpen-ters	Plaster-ers
Scotland	88	84	66
Northern	79	69	66
North Western	52	58	67
Yorkshire	65	74	56
Midlands	67	90	58
Eastern	46	45	48
South Wales	43	51	53
South Western	67	78	76
Southern	82	82	87
London	78	78	89
Nat. Contractors	87	74	68
Total	75	75	69
Total Preceding Quarter	84	84	53

[1] Includes Liverpool

FIRMS' EXPERIENCE OF MATERIALS DELAYS (%)

		Delay		
	No Delay	Up to 2 Weeks	2 Weeks - 2 Months	Over 2 Months
Common Bricks	31	26	42	2
Facing Bricks	8	8	44	40
Roof Tiles	31	30	32	7
Concrete Blocks	41	33	26	0
Aggregates	78	19	3	0
Plumbing and Bathroom Fittings	32	16	42	10
Reinforcing Steel	21	29	46	3
Structural Steel	11	6	28	54
Timber and Joinery	47	29	20	3

Table A2:

PRESENT CAPACITY *

% OF FIRMS OPERATING AT

	Full or Almost Full	¾- ⅔	No More Than ½
1984	27	66	8
1985	34	60	6
1986	43	51	7
1987	57	40	2
1988	67	32	1
87q1	47	50	3
q2	54	42	4
q3	61	37	1
q4	67	32	1
88q1	69	30	1
q2	67	33	1
q3	64	34	1
q4	68	31	1
89q1	71	29	0

% BALANCE BETWEEN FIRMS OPERATING AT FULL AND NO MORE THAN HALF CAPACITY, BY REGION

	88q1	88q2	88q3	88q4	89q1
Scotland	30	66	53	62	66
Northern	34	27	34	47	73
North Western[1]	35	57	54	61	67
Liverpool	19	33	86	-	-
Yorkshire	80	72	73	55	74
Midlands	45	71	55	60	86
Eastern	74	80	73	37	57
South Wales	86	75	84	75	59
South Western	88	72	76	79	77
Southern	71	48	61	89	52
London	82	84	71	57	77
Nat. Contractors	81	64	67	77	68

1 Includes Liverpool from 88q4

% BALANCE BETWEEN FIRMS OPERATING AT FULL AND NO MORE THAN HALF CAPACITY, BY SIZE

Operatives Employed on Site [1]	88q1	88q2	88q3	88q4	89q1
<25	49	59	68	52	60
25-59	59	62	67	60	59
60-114	55	55	61	67	64
115-299	64	62	68	53	63
300-599	58	61	49	74	71
600-1199	73	64	66	46	69
1200+	83	77	70	82	80

1 Directly and indirectly

* In considering these statistics, it is essential to recognise that capacity itself changes over time.

Table A3:

NEW ENQUIRIES
(Change compared with preceding quarter)

FIRMS REPORTING INCREASED NEW ENQUIRIES (%)

	88q1	88q2	88q3	88q4	89q1
Scotland	76	31	40	43	69
Northern	48	35	37	64	36
North Western[1]	38	31	43	51	28
Liverpool	69	53	49	-	-
Yorkshire	50	66	50	35	45
Midlands	45	39	50	56	55
Eastern	49	39	39	32	30
South Wales	58	56	11	11	26
South Western	49	50	51	30	66
Southern	51	35	46	54	41
London	48	60	61	71	57
Nat. Contractors	25	47	41	43	35
Total	44	45	44	46	45

1 Includes Liverpool from 88q4

% BALANCE BETWEEN MORE AND FEWER ENQURIES, BY SECTOR

		Private New Housing	Public New Housing	Private Industrial and Commerical		Public Non-Housing	Housing Repair & Maintenance	Non-Housing Repair & Maintenance	All Works
1984	q1	+ 9	−32	+12		− 5	+ 8	− 7	+ 9
	q2	− 7	−37	+12		−12	− 2	− 4	+ 4
	q3	−20	−42	+ 10		−14	− 5	− 9	− 1
	q4	−23	−37	+16		−20	−15	−22	+ 2
1985	q1	+ 5	−26	− 3		−20	−19	−11	+ 2
	q2	−12	−48	0		−24	−15	− 6	+ 1
	q3	0	−31	+ 9		−19	− 5	−10	+ 5
	q4	+17	−13	+12		− 9	+ 4	− 1	+15
1986	q1	+ 5	−33	+16		− 4	− 2	+ 4	+ 4
	q2	+13	−26	−18		−15	− 3	−10	+ 8
	q3	+ 7	−26	+ 1		−11	− 3	− 8	+11
	q4	0	−16	+14		+ 9	+11	− 1	+21
1987	q1	+16	−24	+42		+ 2	+12	− 1	+35
	q2	+15	−23	+22		− 1	− 9	− 7	+23
	q3	+13	−14	+42		− 1	+ 3	+ 3	+42
	q4	+17	− 1	+47		+12	+11	+10	+45
1988	q1	+17	−12	+34		+ 1	+ 6	− 3	+32
	q2	+15	−25	+48		+ 7	− 4	+ 3	+39
	q3	+16	−29	+40[1]	+40[2]	− 4	− 9	− 7	+35
	q4	−10	0	+22	+45	+14	− 1	+ 5	+41
1989	q1	−14	−16	+24	+36	− 1	+ 9	+ 9	+31

1 = Industrial Enquiries 2 = Commercial Enquiries

Table A4:

WORK-IN-HAND
(Latest quarter)
% OF FIRMS REPORTING

Operatives Employed on Site [1]	Months					
	0-3	3-6	6-9	9-12	12-18	18+
<25	60	25	4	7	3	0
25-59	46	28	19	3	3	0
60-114	19	41	25	12	2	2
115-299	6	40	32	16	4	2
300-599	5	23	45	18	9	0
600-1199	0	22	33	22	11	0
1200+	0	9	18	55	18	0
Total	6	22	29	30	11	0
Total Preceding Quarter	8	21	26	23	18	4

[1] Directly and indirectly

Table A5: EMPLOYMENT EXPECTATIONS
(For the next quarter)

% OF FIRMS ENVISAGING

	Rising	Unchanged	Falling
	EMPLOYMENT		
1984	12	68	20
1985	17	64	20
1986	21	64	15
1987	41	53	7
1988	45	52	4
$87q_1$	37	56	7
q_2	36	59	5
q_3	43	50	7
q_4	46	47	7
$88q_1$	49	48	4
q_2	44	52	3
q_3	37	59	4
q_4	50	47	3
$89q_1$	44	52	4

% BALANCE BETWEEN RISING AND FALLING EMPLOYMENT, BY REGION

	88q1	88q2	88q3	88q4	89q1
Scotland	15	48	36	42	72
Northern	24	19	20	35	-4
North Western[1]	28	21	13	25	42
Liverpool	7	10	-2	-	-
Yorkshire	29	41	40	11	35
Midlands	42	44	60	51	38
Eastern	26	35	15	26	17
South Wales	24	36	12	37	36
South Western	71	54	25	35	52
Southern	17	27	32	36	29
London	60	50	24	67	44
Nat. Contractors	65	44	34	62	46

[1] Includes Liverpool from 88q4

Table B1 Past NEDO forecasts of total construction output (all work)*

Forecasts for :-	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988
Date of forecast:-													
Jan 76	-2	0											
Jul 76	-2	-2	0										
Jun 77		-4	-2										
Dec 77		-6	3	2									
Jun 78			2	2	1								
Aug 79				-2	-2	0							
Jun 80					-5	-3	0						
Dec 80					-6	-6	-1						
May 81						-7	-1	4					
Dec 81						-11	-3	3					
Jun 82							1	3	3				
Dec 82							1	4	2				
Jun 83								5	2	0			
Dec 83								3	1	-1.5			
Jun 84									2.5	0	-1		
Dec 84									4	-0.5	0		
Dec 85											2	1.5	1
Dec 86											2.5	3	1
Jun 87												4.5	3
Dec 87												7.5	3
Jun 88													8
Outturn	-1.5	-0.4	7.5	1.6	-4.7	-9.6	1.3	4.6	3.3	1.1	3.3	7.8	7.1

* All figures refer to percentage change on a year earlier in output at constant prices

FROM: SIR T BURNS
DATE: 18 JULY 1989

CHANCELLOR

cc Sir P Middleton
Mr Wicks
Mr Scholar
Mr Odling-Smee
Mr Peretz
Mr Gieve
Mr Hibberd
Mr O'Donnell
Mr Pickford
Mr Deane (EB)

Thanks.

CBI QUARTERLY INDUSTRIAL TRENDS SURVEY: JULY 1989

I attach the latest survey results and a short commentary by the CBI. I have pencilled in my estimates of the seasonally adjusted series in a few cases.

2. I find it difficult to interpret the results. They give a slightly less bearish impression if account is taken of normal seasonal variation; as you will recall the results for July are normally worse than for April.

3. On an unadjusted basis business confidence has fallen over the last few months, reflecting slower growth in orders and output. Investment intentions are less buoyant as capacity utilisation has fallen back. And although costs have picked up the rate of price increases has moderated.

4. On an adjusted basis business confidence fell sharply in April and the balance in July is much the same as in April (although interpreted literally this still means a further decline in confidence). The same pattern is evident for new orders and stocks of raw materials; a sharp change in April but not much change in July. Price pressures on an adjusted basis seem to have picked up and are now at the highest level since last December.

5. We will have to look closely at some of the other series on an adjusted and unadjusted basis. They bear out the seasonally adjusted results we computed in April and the market effect, which is much more dependent on the raw numbers, should be helpful.

T BURNS

THE JULY 1989 INDUSTRIAL TRENDS SURVEY

No. 113

Total Response: 1336, Trade Response: 905

Conducted between 21 June and 12 July 1989

The July Industrial Trends Survey shows business confidence falling significantly over the last four months, reflecting slower growth in demand and output. Over the next four months, both output and orders are expected to rise at rates similar, to April's expectations. Investment intentions are now markedly less buoyant than in April, as capacity utilisation has fallen back and demand prospects have moderated. The rate of increase in unit costs picked up in the last four months, but is now expected to be broadly stable while the rate of price increases moderated quite significantly in the last four months. Though prices are now expected to pick up slightly, expectations are lower than in the April survey. Following slight growth in the four months to July, employment is now expected to decline.

