PO-CH/NL/0143
PART A

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PART A

SECRET

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PART A

istics,

ac (RPI)

Begins: ~~9/1/86~~ 6/1/86

DD: 25 years

Ends: ~~16/4/86 (CONTINUED)~~

21/2/86 (CONTINUED)

8/9/95

CHANCELLOR'S 1986 PAPERS ON ECONOMIC STATISTICS, TRADE FIGURES AND THE RETAIL PRICE INDEX (RPI)

PO -CH /NL/0143

PART A

DM

PERSONAL AND SECRET

Caxton House Tothill Street London SW1H 9NF

Telephone Direct Line 01-213 6460

Switchboard 01-213 3000

Very disappointing - though see para 2

David Norgrove Esq
Private Secretary to the Prime Minister
10 Downing Street
LONDON
SW1

6 January 1986

Dear David,

MONTHLY COUNT OF THE UNEMPLOYED AND VACANCIES IN DECEMBER 1985

... I attach a copy of the DE Note for December 1985.

Copies also go to Rachel Lomax (Treasury), Sir Peter Middleton (Treasury), John Bartlett (Bank of England), Rachel Passmore (Central Statistical Office), Ros Mulligan (Cabinet Office), John Mogg (Department of Trade and Industry), John Graham (Scottish Office), N D Ward (Northern Ireland Office), and Colin Williams (Welsh Office) and Andrew Lansley (Office of the Chancellor of the Duchy of Lancaster).

Yours etc,

CHRISTOPHER SNELL
Private Secretary

PERSONAL AND SECRET

UNEMPLOYMENT STATISTICS : DECEMBER 1985

1. The seasonally adjusted level of unemployment in the UK (excluding school leavers) rose by 15 thousand in the month to December, to 3.181 million (13.2 per cent). This increase follows three consecutive monthly falls, and there are reasons for regarding it as erratic. It should not be taken as indicating a change from the broadly flat trend seen over recent months.

2. The count was taken later than usual in December, when few employers are recruiting and therefore the outflows from unemployment are low. Also, the figure may have been distorted more than usual by the temporary changes in the signing-on arrangements which are introduced approaching Christmas. Our assessment is that, without these special factors, unemployment would still have risen this month, but only slightly. Small rises can be expected from time to time while the trend remains broadly flat, or even slightly downward.

3. The employment and training measures are still having a significant impact on the trend in unemployment, as the build-up in the Community Programme continues. Without this beneficial influence, the trend would still be slightly upward.

4. The headline total of unemployed claimants (unadjusted including school leavers) increased in the month by 14 thousand to 3.273 million, giving an unemployment rate of 13.5 per cent. The number of school leavers in the total was 99 thousand, a fall of 11 thousand since November and 12 thousand less than in December last year.

5. The stock of unfilled vacancies at jobcentres (seasonally adjusted and excluding Community Programme vacancies) fell by 8 thousand in the month to December, to 162 thousand. Community Programme vacancies fell by 2 thousand in the month. The fall in unfilled vacancies is mainly explained by a reduction in the inflow of notified vacancies. The outflow increased by 2 thousand and, within that, placings increased slightly. Both outflows and placings are at their highest levels since the winter of 1979/80.

FURTHER DETAILS

1. The increase of 14 thousand in the headline total between November and December 1985, is the net result of a fall of 11 thousand school leavers and an increase of 25 thousand adults. Taking account of the normal seasonal increase of about 10 thousand among adults, the seasonally adjusted level of adult unemployment increased by 15 thousand to 3.181 million.

2. Over the six months to December, the seasonally adjusted level of unemployment has increased by an average of 2 thousand per month, compared with an average rise of 10 thousand in the six months to June 1985 and 12 thousand per month in the six months to December 1984.

3. The relatively large increase in unemployment between November and December is the result of a smaller outflow than might be expected. This is consistent with our view that the later than usual December count date is responsible for at least part of the increase in unemployment.

4. The outlook for the January headline total is for an increase of around 100 thousand. The January headline total is virtually certain to be a new highest level on record.

5. The full brief, with all supporting tables, will be sent on Wednesday, 8 January. Details of special employment measures and regional comparisons are appended now for reference.

January figures

6. The next count of unemployment will relate to Thursday 9 January and the next vacancy figures to Friday 3 January. A summary will reach you on Monday 27 January in advance of press release on Thursday 30 January.