During the Survey period the pound averaged $1.58 and DM3.048, compared with $1.70 and DM3.193 over the April survey period. Sterling's effective exchange rate fell by 4.7% between the survey periods.

SUMMARY

Business confidence has fallen, on balance, for the third consecutive survey, after the continued increases in optimism seen in 1987 and 1988. Respondents indicated that they were markedly less optimistic than four months ago, with a balance of -19%, the lowest since October 1982, comparing with April's -5%.

Demand growth has moderated for the fifth consecutive survey despite April's expectations of a broadly stable rate of increase. Over the coming months, new orders are expected to grow a little more quickly, close to April's recorded rates, but well below the strong growth rates reported throughout 1987 and 1988. Order books meanwhile have weakened since April: a balance of -5% now indicate them to be below normal, confirming the pattern of reduced demand growth observed over the past year.

The rate of growth in output has continued to slow, broadly as expected in April. A balance of +10% of firms indicating output increases over the past four months is the lowest since January 1987 and considerably below the growth rates seen over the past two years. With output slowing a little less than demand, stocks of raw materials and finished goods have built up slightly. However, over the next four months, output is expected to rise by a balance of only +14% of firms, and stocks are expected, on balance, to decline.

Investment intentions have weakened significantly since April, partly reflecting lower capacity utilisation and expectations of moderate demand growth. A balance of 3% of manufacturers expect to increase investment over the next twelve months, suggesting a marked slowing in investment growth. The proportion of firms operating below capacity

has risen to 39%, from 37% in April and 31% in the preceding three surveys. 85% of firms now report their capacity at least adequate to meet expected demand over the next twelve months, and fixed capacity as a constraint on output has fallen further to 19%. Orders or sales, as a limiting factor on output, has fallen from 72% to 70%. Though skilled labour has increased as a constraint from 22% in April to 24% now, it remains below last October's level.

For the eighth survey in succession, employment has increased, albeit slightly: a balance of +2% of firms report increases in their workforce over the past four months despite April's expectations of a slight decline. Over the next four months, employment is expected to fall by a balance of -3% of companies, although as in previous surveys smaller firms expect further employment growth.

The rate of increase in unit costs picked up over the last four months, consistent with April's expectations, though factory gate prices rose rather more slowly than expected in April. Unit cost growth is now expected to stabilise slightly below rates reported over the past four months. Though the rate of price increases is expected to pick up slightly, expectations are lower than in the April survey and broadly similar to those a year ago.

Export optimism has increased since April. A balance of +2% now compares with -5% and -9% respectively in January and April. Export orders grew very little over the last four months, despite April's expectations of a pick up, but resumed growth is now expected in the coming months. Order books, nonetheless, remain on balance below normal. Export prices slowed as expected in April, but now are expected, on balance, to pick up slightly, though only 24% of companies expect to raise prices in overseas markets. Prices as a constraint on export orders are now cited by 62% of firms, as against 70% in April, while the proportion reporting delivery dates as a constraint has risen to 17%, though below last October's 21%.

Industrial Trends Survey: summary of results July 1989

CBI

The results of the Survey are available for twelve broad industry groups and for fifty individual industries engaged in manufacturing in the UK. Please see over for details.

Number of RESPONDENTS: Total Trade Questions **1336**

Export Trade Questions **905**

Number of RESPONDENTS in each employment size group:

(a) 0–199 **759** (b) 200–499 **315** (c) 500–4,999 **239** (d) 5,000 and over **23**

1 Are you more, or less, optimistic than you were four months ago about the general business situation in your industry

MORE	SAME	LESS
12	56	31

2 Are you more, or less, optimistic about your export prospects for the next twelve months than you were four months ago

MORE	SAME	LESS	N/A
22	54	20	3

3 Do you expect to authorise more or less capital expenditure in the next twelve months than you authorised in the past twelve months on:

a. buildings	23	34	30	13
b. plant and machinery	30	40	27	3

4 Is your present level of output below capacity (i.e. are you working below a satisfactory full rate of operation)

YES	NO	N/A
39	60	1

5 **Excluding seasonal variations,** do you consider that in **volume** terms:

	ABOVE NORMAL	NORMAL	BELOW NORMAL	N/A
a. Your present total order book is	22	50	27	1
b. Your present export order book is *(firms with no order book are requested to estimate the level of demand)*	20	47	29	5

	MORE THAN ADEQUATE	ADEQUATE	LESS THAN ADEQUATE	N/A
c. Your present stocks of finished goods are	17	62	8	13

Excluding seasonal variations, what has been the trend over the PAST FOUR MONTHS, and what are the expected trends for the NEXT FOUR MONTHS, with regard to:

	TREND OVER PAST FOUR MONTHS				EXPEXTED TREND OVER NEXT FOUR MONTHS			
	UP	SAME	DOWN	N/A	UP	SAME	DOWN	N/A
6 Numbers employed	24	54	22	+	18	60	21	+
7 **Volume** of total new orders	30	44	25	1	28	52	19	2
of which: a. domestic orders	29	48	23	1	24	56	18	2
b. export orders	24	49	23	4	24	55	18	3
8 **Volume** of output	27	55	17	1	26	60	12	1
9 **Volume** of: a. domestic deliveries	28	51	21	1	28	54	16	1
b. export deliveries	24	52	20	3	27	52	18	3
10 **Volume** of stocks of: a. raw materials and brought in supplies	19	61	18	2	9	65	23	3
b. work in progress	17	59	19	5	8	65	20	6
c. finished goods	18	53	16	13	8	54	25	13

Excluding seasonal variations, what has been the trend over the PAST FOUR MONTHS, and what are the expected trends for the NEXT FOUR MONTHS, with regard to:

	TREND OVER PAST FOUR MONTHS				EXPEXTED TREND OVER NEXT FOUR MONTHS			
	UP	SAME	DOWN	N/A	UP	SAME	DOWN	N/A
11 Average costs per unit of output	38	55	6	1	38	50	8	4
12 Average prices at which: a. domestic orders are booked	25	67	8	1	34	54	8	4
b. export orders are booked	20	68	9	3	24	63	10	3

13 Approximately how many months' production is accounted for by your present order book or production schedule

LESS THAN 1	1–3	4–6	7–9	10–12	13–18	18	N/A
19	42	16	4	2	3	3	12

14 What factors are likely to limit your output over the next four months. Please tick the most important factor or factors.

ORDERS OR SALES	SKILLED LABOUR	OTHER LABOUR	PLANT CAPACITY	CREDIT OR FINANCE	MATERIALS OR COMPONENTS	OTHER
70	24	4	19	3	5	4

15 What factors are likely to limit your ability to obtain export orders over the next four months. Please tick the most important factor or factors.

PRICES (compared with overseas competition)	DELIVERY DATES	CREDIT OR FINANCE	QUOTA AND IMPORT LICENCE RESTRICTIONS	POLITICAL OR ECONOMIC CONDITIONS ABROAD	OTHER
62	17	8	7	23	11

16 a. In relation to expected demand over the next twelve months is your present fixed capacity:

MORE THAN ADEQUATE	ADEQUATE	LESS THAN ADEQUATE
23	62	15

b. What are the main reasons for any expected CAPITAL EXPENDITURE AUTHORISATIONS ON BUILDINGS, PLANT OR MACHINERY over the next twelve months:

to expand capacity	33	other (please specify)	10
to increase efficiency	70	N/A	7
for replacement	47		

c. What factors are likely to limit (wholly or partly) your capital expenditure authorisation over the next twelve months:

Inadequate net return on proposed investment	45	Uncertainty about demand	36
Shortage of internal finance	15	Shortage of labour including Managerial and Technical staff	9
Inability to raise external finance	1	Other *(please specify)*	2
Cost of finance	17	N/A	13

INDIVIDUAL INDUSTRIES IN THE CBI INDUSTRIAL TRENDS SURVEY

FOOD, DRINK AND TOBACCO
Food; drink and tobacco.

CHEMICALS
Industrial chemicals; agricultural chemicals; pharmaceuticals and consumer chemicals; man-made fibres.

METAL MANUFACTURE
Ferrous metals; non-ferrous metals.

MECHANICAL ENGINEERING
Constructional steelwork; heavy industrial plant; agricultural machinery; metal working machine tools; engineers' small tools; industrial machinery; contractors' plant; industrial engines; pumps and compressors; heating, ventilating and refrigerating equipment; other mechanical engineering.

ELECTRICAL AND INSTRUMENT ENGINEERING
Office machinery and data processing equipment; electrical industrial goods; electronic industrial goods; electrical consumer goods; electronic consumer goods; instrument engineering.

MOTOR VEHICLES AND OTHER TRANSPORT EQUIPMENT
Motor vehicles; shipbuilding; aerospace and other vehicles.

METAL PRODUCTS
Foundries; and forging, pressing and stamping; metal goods; hand tools and implements.

TEXTILES
Wool textiles; spinning and weaving; hosiery and knitwear; textile consumer goods; other textiles; footwear; leather and leather goods; clothing and fur.

OTHER MANUFACTURING
Paper, printing and publishing; all other manufacturing; extraction of minerals and metalliferous ores; building materials; glass and ceramics; timber and wooden products other than furniture, upholstery and bedding; pulp, paper and board; paper and board products; printing and publishing; rubber products; plastic products; other.

The full analysis of the results is available on a subscription basis. The annual subscription is £195 (CBI Members £120) and can be arranged through CBI Industrial Trends and Economic Forecasting Dept.

Printed by Spice Litho 24-28 Hatton Wall, London EC1
Published by Confederation of British Industry, Industrial Trends Department, Centre Point, 103 New Oxford Street, WC1A 1DU

CBI INDUSTRIAL TRENDS SURVEY: SUMMARY OF RESULTS FROM APRIL 1988 TO JULY 1989

(All figures are percentage balances * except where otherwise stated)

TOTAL TRADE		Apr 88	Jul 88	Oct 88	Jan 89	Apr 89	Jul 89
1 Optimism re business situation		+19	+ 8	+ 6	- 6	- 5	-19
3 12 month forecast of capital expenditure authorisations compared with previous 12 months on:		(9)	(12)	(9)	(-3)	(-14)	(-15)
a buildings		+ 6	- 6	- 4	- 9	- 1	- 7
b plant and machinery		+32	+19	+21	+21	+18	+ 3
4 Firms working below capacity[1]		32	31	31	31	37	39
6 Numbers employed	- past 4 months	+ 8	+ 8	+ 4	+14	+ 4	+ 2
	- next 4 months	+ 7	+ 9	+ 4	+ 1	- 2	- 3
7 Volume of new orders	- past 4 months	+31	+24	+21	+16	+ 7	+ 5
	- next 4 months	(25) +23	(26) +23	(24) +24	(17) +21	(1) + 9	(7) + 9
8 Volume of output	- past 4 months	+36	+27	+21	+30	+18	+10
	- next 4 months	+29	+27	+24	+18	+12	+14
10a Stocks of raw materials	- past 4 months	+ 2	+ 8	+ 1	+ 6	+ 5	+ 1
	- next 4 months	0 (-3)	- 5 (-6)	- 1 (2)	- 9 (-8)	-13 (-16)	-14 (-15)
b Stocks of work in progress	- past 4 months	+ 1	+ 7	+ 5	+ 8	- 6	- 2
	- next 4 months	- 3	- 3	- 6	-11	- 6	-12
c Stocks of finished goods	- past 4 months	+ 1	+ 5	- 8	+ 7	+ 4	+ 2
	- next 4 months	- 4	- 7	- 5	- 7	- 7	-17
11 Average unit costs	- past 4 months	+10	+24	+22	+22	+25	+32
	- next 4 months	+23	+19	+25	+34	+34	+30
12a Average domestic prices	- past 4 months	+28	+21	+26	+23	+33	+17
	- next 4 months	+31	+23	+32	+37	+30	+26
16a Firms with present capacity at least adequate to meet expected demand[1]		86	82	80	88	89	85
b Reasons for expected capital expenditure authorisations[1]							
Expand Capacity		39	39	42	40	35	33
Increase Efficiency		76	76	73	78	75	70
Replacement		45	48	43	45	52	47
Other		9	6	3	9	7	10
c Twelve month forecast of factors likely to limit capital expenditure authorisation[1]							
Inadequate net return		44	48	44	44	45	45
Internal finance shortage		20	18	18	17	16	15
Inability to raise external finance		2	1	1	1	1	1
Cost of finance		5	7	14	16	14	17
Uncertainty about demand		31	33	30	35	37	36
Labour shortage		6	7	12	11	8	9
Other		4	3	3	2	3	2

		Apr 88	Jul 88	Oct 88	Jan 89	Apr 89	Jul 89
14	Four month forecast of factors likely to limit output[1]						
	Orders or sales	68	60	56	66	72	70
	Skilled labour	19	22	28	25	22	24
	Other labour	3	6	4	5	3	4
	Plant capacity	26	26	29	17	21	19
	Credit or finance	2	2	2	2	2	3
	Materials/components	9	9	9	8	6	5
	Other	2	4	3	6	2	4
	EXPORT TRADE						
2	Optimism re export prospects	- 5	+ 8	+ 7	- 9	- 5	+ 2
7b	Volume of new export orders - past 4 months	+18	+12	+ 9	-15	+ 3	+ 1
	- next 4 months	+ 9	+12	+17	+20	+ 9	+ 6
9b	Volume of export deliveries - past 4 months	+20	+19	+13	+22	+10	+ 4
	- next 4 months	+11	+20	+21	- 8	+ 9	+ 9
12b	Average export prices - past 4 months	+10	+ 8	+10	+ 5	+21	+11
	- next 4 months	+ 8	+ 7	+22	+19	+10	+14
15	Four month forecast of factors likely to limit export orders[1]						
	Prices	70	61	61	61	70	62
	Delivery dates	14	14	21	9	12	17
	Credit or finance	8	5	7	8	5	8
	Quota and licence	10	5	7	6	8	7
	Political/economic conditions abroad	24	18	14	17	24	23
	Other	10	13	16	7	10	11

CBI Monthly Trends Enquiry: Time Series of results from July 1988 to July 1989

In the intervening months between the main quarterly Industrial Trends Surveys the CBI carries out a much abbreviated monthly Trends Enquiry. In the latter participants are only asked to answer five questions. These five questions are also included in the main quarterly Survey and the table below sets out the time series of results for the past year.

			Jul	Aug	Sept	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul
1a	Total Order Book	(Q.5a)*	+14 (17)	+17 (17)	+15 (17)	+11 (16)	+14 (14)	+14 (12)	+ 7 (13)	+ 3 (-2)	+ 6 (1)	+ 1 (2)	- 5 (-10)	- 6 (-6)	- 5 (-2)
1b	Export Order Book	(Q.5b)	+ 6 (3)	- 2 (2)	+ 2 (7)	- 2 (4)	- 4 (-6)	- 5 (-5)	- 9 (-5)	- 7 (-12)	- 8 (-14)	- 7 (-4)	- 9 (-13)	-14 (-16)	- 9 (-12)
2	Stocks	(Q.5c)	+ 1	0	0	+ 1	+ 6	+ 1	+ 7	+ 6	+ 9	+12	+ 8	+ 9	+ 9
3	Volume of Output	(Q.8)	+27	+33	+31	+24	+25	+27	+18	+26	+22	+12	+18	+13	+14
4	Average Prices	(Q.12a)	+23 (28)	+22 (28)	+26 (32)	+32 (35)	+33 (33)	+37 (32)	+37 (29)	+32 (25)	+27 (25)	+30 (27)	+25 (25)	+21 (28)	+26 (31)

* question number in quarterly survey

1 Percentage Figures

* The 'balance' is the difference between those replying 'more', 'up', 'above normal' or 'more than adequate' and those replying 'less', 'down', 'below normal' or 'less than adequate'.

EDTRENDS1P

Confederation of British Industry
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Telephone 01-379 7400
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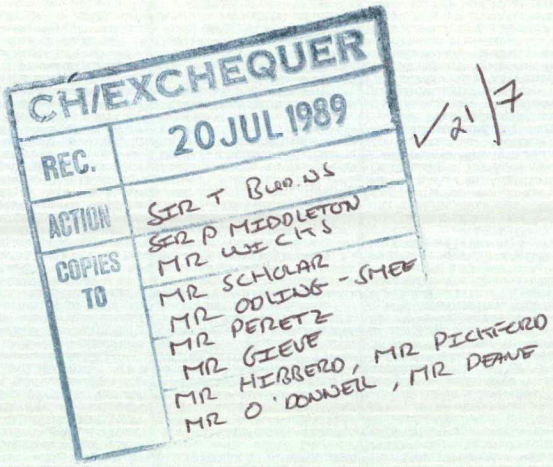
Facsimile 01-240 1578

From
John M M Banham
Director-General

CBI

CONFIDENTIAL



20 July 1989

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
H M Treasury
Treasury Chambers
Parliament Street
London SW1P 3AG

Dear Nigel

When we spoke last week I mentioned that we would shortly have the results of our July Industrial Trends Survey. Because of their importance at this stage of the business cycle I am now sending you an early copy in confidence. The full results will be released to the press at 11.30 am, Tuesday 25 July.

The Survey backs up the anecdotal evidence that I gave you in that it points to a significant deterioration in optimism and in investment intentions. It also shows a moderation of price increases in the past 4 months.

My economists will brief Sir Terence Burns on the full details of the survey results but I thought it important that you should see them as early as possible.

Yours sincerely

John M M Banham

Enclosure

Industrial Trends Survey: summary of results July 1989

CBI

The results of the Survey are available for twelve broad industry groups and for fifty individual industries engaged in manufacturing in the UK. Please see over for details.

Number of RESPONDENTS: Total Trade Questions **1336**

Export Trade Questions **905**

Number of RESPONDENTS in each employment size group:

(a) 0–199 **759** (b) 200–499 **315** (c) 500–4,999 **239** (d) 5,000 and over **23**

1 Are you more, or less, optimistic than you were four months ago about the general business situation in your industry

MORE	SAME	LESS
12	56	31

2 Are you more, or less, optimistic about your export prospects for the next twelve months than you were four months ago

MORE	SAME	LESS	N/A
22	54	20	3

3 Do you expect to authorise more or less capital expenditure in the next twelve months than you authorised in the past twelve months on:

a. buildings	23	34	30	13
b. plant and machinery	30	40	27	3

4 Is your present level of output below capacity (i.e. are you working below a satisfactory full rate of operation)

YES	NO	N/A
39	60	1

5 **Excluding seasonal variations,** do you consider that in **volume** terms:

	ABOVE NORMAL	NORMAL	BELOW NORMAL	N/A
a. Your present total order book is	22	50	27	1
b. Your present export order book is *(firms with no order book are requested to estimate the level of demand)*	20	47	29	5

	MORE THAN ADEQUATE	ADEQUATE	LESS THAN ADEQUATE	N/A
c. Your present stocks of finished goods are	17	62	8	13

Excluding seasonal variations, what has been the trend over the PAST FOUR MONTHS, and what are the expected trends for the NEXT FOUR MONTHS, with regard to:

	TREND OVER PAST FOUR MONTHS				EXPEXTED TREND OVER NEXT FOUR MONTHS			
	UP	SAME	DOWN	N/A	UP	SAME	DOWN	N/A
6 Numbers employed	24	54	22	+	18	60	21	+
7 **Volume** of total new orders	30	44	25	1	28	52	19	2
of which: a. domestic orders	29	48	23	1	24	56	18	2
b. export orders	24	49	23	4	24	55	18	3
8 **Volume** of output	27	55	17	1	26	60	12	1
9 **Volume** of: a. domestic deliveries	28	51	21	1	28	54	16	1
b. export deliveries	24	52	20	3	27	52	18	3
10 **Volume** of stocks of: a. raw materials and brought in supplies	19	61	18	2	9	65	23	3
b. work in progress	17	59	19	5	8	65	20	6
c. finished goods	18	53	16	13	8	54	25	13

Excluding seasonal variations, what has been the trend over the PAST FOUR MONTHS, and what are the expected trends for the NEXT FOUR MONTHS, with regard to:

	TREND OVER PAST FOUR MONTHS				EXPEXTED TREND OVER NEXT FOUR MONTHS			
	UP	SAME	DOWN	N/A	UP	SAME	DOWN	N/A
11 Average costs per unit of output	38	55	6	1	38	50	8	4
12 Average prices at which: a. domestic orders are booked	25	67	8	1	34	54	8	4
b. export orders are booked	20	68	9	3	24	63	10	3

13 Approximately how many months' production is accounted for by your present order book or production schedule

LESS THAN 1	1–3	4–6	7–9	10–12	13–18	18	N/A
19	42	16	4	2	3	3	12

14 What factors are likely to limit your output over the next four months. Please tick the most important factor or factors.

ORDERS OR SALES	SKILLED LABOUR	OTHER LABOUR	PLANT CAPACITY	CREDIT OR FINANCE	MATERIALS OR COMPONENTS	OTHER
70	24	4	19	3	5	4

15 What factors are likely to limit your ability to obtain export orders over the next four months. Please tick the most important factor or factors.

PRICES (compared with overseas competition)	DELIVERY DATES	CREDIT OR FINANCE	QUOTA AND IMPORT LICENCE RESTRICTIONS	POLITICAL OR ECONOMIC CONDITIONS ABROAD	OTHER
62	17	8	7	23	11

16 a. In relation to expected demand over the next twelve months is your present fixed capacity:

MORE THAN ADEQUATE	ADEQUATE	LESS THAN ADEQUATE
23	62	15

b. What are the main reasons for any expected CAPITAL EXPENDITURE AUTHORISATIONS ON BUILDINGS, PLANT OR MACHINERY over the next twelve months:

to expand capacity	33	other (please specify)	10
to increase efficiency	70	N/A	7
for replacement	47		

c. What factors are likely to limit (wholly or partly) your capital expenditure authorisation over the next twelve months:

Inadequate net return on proposed investment	45	Uncertainty about demand	36
Shortage of internal finance	15	Shortage of labour including Managerial and Technical staff	9
Inability to raise external finance	1	Other *(please specify)*	2
Cost of finance	17	N/A	13

INDIVIDUAL INDUSTRIES IN THE CBI INDUSTRIAL TRENDS SURVEY

FOOD, DRINK AND TOBACCO
Food; drink and tobacco.

CHEMICALS
Industrial chemicals; agricultural chemicals; pharmaceuticals and consumer chemicals; man-made fibres.

METAL MANUFACTURE
Ferrous metals; non-ferrous metals.

MECHANICAL ENGINEERING
Constructional steelwork; heavy industrial plant; agricultural machinery; metal working machine tools; engineers' small tools; industrial machinery; contractors' plant; industrial engines; pumps and compressors; heating, ventilating and refrigerating equipment; other mechanical engineering.

ELECTRICAL AND INSTRUMENT ENGINEERING
Office machinery and data processing equipment; electrical industrial goods; electronic industrial goods; electrical consumer goods; electronic consumer goods; instrument engineering.

MOTOR VEHICLES AND OTHER TRANSPORT EQUIPMENT
Motor vehicles; shipbuilding; aerospace and other vehicles.

METAL PRODUCTS
Foundries; and forging, pressing and stamping; metal goods; hand tools and implements.

TEXTILES
Wool textiles; spinning and weaving; hosiery and knitwear; textile consumer goods; other textiles; footwear; leather and leather goods; clothing and fur

OTHER MANUFACTURING
Paper, printing and publishing; all other manufacturing; extraction of minerals and metalliferous ores; building materials; glass and ceramics; timber and wooden products other than furniture, upholstery and bedding; pulp, paper and board; paper and board products; printing and publishing; rubber products; plastic products; other.

The full analysis of the results is available on a subscription basis. The annual subscription is £195 (CBI Members £120) and can be arranged through CBI Industrial Trends and Economic Forecasting Dept.

Printed by Spice Litho 24-28 Hatton Wall, London EC1
Published by Confederation of British Industry, Industrial Trends Department, Centre Point, 103 New Oxford Street, WC1A 1DU

CBI INDUSTRIAL TRENDS SURVEY: SUMMARY OF RESULTS FROM APRIL 1988 TO JULY 1989

(All figures are percentage balances * except where otherwise stated)

TOTAL TRADE		Apr 88	Jul 88	Oct 88	Jan 89	Apr 89	Jul 89
1 Optimism re business situation		+19	+ 8	+ 6	- 6	- 5	-19
3 12 month forecast of capital expenditure authorisations compared with previous 12 months on:							
a buildings		+ 6	- 6	- 4	- 9	- 1	- 7
b plant and machinery		+32	+19	+21	+21	+18	+ 3
4 Firms working below capacity[1]		32	31	31	31	37	39
6 Numbers employed	- past 4 months	+ 8	+ 8	+ 4	+14	+ 4	+ 2
	- next 4 months	+ 7	+ 9	+ 4	+ 1	- 2	- 3
7 Volume of new orders	- past 4 months	+31	+24	+21	+16	+ 7	+ 5
	- next 4 months	+23	+23	+24	+21	+ 9	+ 9
8 Volume of output	- past 4 months	+36	+27	+21	+30	+18	+10
	- next 4 months	+29	+27	+24	+18	+12	+14
10a Stocks of raw materials	- past 4 months	+ 2	+ 8	+ 1	+ 6	+ 5	+ 1
	- next 4 months	0	- 5	- 1	- 9	-13	-14
b Stocks of work in progress	- past 4 months	+ 1	+ 7	+ 5	+ 8	- 6	- 2
	- next 4 months	- 3	- 3	- 6	-11	- 6	-12
c Stocks of finished goods	- past 4 months	+ 1	+ 5	- 8	+ 7	+ 4	+ 2
	- next 4 months	- 4	- 7	- 5	- 7	- 7	-17
11 Average unit costs	- past 4 months	+10	+24	+22	+22	+25	+32
	- next 4 months	+23	+19	+25	+34	+34	+30
12a Average domestic prices	- past 4 months	+28	+21	+26	+23	+33	+17
	- next 4 months	+31	+23	+32	+37	+30	+26
16a Firms with present capacity at least adequate to meet expected demand[1]		86	82	80	88	89	85
b Reasons for expected capital expenditure authorisations[1]							
Expand Capacity		39	39	42	40	35	33
Increase Efficiency		76	76	73	78	75	70
Replacement		45	48	43	45	52	47
Other		9	6	3	9	7	10
c Twelve month forecast of factors likely to limit capital expenditure authorisation[1]							
Inadequate net return		44	48	44	44	45	45
Internal finance shortage		20	18	18	17	16	15
Inability to raise external finance		2	1	1	1	1	1
Cost of finance		5	7	14	16	14	17
Uncertainty about demand		31	33	30	35	37	36
Labour shortage		6	7	12	11	8	9
Other		4	3	3	2	3	2

		Apr 88	Jul 88	Oct 88	Jan 89	Apr 89	Jul 89
14	Four month forecast of factors likely to limit output[1]						
	Orders or sales	68	60	56	66	72	70
	Skilled labour	19	22	28	25	22	24
	Other labour	3	6	4	5	3	4
	Plant capacity	26	26	29	17	21	19
	Credit or finance	2	2	2	2	2	3
	Materials/components	9	9	9	8	6	5
	Other	2	4	3	6	2	4
	EXPORT TRADE						
2	Optimism re export prospects	- 5	+ 8	+ 7	- 9	- 5	+ 2
7b	Volume of new export orders - past 4 months	+18	+12	+ 9	-15	+ 3	+ 1
	- next 4 months	+ 9	+12	+17	+20	+ 9	+ 6
9b	Volume of export deliveries - past 4 months	+20	+19	+13	+22	+10	+ 4
	- next 4 months	+11	+20	+21	- 8	+ 9	+ 9
12b	Average export prices - past 4 months	+10	+ 8	+10	+ 5	+21	+11
	- next 4 months	+ 8	+ 7	+22	+19	+10	+14
15	Four month forecast of factors likely to limit export orders[1]						
	Prices	70	61	61	61	70	62
	Delivery dates	14	14	21	9	12	17
	Credit or finance	8	5	7	8	5	8
	Quota and licence	10	5	7	6	8	7
	Political/economic conditions abroad	24	18	14	17	24	23
	Other	10	13	16	7	10	11

CBI Monthly Trends Enquiry: Time Series of results from July 1988 to July 1989

In the intervening months between the main quarterly Industrial Trends Surveys the CBI carries out a much abbreviated monthly Trends Enquiry. In the latter participants are only asked to answer five questions. These five questions are also included in the main quarterly Survey and the table below sets out the time series of results for the past year.

			Jul	Aug	Sept	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul
1a	Total Order Book	(Q.5a)*	+14	+17	+15	+11	+14	+14	+ 7	+ 3	+ 6	+ 1	- 5	- 6	- 5
1b	Export Order Book	(Q.5b)	+ 6	- 2	+ 2	- 2	- 4	- 5	9	- 7	- 8	- 7	- 9	-14	- 9
2	Stocks	(Q.5c)	+ 1	0	0	+ 1	+ 6	+ 1	+ 7	+ 6	+ 9	+12	+ 8	+ 9	+ 9
3	Volume of Output	(Q.8)	+27	+33	+31	+24	+25	+27	+18	+26	+22	+12	+18	+13	+14
4	Average Prices	(Q.12a)	+23	+22	+26	+32	+33	+37	+37	+32	+27	+30	+25	+21	+26

* question number in quarterly survey

1 Percentage Figures

* The 'balance' is the difference between those replying 'more', 'up', 'above normal' or 'more than adequate' and those replying 'less', 'down', 'below normal' or 'less than adequate'.

EDTRENDS1P

UNCLASSIFIED

FROM: D I SPARKES
DATE: 4 SEPTEMBER 1989

C. Turk dealing.

MR RITCHIE

Mr Sparkes.
Two more pts.
(i) points on page 3-4 are only true of last 7 years (81-88) not last 8 years.
(ii) we lost export market share in 87 and 88 (page 12) but like could be to say "share broadly flat since 1983" or perhaps better to delete altogether.

PRIME MINISTER'S SPEECH AT CUMBRIAN NEWSPAPER AWARDS, 13 SEPTEMBER

No 10 have asked for the attached speech, which the Prime Minister is to give next week, could be checked for factual accuracy. This needs to be done by close today, as the Prime Minister is about to depart for her annual sojourn at Balmoral. I would be very grateful if you could take on this task and jot down your manuscript comments (no need for a typed minute; I shall be telephoning any comments you have to No 10).

DUNCAN SPARKES

CUMBRIAN NEWSPAPER EXPORT AWARDS

It is a great pleasure to be invited to present the fifth Export Awards made by Cumbrian Newspapers and to express appreciation on behalf of all guests to Cumbrian Newspapers for sponsoring the scheme.

For if a nation is to prosper, it is essential not just that enterprise and effort are rewarded but that success is valued and applauded.

Could I also say, Mr. Chairman, a special

word of thanks to Vernon Addison who retires shortly after a long and distinguished career, during which he was President of the National Guild of British Newspaper Editors in 1984.

Since 1981

ends Dec 88.

Mr. Chairman, over the past ~~eight~~ Seven years we have achieved a combination of strong 3% and steady growth not matched since the War. Over that time growth has averaged over

80-88 = 2.6%.

81-88 = 3.2

3 per cent.

The profitability and productivity of British industry have been transformed.

And this has not been simply a short term consumer boom for total investment has grown twice as fast as total consumption over the last 7 yrs 81-88. Business investment in 1988 was the highest ever recorded as a share of GDP.

This exceptional growth has brought great benefits not least for unemployment which has fallen for thirty six months in succession, faster than in any other major industrialised country.

And it has fallen in all regions, not least here in Cumbria - indeed it is below the national average.

But this strong growth has brought problems too.

Inflation has risen to a level which is undeniably too high but the necessary measures have been taken and will be sustained until it is brought down again.

I recognise the difficulties that high interest rates bring for families as for companies, but we must never forget the lessons of the 1960's and 1970's when

inflation was not tackled robustly enough.

With the comfort of rising living standards and increasing numbers of jobs there is another lesson which once seemed learned but is now in danger of being forgotten - the danger of excessive pay settlements. It used to be said that one man's pay increase was another man's price increase.

But it can be worse than that for excessive pay increases put at risk jobs and the investment needed to sustain them.

We have also seen the emergence of a large current account deficit.

In part this is the consequence of the strength of the domestic economy.

It was to be expected that with a substantive increase in living standards

demand for imports would rise.

But another important reason for the deficit has been the surge of investment in the UK, leading to a significant increase in imports of capital goods.

But that will add to our industrial efficiency and should in future boost our exports further.

In the meantime the deficit can be sustained, provided the Government is seen to pursue the firm fiscal and monetary policies required to defeat inflation.

But in concentrating on the trade balance we should not overlook what has been achieved by exports.

In 1988 the United Kingdom exported goods and services worth £108 billion, that is

almost ~ 1,900

£2000 for every man, woman and child in the country.

And in the last three months visible exports excluding oil and erratic items were 9 per cent higher in real terms than in the same period a year ago.

Exports account for a quarter of the UK's Gross Domestic Product - a higher proportion than in the US, or France, or even Japan.

After decades of decline we have ~~maintained our share of world trade in manufactures since 1981, and even increased our share in 1987 and 1988.~~ lost share in both 1987 and 1988

That's success.

But we need to build on it.

For today's markets are becoming more

international.

It is unrealistic to expect to supply all our needs for modern specialised equipment ourselves.

We need to benefit from the skills and expertise of others.

That is not something that need frighten us.

The UK has long been a major trading nation and increased trade has given us

the opportunity to specialise in areas in which we are efficient.

For this we need to be able to compete in markets larger than the UK itself.

That is why we are fully committed to the successful completion of the Single European Market which already takes over half our exports.

Around [x] of the [y] measures which

the Community agreed to take have been put into effect.

And in many areas such as exchange control and financial liberalization the UK is ahead of the field.

For British companies, it will mean a greater challenge from competitors but also many new opportunities - the prospect of trading in a large market of 320 million

people in some of the most prosperous countries in the world.

A vast market on our own doorstep.

Export markets can be profitable and a route to growth.

But they are also highly competitive, though the rewards are there for firms that are prepared

- to plan their approach to a new market

- meet the quality standards that will be expected of them

- and to make an effort to speak the customer's language.

These may sound like demanding standards,

especially for small firms.

There is valuable assistance available to exporters through the export services of the British Overseas Trade Board. Assistance in investigating foreign markets, finding agents and identifying sales leads. This can certainly help firms already exporting or thinking of doing so.

But only the individual running a business can decide whether he is prepared to make the commitment that is required to export successfully.

As those exporters here today will know, exporting is not a sideline - it requires the wholehearted involvement of a company from the top to the bottom.

I have been very pleased to see that from the small craft business through to the large international concern, Cumbrian firms are making an important contribution to the UK's overseas earnings.

The County boasts successful exporters in traditional sectors, such as engineering, chemicals and footwear, and the newer hi-tech industries - nuclear, electronics

Not checked Thurs.

and robotics.

During the last year, British Nuclear Fuels, whose major reprocessing operations are based at Sellafield, secured record overseas business of £169 million. Well over half of this was from Japan. The Company is one of Britain's biggest Yen earners and has contracts worth over 500 billion Yen or £2.5 billion.

BNFL's major project is its thermal oxide reprocessing plant currently under construction.

Two thirds of business for the first ten years of its operation is with overseas customers.

Moreover BNFL is currently negotiating with the Germans a further £1.6 billion of business for the plant to take its operations well into the next century.

I should also like to mention British Steel Track Products at Workington who in June this year secured their largest ever export order - a £12 million contract to supply rail track for the Calcutta-Delhi railway, won in the face of stiff international competition from Austria, Japan and Germany.

Last year it was one of Cumbria's hi-tech

firms, Oxley Developments, who beat off the competition to supply the state-of-the-art communications system used by sports commentators at the Seoul Olympics.

Ladies and Gentlemen, through today's event, our host, the Cumbrian Newspaper Group, have shown an exemplary commitment to encouraging exporters and ensuring that

companies' overseas successes are widely recognised and acknowledged.

I am sure you will join with me in congratulating today's winners who have made their contribution to our export success.

DTI figures
use narrow definition
of world

10 DOWNING STREET

LONDON SW1A 2AA

From the Principal Private Secretary

5 September 1989

Dear Duncan,

UK EXPORT PERFORMANCE

I showed you the draft speaking note which I had prepared for the Prime Minister to use when presenting the Cumbrian Newspapers Exports Awards at a lunch on Monday 11 September. Much of the material had been provided by the Department of Trade and Industry.

You queried the paragraph which read:

> "....we have maintained our share of world trade in manufactures since 1981, and even increased our share in 1987 and 1988".

You provided an alternative run of figures which showed the downward trend continuing, albeit not as rapidly as in earlier years.

I assume that the DTI had based their statement on the attached table which comes from DTI's "Monthly Review of External Trade Statistics - Annual Supplement 1989". I am not sure of the basis of the figures you quoted to me which I have marked in manuscript on the table. The main difference from the DTI series relates to the performance in 1987 and 1988.

Could you take this up with Ben Slocock in the Department of Trade and Industry to clarify the definitions being used and to establish which provides the better indication of the United Kingdom's performance. Pending that, I have taken this sentence out of the text.

I am copying this letter to Ben Slocock (Department of Trade and Industry).

Yours sincerely

Andrew Turnbull

(ANDREW TURNBULL)

Duncan Sparkes, Esq.,
HM Treasury.

820
5713

E1

UK AND MMC'S EXPORTS OF MANUFACTURES

seasonally adjusted

	Value US$ billion, Main Manufacturing Countries[2]			Volume Index 1985=100, Main Manufacturing Countries[2]		United Kingdom	
	Total	United Kingdom	UK share %	Index	Change on previous period %	Index	Change on previous period %
1970	154.3	16.4	10.6	45.0		61.7	
1971	173.9	18.8	10.8	48.4	7.5	66.7	8.1
1972	204.7	20.2	9.9	52.6	8.7	67.2	0.8
1973	271.9	24.6	9.0	59.7	13.5	75.9	12.9
1974	364.8	31.1	8.5	66.6	11.5	80.1	5.5
1975	391.7	35.5	9.1	63.7	-4.3	77.9	-2.8
1976	439.9	37.1	8.4	71.0	11.4	84.5	8.6
1977	501.6	45.0	9.0	74.2	4.6	90.9	7.5
1978	603.0	53.7	8.9	77.6	4.5	90.4	-0.5
1979	721.8	65.6	9.1	81.7	5.3	89.7	-0.8
1980	837.5	80.9	9.7	86.3	5.7	90.6	1.0
1981	818.6	69.9	8.5	88.4	2.4	85.2	-6.0
1982	774.2	65.3	8.4	84.9	-3.9	86.7	1.8
1983	769.7	60.7	7.9	87.2	2.7	86.5	-0.3
1984	820.5	62.5	7.6	96.1	10.2	94.3	9.1
1985	864.1	68.0	7.9	100.0	4.1	100.0	6.0
1986	1048.3	80.0	7.6	101.8	1.8	103.0	3.0
1987	1233.4	100.1	8.1	107.2	5.3	111.3	8.1
1988	1425.2	117.5	8.2	117.1	9.3	117.7	5.7
1970 Q1	36.6	4.1	11.2	43.3		62.9	
Q2	38.4	4.0	10.5	45.0	3.9	61.0	-3.1
Q3	39.0	3.9	10.0	45.5	1.0	57.9	-5.1
Q4	40.3	4.4	10.9	46.1	1.4	65.2	12.6
1971 Q1	41.2	4.2	10.3	47.1	2.1	62.7	-3.8
Q2	42.1	4.6	11.0	47.9	1.7	67.5	7.7
Q3	45.4	4.8	10.5	50.8	6.0	67.5	0.1
Q4	45.1	5.1	11.3	47.7	-6.0	69.2	2.4
1972 Q1	49.1	5.1	10.3	50.8	6.6	66.6	-3.7
Q2	49.9	5.2	10.5	51.6	1.4	67.4	1.3
Q3	50.2	4.4	8.7	52.0	0.8	58.8	-12.8
Q4	55.5	5.5	10.0	56.0	7.7	76.1	29.4
1973 Q1	59.7	5.6	9.5	57.5	2.8	74.0	-2.7
Q2	64.5	6.2	9.6	58.8	2.3	75.3	1.8
Q3	72.3	6.4	8.8	60.5	2.9	76.7	1.9
Q4	75.4	6.4	8.5	62.0	2.4	77.5	0.9
1974 Q1	80.0	6.6	8.3	65.0	4.8	77.9	0.5
Q2	90.3	7.8	8.6	67.0	3.2	80.0	2.7
Q3	96.2	8.3	8.6	68.0	1.4	82.4	2.9
Q4	98.3	8.4	8.5	66.3	-2.5	80.1	-2.8
1975 Q1	98.5	9.2	9.3	62.5	-5.8	78.6	-1.8
Q2	98.7	8.9	9.1	63.2	1.2	76.8	-2.3
Q3	95.5	8.5	8.9	63.4	0.3	75.8	-1.3
Q4	98.9	8.9	9.0	65.7	3.6	80.2	5.9
1976 Q1	103.4	9.2	8.9	68.8	4.7	81.8	1.9
Q2	106.8	9.1	8.6	70.8	2.9	85.7	4.9
Q3	112.5	9.3	8.2	71.7	1.3	84.0	-2.0
Q4	117.2	9.5	8.1	72.6	1.3	86.7	3.2

HMT figures ↓

7.81	
7.14	
7.26	
6.90	
6.80	
6.77	
6.82	
6.80	
6.47	

1 SITC Sections 5-8: UK Rev 3 throughout, others Rev 2 to 1987
2 See Table E2 for list of countries

CONFIDENTIAL

29/9/89.

[Ch/ The Channel Tunnel section, in particular, makes grisly reading]

D15

INVESTMENT AND FINANCING REVIEW 1989: TRANSPORT NATIONALISED INDUSTRIES

Note of a meeting held in the Chief Secretary's room, H M Treasury, on 22 September 1989

Present:	Treasury	Department of Transport
	Chief Secretary	Secretary of State
	Mr Monck	Sir Alan Bailey
	Mrs Lomax	Mr Osmotherly
	Mr Moore	Mr Stevens
	Miss Evans	Mr Bird
	Mr Guy	
	Mr Bowden	Welsh Office
	Mrs Chaplin	
		Mr Shortridge

The Chief Secretary opened the meeting by reminding the Secretary of State of the goal agreed by Cabinet of maintaining the downward trend in public expenditure as a share of GDP. The Department of Transport bids for road and rail amounted to a significant share of GDP over the Survey period. He recognised the problems which the Secretary of State faced and the case for giving transport a higher priority, but he could not accept bids on anything like the present scale. It was disappointing that in the case of roads the Secretary of State had so far felt unable to negotiate and had referred to seeking adjudication elsewhere. This did not present a meaningful basis for bilateral discussions; other colleagues with large bids were willing to negotiate constructively.

2. The Secretary of State stressed that he was prepared to negotiate. His point on roads had simply been that, whilst the Chief Secretary might find his bid unrealistic, for his part he found the Chief Secretary's suggestion of an increase in total Departmental bids approaching £1 billion over the three Survey years unrealistic. He recognised that his bids for rail were also very high, but higher spending on railways was unavoidable and was

a quite separate issue. Although he was responsible for roads as well as BR and the London Underground, the Secretary of State did not feel that it was useful to look at them all together. He could quite understand the Chief Secretary's concern, but in each area he had inherited unique problems and a uniquely pressing case for extra resources which, although he was doing all he could to moderate their demands, could not be ignored. The roads bid emerged from a study in which the Treasury had participated and which had been endorsed by Cabinet. On rail, also, higher spending could not be avoided although he could offer some reductions from his bid. The Chief Secretary said that the road and rails bids had to be looked at together. They represented a huge bid for resources for transport which would on its own, if conceded, make a material impact on the outcome of the Survey.

3. It was agreed to take the industries in the order set out in the Chief Secretary's letter of 19 September.

BRITISH RAIL

4. The Secretary of State explained that British Rail had originally asked for an extra £1.7 billion over the Survey period. The Board had reduced this to £1.4 billion, and the Department had persuaded them to reduce it further, to £1.1 billion. He accepted that this was still too high. He did however want to stress that this was not the fault of British Rail management, which on the whole were doing a good job in difficult circumstances. Subsidy was less than half of its peak level, and investment had risen. Projects such as the East coast electrification were being handled well. The problems arising out of the Channel Tunnel were due to British Rail having to break new ground, to a timetable not of its own choosing. They had not built a major railway line since the last century. Necessarily their first cost estimates had a large element of guesswork. Nobody had ever tried to build trains that would run in three different countries before: they could not adapt existing technology, and had to evolve brand new equipment. The product was an engineering miracle. Its price was coming out higher than hoped, but that was not BR's fault and it was a price which had to be paid if the UK was to link up to the Continent.

5. The **Chief Secretary** said that he did not want to make debating points about British Rail management. However, much of the improvement on the existing railway was due to the improved economic climate, and to more people travelling. Looking at unit costs of operations the evidence for improvement was less clear cut. Project control did not seem firm - the unit costs of Class 465 Networkers had risen by 64 per cent between last year and this year, and these did not represent the technical challenge of the Channel Tunnel trains. The quality of investment management had been criticised by the Vice Chairman's report to the Board in March, and again in the recent Touche Ross report. These management problems were an argument for investing more slowly in the big projects. The **Secretary of State** argued that the Touche Ross criticisms were relevant to small regional projects more than the big central ones. But having asked Touche Ross in, BR had not tried to rubbish their report. They were trying to deal urgently with what it said. British Rail had certainly benefited from revenue growth, but that did not explain the whole of their improved performance which was a credit also to management initiatives.

6. The **Secretary of State** added that he was currently looking for new top management. This should help to strengthen the corporation further. But in the meantime he could not just let the infrastructure deteriorate on the basis that there had been some management mistakes in the past. He shared the Chief Secretary's concerns, as did British Rail. The evidence was that things were getting better. However, the bid probably was unrealistic and, after looking at it carefully, the Secretary of State confirmed that he would meet the Chief Secretary's request to get the bid for the existing railway down to baseline, and possibly £30 million beyond. This would involve some unpopular measures. British Rail would fail to meet some of its service improvement targets, and there would be large fare increases. His officials would provide details of the proposed bid reductions. He expected the Treasury to support him if the RPI consequences or quality of service implications were criticised.

Channel Tunnel Phase I

7. The **Chief Secretary** welcomed the Secretary of State's offer, but stressed that he was looking for reductions below baseline in respect of the existing railway to accommodate cost increases on the new railway. He welcomed the Secretary of State's view that management was improving, but suggested that the new railway programme proposed would stretch the best established management, let alone one that was thought to be improving. He had asked for the 'new' railway bid to be brought down to baseline provision in respect of projects which were included in the baseline. This meant absorbing the cost overruns on Phase I of the Channel Tunnel, which were now almost 50 per cent above the approved ceiling and which he was not prepared to validate.

8. On the 'new' railway, the **Secretary of State** argued that there was less scope for reducing the bid. Within Phase I of the Channel Tunnel project, the largest increase was due to increases in the cost of the rolling stock. There was little that could be done about that. There was only one supplier in Europe capable of producing the rolling stock - GEC Alsthom - and the cost increases were the price that must be paid for the new technology. The **Chief Secretary** raised a wider issue about BR rolling stock procurement, which seemed to be planned to exceed UK supply capacity. There was already price escalation on the Networker programme as well as the Channel Tunnel rolling stock. British Rail should rephase their proposals to reduce demand. The **Secretary of State** felt that if completion of the EC internal market was to mean anything, it had to mean looking wider than UK industry to supply demand both for rail procurement and for road construction. There were railway suppliers in Europe who could be used, and there was a welcome trend to European mergers in the railway industry which was strengthening UK firms. The point about phasing of rolling stock supply was one which he recognised, however, and it had been taken into account in his proposals for getting the existing railway back to baseline.

9. The **Chief Secretary** asked why other elements of Phase I had risen in cost. He pointed out that the Waterloo terminus had more than doubled in price, and for example the cost of the Chislehurst to Dover resignalling had escalated. **Mr Osmotherly** said that the increase at Waterloo represented a change in design. The whole of the increase was expected to be covered by increased property receipts, but these might well fall outside the PES period. The **Chief Secretary** suggested that this timetable might be re-examined. The **Secretary of State** agreed to look into it, and into the apparent increase in resignalling costs. He argued that in big and novel projects like BR's preparations for the Channel Tunnel, unforeseen cost escalations should not come as a surprise to anyone. He agreed with the Chief Secretary that they had probably not seen the last of these surprises. It was in the nature of that sort of project for there to be upward revisions from earlier estimates as better information came along.

Freight

10. On Channel Tunnel freight the **Chief Secretary** asked why British Rail wanted to invest £230 million on a service that they expected to be uneconomic. He also expressed concern with freight on the existing railway. Railfreight Distribution was a commercial disaster, and BR seemed to be resisting private sector involvement. The **Secretary of State** agreed that there was a problem. BR were considering bringing Channel Tunnel freight within the joint venture that might build the high speed link. It was impossible to say how much this might help. But there was a widespread belief in the North that the Channel Tunnel would only benefit the South East. One reason for BR to retain regional freight depots was to demonstrate commitment to bringing benefits to the North. This was a political issue which they had not wished upon themselves. There were other pressures on Freight. They were to lose £150 million on their coal moving business as a result of the privatisation of the electricity generation. It was right to subject them to competitive pressure in that way, and for them to be squeezed as a result. He would, however, look further into the whole subject of Freight.

Channel Tunnel Phase II

11. The **Secretary of State** went on to say that British Rail would shortly be presenting their proposals on passenger through trains North of London. What they were proposing - at a cost of £70 million - was the absolute minimum that they could get away with, involving no more than four through trains a day. The **Chief Secretary** pointed out that there was no commitment to running through trains at all. The **Secretary of State** said that there had been enormous concern, in all debates on the subject, that all the benefits would be in the South East. That was why there was a commitment to publish proposals, and to run them from the first day. British Rail did not know whether it would be viable, but if the rolling stock was not used for through trains, it could be used for extra services stopping at London. The pressure for through services would not go away, and it would not be helpful to public expenditure planning for him to pretend that it would.

12. The **Chief Secretary** asked whether there was an economic railways case for a station at Ashford. The **Secretary of State** said that the case could only be made in development terms, but he was confident that costs would be recovered, though perhaps not all in the Survey period. On timing he agreed to look again, and to show how it could be financed. He pointed out that the station was essential to public support for the high speed line, and there would be an expectation that the station would be there when the Tunnel opened. The nature of the station would be affected by the outcome of proposals for the high speed line. As it was not clear what form the station would take, or exactly when, or what its net costs in the PES period might be, he felt that there could be a case for dropping it from the plans, and he would look into that.

Channel Tunnel Phase III

13. On Phase III and Kings Cross the **Secretary if State** explained that there had been no provision made, but everyone had known that they were coming. The bid consisted of blight compensation, and development costs. While there would be contributions from

developers these would not come within the PES period. The Kings Cross bid seemed to be for the absolute minimum possible, much of which was in respect of interest payments.

14. The **Chief Secretary** asked why British Rail were spending £100 million on blight compensation for properties outside the high speed corridor. He asked whether there was scope here for savings, or for faster turnover. The **Secretary of State** did not recognise the figure, which he would investigate, but he was sure that BR were only responding to apparently genuine hardship cases. They could not ignore, eg, doctors certificates reporting suicidal tendencies amongst householders near the route.

Fares

15. The **Chief Secretary** concluded the discussion of British Rail by asking about fares, and the real increase in gross pay costs implied by the Corporate Plan. The **Secretary of State** explained that increased fares were part of the package to bring the existing railway back to baseline. Last year's fare increases had been 50% bigger than the previous one, and he was proposing an increase this year 50% greater again. On gross pay costs, he felt that it was difficult to tell British Rail management exactly how to go about cutting their costs. He would however look at the planned rise.

London Regional Transport

16. The **Secretary of State** accepted that LRT's bids were massive. He understood the Chief Secretary's view that it was not the new management's job to rewrite public expenditure plans. However, the new management was there to clean up what was, in his view, a disgusting mess in many areas. London Regional Transport had nightmare potential without strong management. There must not be another Kings Cross. He had spoken at length with the new Chairman. The bids were high because the new management could not accept the standards of their predecessors. He was pleased that the Treasury was prepared to accept the part of the bid relating to safety.

17. The **Chief Secretary** recalled that London Regional Transport had been given £226 million for safety measures in the previous IFR and wondered why more was needed now? The **Secretary of State** explained that the earlier settlement had been in advance of publication of the full Fennell report. That report had then been followed up by other studies on areas that Fennell had not gone into fully. He said that he was satisfied that the identified safety element was genuinely for safety measures.

18. The **Secretary of State** then explained that he had identified non-safety savings of £283 million. This was made up of £134 million for capacity improvements on the Docklands Light Railway (to which the Government would be committed if Olympia and York were to proceed with the second phase of their Canary Wharf scheme), £56 million on investment in bus replacement and passenger information at bus stops, £14 million from the proposal to extend the East London line, and £79 million from a programme of fare increases. He had looked into London Regional Transport's inflation assumptions, but felt that as they were an all-London business it would be unreasonable to push them on their judgement.

19. The **Chief Secretary** thanked the Secretary of State for his proposal, but pointed out that this was only a reduction of around £300 million - and only around £150 million if Olympia and York called in the Government's DLR commitment - from a bid of £1 billion. He expressed scepticism of London Regional Transport's ability to manage this scale of investment.

20. The **Secretary of State** said that Mr Newton was a tough manager, with experience from running the Hong Kong Metro. He had discussed the programme with him, and believed that it was reasonable. He stressed that it was important to have a little expenditure on some of the things that might appear to be optional. For example, station cleaning and repainting encouraged passengers - who would be enduring 14 per cent nominal fare rises, and disruption at stations - to believe that things were happening in return: the new rolling stock etc would not arrive for some time.

21. The **Chief Secretary** asked how much investment in buses was now left in the bid, and why buses showed such great deterioration in operating costs. Given the forthcoming privatisation was there not scope for cutting investment, and leaving it to the private sector?

22. The **Secretary of State** explained that bus investment was already well below commercial replacement levels. Operating costs were rising as a result of increased traffic congestion. He would, however, have a hard trawl through the bid to see what further scope there was for reducing public expenditure by London Regional Transport.

Megaprojects

23. The **Secretary of State** stressed that these proposals involved wider political issues. He would have to take the views of colleagues which might require collective discussion in a different forum. Negotiations on the Jubilee extension had just been joined in earnest with Olympia and York, and they had at last made a cash offer which although it involved a sizeable sum, envisaged phasing over a period of 25 years. He had told Mr Reichmann that this was not attractive.

24. The **Chief Secretary** explained that he had several areas of concern, and was certain that the projects could not all go ahead on the timescale currently proposed. In his view discussion and decisions on the projects should be taken in a Survey context. It was important that, before the next bilateral discussion of the projects, Transport officials should continue to keep the Treasury abreast of their work and for full answers to be provided to the points made in Mr Major's letter of 3 July. The **Secretary of State** agreed that there should be further discussion at official level. He himself was meeting Olympia and York in the next week.

Civil Aviation Authority

25. The **Secretary of State** thanked the Chief Secretary for agreeing to his bid.

Conclusions

26. The **Chief Secretary** thanked the Secretary of State for what he had offered on BR and LUL, and for his agreement to look at

further possibilities for savings. But he stressed that there was still a long way to go and, in considering what might be acceptable, he would have to bear in mind the position on t[redacted] roads programme, as well as the megaprojects.

CE

H M Treasury
29 September 1989

MISS C EVANS
Private Secretary

Treasury Distribution:
those present
PS/Chancellor
Mr Anson
Mrs Case
Mr MacAuslan
Mr Mortimer

COVERING CONFIDENTIAL

PCT

CHIEF SECRETARY TO THE TREASURY

Thanks – Important to stress X ?

~~MR GIEVE~~ Chancellor

You may like to see this analysis of the DTp bids & likely outcomes.

JC.

we spoke.

£4 billion was £1.4 bn for roads (Annex B) £2.9 for BR/LRT etc.

The £2.9 is highly uncertain, we should improve on it – see paras 14 – 15 of Annex A.

The total bids were £6.6 billion (£3 billion for roads, £3.6 for BR/LRT)

Carys Evans

29/9/89. A

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NATIONALISED INDUSTRIES AND TRANSPORT MEGAPROJECTS

1. At the end of August, PE's provisional forecast outcome was for additions to the baseline of:

	1990-91	1991-92	1992-93
BR	350	400	400
LRT	175	275	275
Megaprojects	60	330	550
CAA	19	1	24
	604	1006	1249 = 2859

The latest position is as follows.

British Rail

2. Early in September the BR bid was reduced to give a more realistic profile of expenditure at Kings Cross. At the first bilateral on 22 September Mr Parkinson offered savings of £354 million over the 3 years. His officials have subsequently pointed out that the latest proposals for the rating revision of BR will cost an additional £12/26/44 million. This leads to net additional bids of:

234 295 314

3. In addition to the rates increase, this remaining bid is mainly to get ready for the Channel Tunnel opening in 1993 eg, rolling stock, terminal developments at Waterloo and Kings Cross, compensation for blighted property on the route of the proposed new rail link. There is no provision for work on the link itself on the assumption that this will be privately financed or, if not, deferred beyond the present Survey.

4. The bids are already below the end August forecast. There is probably not much scope for cutting the Tunnel related expenditure, though we are looking at the realism of the phasing. But there is a case for pressing for more cuts on the remaining railway business. These would be spread around but might, for example, fall on investment in the heavily subsidised Provincial sector. If, as a minimum, we went for reductions to baseline of all those projects in the baseline last year we would be looking for further savings of:

118 98 5

London Transport

5. At the bilateral Mr Parkinson offered reductions of £283 million over the 3 years. These included £56 million off buses, and real annual fares increases from January 1990 of 7/3/3%. But £134 million is for the upgrading of the Docklands Light Railway, and the Government have a contractual obligation to Olympia and York to carry out this upgrading if they proceed with Phase II of their Canary Wharf development. If they do proceed without releasing the DLR commitment, the £134 million (0/64/70) would have to be restored. They may be prevailed upon to release the DLR from its obligations as a quid pro quo for a Jubilee line extension.

6. Assuming the DLR savings stand, the bid is now for:

1990-91	1991-92	1992-93
186	269	269

ie, very near to the end August forecast.

7. The bid provides for £350 million extra expenditure on Underground safety measures, which we have not challenged, and for major upgrading of the present system (eg, the Central and Northern Line). We might look for some modest cuts on Underground investment which is so far untouched. But allowing for all the upgrading strengthens our case for deferring one or more of the megaprojects designed to relieve congestion.

Transport Megaprojects

8. Transport assume Private Bills in November 1989 for:

a. **East/West Crossrail** (total estimated cost **at 1989 prices** £1½ billion). BR gauge tunnel linking Paddington and Liverpool Street;

b. Jubilee Extension serving Docklands (£1 billion) - Green Park, Waterloo, Canary Wharf, Stratford.

And in November 1990 for:

c. Chelsea/Hackney tube line from southwest to northeast London (£1½ billion).

Work would then start as soon as the Bills were through - the assumption is about 18 months - though there would be some expenditure on safeguarding the routes beforehand.

9. The bids are for:

	1990-91	1991-92	1992-93
East/West Crossrail	70	345	455
Chelsea/Hackney	-	17	257
Jubilee extension	21	51	210

10. PE's forecast outcome assumed deferment for at least one year of Chelsea/Hackney, some reductions for realism on East/West Crossrail, and developers' contributions to the Jubilee extension.

11. The megaprojects will be discussed at the bilateral on 4 October. The cost/benefit analyses are unconvincing. Transport are pessimistic on getting significant financing contributions from fares. Provisionally our position might be:

a. the Jubilee extension to serve Docklands will go ahead if Olympia and York and other developers make adequate contributions (NB the Prime Minister is very committed to this project);

b. Chelsea/Hackney should certainly be deferred by at least one year, giving large savings in 1992-93;

c. in addition, East/West Crossrail should be deferred by one year, leading to large savings in 1991-92.

Civil Aviation Authority

12. The bid has been accepted. It is mainly for the new National En-Route Centre to provide air traffic control for planes flying over Britain.

Latest assessment of possible outcome

13. We have already reached the position that we are bound to do better than the provisional forecast outcome of £2859 million additions.

14. If we got about £150 million more off BR, settled on the present position on LRT, and achieved the outcome on the megaprojects assumed in paragraph 11 the outcome would be in the order of:

	1990-91	1991-92	1992-93
BR	190	240	260
LRT	186	269	269
Megaprojects	60	55	460
CAA	19	1	24
TOTAL	455	565	1013 = 2033

NB: There would still be some expenditure in the first 2 years on E/West Crossrail to safeguard routes (and there is a risk that it would turn out to be more than we have assumed from Transport's work so far). The assessment arbitrarily assumes a £130 million developers' contribution to the £282 million Jubilee extension costs in the period.

15. But if East/West Crossrail went ahead as Transport wish, and only Chelsea/Hackney were postponed, the figures would be:

Megaprojects	85	375	575
TOTAL	480	885	1128 = 2493

and if there were no further savings on BR the total would be:

524 940 1182 = 2646

B.

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PES 1989: FORECAST OUTCOME FOR DEPARTMENT OF TRANSPORT, EXCLUDING NATIONALISED INDUSTRIES

1. The forecast outcome for DTp's departmental bids is £1.4 billion over the three Survey years. This represents a cut of over 50 per cent in DTp's bids. The table below shows the breakdown of the forecast outcome by year and by expenditure category:

	1990-91	1991-92	1992-93	Total
National roads:				
- new construction	210	355	430	995
- maintenance	85	100	100	285
LA Capital:				
- capital grants	0	20	20	40
- credit approvals	20	30	30	80
Running costs:	20	25	30	85
Minor bids:	3	5	0	8
Reductions:	-16	-16	-21	-53
Total	**322**	**519**	**589**	**1430**

3. **National roads:** the Government is committed to a significant increase in roads expenditure. The forecast outcome would allow an acceleration of the existing roads programme, together with a start on the expanded programme. By 1992-93, roads expenditure would be over 50 per cent higher than in 1989-90 in cash terms.

4. **LA Capital:** transport will benefit from better targeting of receipts under the new capital finance regime. The forecast outcome would allow for an increase in local roads expenditure in years 1 and 2, and progress on light rail schemes and LA airports.

5. **Running costs:** the forecast outcome allows for new work on privatisation, safety, and the sale of cherished vehicle numbers; growth in demand for DVLD's services; and partial acceptance of the bid for running costs associated with the accelerated and expanded road programmes.

HE1 29/9/89

chex.ps/ds2/33 **CONFIDENTIAL**

FROM: D I SPARKES
DATE: 4 OCTOBER 1989

PS/CHIEF SECRETARY

INVESTMENT AND FINANCING REVIEW: TRANSPORT NATIONALISED INDUSTRIES

The Chancellor has seen the record of the Chief Secretary's meeting with Mr Parkinson on 22 September. He found it appalling reading.

2. He noted Mr Parkinson's remark that getting the BR bid for the existing railway down to baseline, and possibly beyond, would involve some unpopular measures such as failure to meet improvement targets and fare increases. He commented that BR must be made to cut costs and not simply take the soft option (for them) of higher fares.

3. The Chancellor also noted Mr Parkinson's argument that there was little that could be done to reduce the bid for rolling stock for the Channel Tunnel project since there was only one supplier in Europe capable of producing it. He commented that a monopoly supplier (especially GEC Alsthom) is highly undesirable. Could not the Americans supply the rolling stock? Or even the Japanese? GEC Alsthom must be put in a competitive situation.

D.I.S.

DUNCAN SPARKES

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chex.ps/ds2/61 UNCLASSIFIED

FROM: D I SPARKES
DATE: 16 OCTOBER 1989

MR M C SCHOLAR

cc Miss Wallace

GEARING OF UK COMPANY SECTOR

The Chancellor has asked me whether you could please let him have a brief and quick note showing how the UK company sector is much more healthily financed than the US company sector, ie has a much healthier debt/equity ratio in general and much less junk bond finance in particular. It would be helpful to have this before the Mansion House Speech meeting at 3.00 pm, for which this is clearly relevant.

D.I.S.

DUNCAN SPARKES

UNCLASSIFIED

MCS

Pls let me have a brief
quick note showing
how the company sector in the
UK is much more healthier
financially than the US company sector —
it is much healthier
debt/equity ratios in general
& much less junk bond finance
in particular.

It would be helpful to have this
before the Madrid Ecofin mtg,
if poss. Or as early thereafter as

FROM: A J SHARPLES (FIM2)

DATE: 16 October 1989

EXT: 4482

1. MR SCHOLAR

2. CHANCELLOR

cc: Financial Secretary
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Wicks
Mr Monck
Mr Peretz
Mr Walsh Mr O'Donnell
Mr Ilett
Mrs Chaplin

There is further background material on debt/equity ratios and junk finance in paras 1-24 of our recent paper on the subject (my minute of 21 Sept).

MLS 16/10

GEARING OF UK COMPANY SECTOR

You asked for a brief note showing how the UK company sector is more healthily financed than its US equivalent.

Debt/Equity Ratios

2. International comparisons are made difficult by differences in accounting practices. However there is evidence that debt is lower in relation to the capital base of UK companies than it is for US companies. OECD data for 1985 show that while capital gearing in the UK was 23%, the equivalent US figure was 34%. (Gross debt as a proportion of capital base at historic cost. Source: OECD)

3. There are no published figures for later years which provide a direct basis for comparison. However there is evidence that gearing ratios in the US have been rising. The debt/equity ratio rose from 39% in 1985 to 46% in 1987. (Source: OECD financial statistics 1988).

4. In the UK debt equity ratios have generally been falling since the mid-1970s. The average debt/equity ratio at market value for UK industrial and commercial companies fell from 24.5%

in 1980-82 to 19.9% in 1983-85 and 15.2% in 1986-88. (See table attached.)

5. It should be said however that a new OECD study (which is as yet unpublished and not to be quoted) casts doubt on the conventional picture sketched above. Table 2 attached confirms the pattern of declining debt ratios in the UK but suggest that US ratios have been static and are now not significantly higher than in the UK. It is not yet possible to reconcile these two sets of figures, so the new figures should be treated as a cautionary note on the comparisons outlined above.

Junk Bond finance

6. The market for "junk bonds" in the US is generally estimated to be worth some $200 billion (recent falls in the market will have reduced this figure somewhat). In 1987 junk bonds represented more than 20% of the total US corporate bond market. In the UK, there is no market for junk bonds as such and so there is no basis for direct comparison. The nearest equivalent is "mezzanine finance" which covers various forms of relatively high risk debt, often associated with management buyouts. Total advances of mezzanine debt for MBOs in the UK amount to just under £1.5bn.

7. Hence UK mezzanine finance is only 1% the size of the US junk bond market.

Adam Sharples

A J SHARPLES

Table: United Kingdom: ICC's

		Net issues (Ordinary shares)	Short term debt/ total debt
1980		0.9	
1981		1.6	
1982		1.0	
1983		1.7	
1984		1.0	
1985		3.2	
1986		5.4	
1987		12.7	
1988		4.4	74.5
1989	Q1	-1.6	78.4
	Q2	1.3	74.8

		Income Gearing (net)	Debt/Total Capitalisation (market value)	Debt/Equity (market value)
1970		14.7	18.3	22.5
1971		13.1	18.5	22.8
1972		13.2	16.7	20.0
1973		15.2	21.4	27.3
1974		26.5	34.9	54.6
1975		23.1	27.3	38.0
1976		19.9	24.4	32.3
1977		14.9	21.1	26.8
1978		13.6	18.2	22.2
1979		17.1	17.6	21.4
1980		24.0	21.0	26.7
1981		22.7	17.6	21.4
1982		21.6	20.2	25.4
1983		13.2	16.2	19.4
1984		11.5	16.7	20.1
1985		11.9	15.7	20.1
1986		12.1	13.3	15.3
1987		7.4	10.9	12.3
1988		9.7	15.3	18.1
1989	Q1	14.1		

SOURCE : BANK OF ENGLAND

Table 2

Ratios of gross debt to total assets (market values)

Countries	1970	1975	1980	1985	1986	1987
Low leverage						
United States[1]	0.45	0.52	0.50	0.50	0.49	0.51
United Kingdom[2]	0.51	0.64	0.63	0.52	0.48	0.48
Canada[3]	0.50	0.58	0.54	0.47	0.45	0.45
High leverage						
Japan[4]	0.86	0.83	0.84	0.73[5]	0.63	0.59
Germany[6]	0.72	0.76	0.81	0.71	0.70	0.77
France[7]	0.58	0.67	0.64	0.50	0.41	0.47

1 Private non-financial corporations, consolidated, equity at market value.
2 Private non-financial corporations, non-consolidated, equity and bonds at market value.
3 Private non-financial corporations, non-consolidated, equity at market value.
4 Private non-financial corporations, non-consolidated, equity at market value.
5 Break in the series.
6 Private and public-sector non-financial corporations and unincorporated businesses, non-consolidated, equity at market value.
7 Private corporate and unincorporated businesses excluding sole proprietorships, non-consolidated, equity at market value.

Sources: National flow-of-funds statistics and own estimates.

SOURCE:
'LEVERAGE AND FINANCING OF NON-FINANCIAL COMPANIES' C.E.V. BORIO (UNPUBLISHED)