Statistics Division
Department of Employment
6 January 1986

UNEMPLOYMENT - regions and sex : December 1985
SEASONALLY ADJUSTED, EXCLUDING SCHOOL LEAVERS

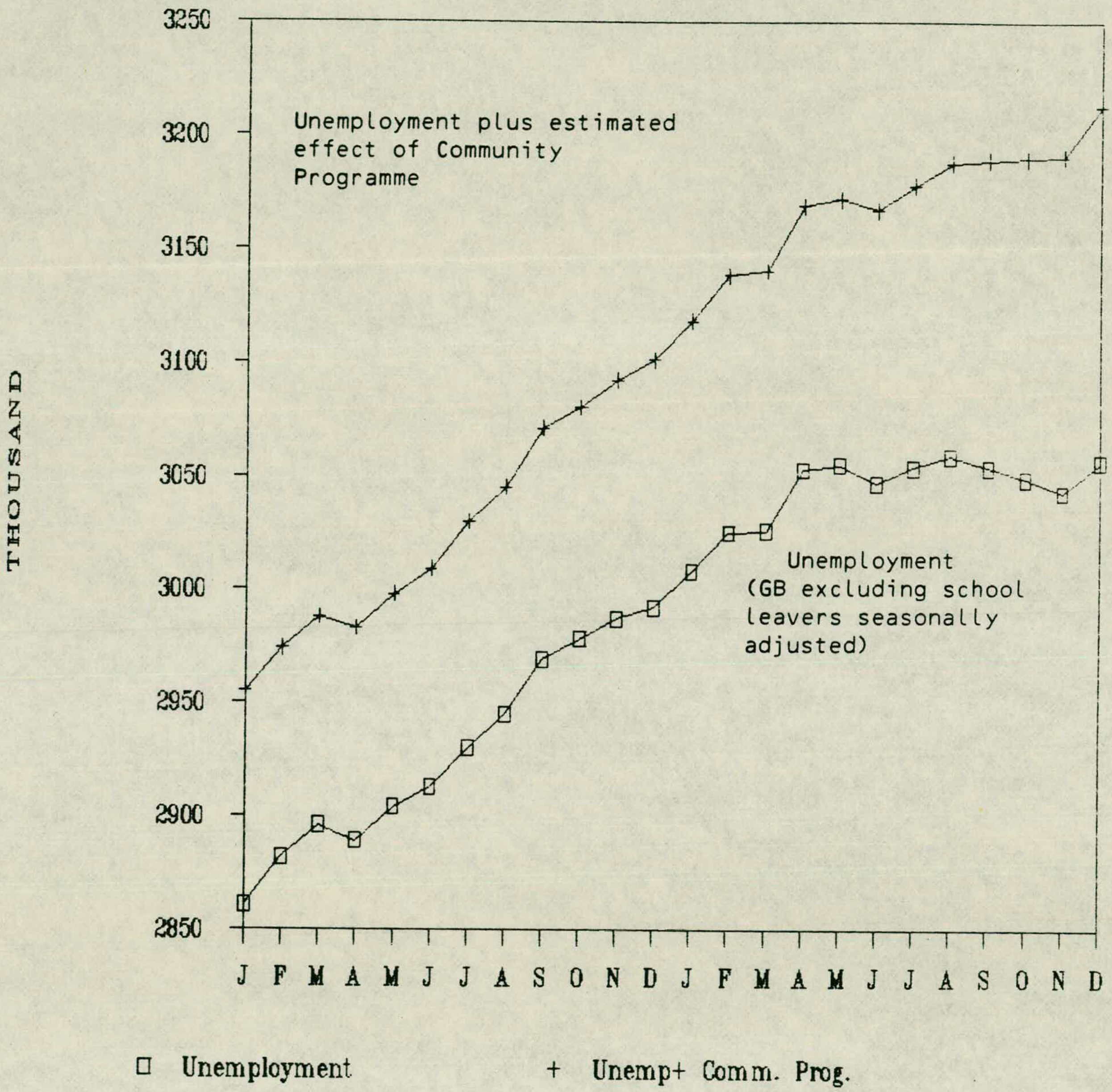
	NUMBER (Thousands)		UNEMPLOYMENT RATE (Per Cent)		
	At 12 December	Change in month since November	At 12 December	Change in month since November	Change in year since December 1984
REGIONS					
South East	766.6	+ 1.7	9.7	-	+ 0.2
(Greater London)	396.5	-	10.3	-	+ 0.4
East Anglia	81.4	+ 1.2	10.7	+ 0.2	+ 0.7
South West	202.1	+ 0.8	11.8	-	+ 0.4
West Midlands	336.2	+ 0.3	14.9	-	-
East Midlands	197.0	+ 1.2	12.3	+ 0.1	+ 0.2
Yorks and Humberside	297.8	+ 3.5	14.7	+ 0.2	+ 0.6
North West	435.5	+ 1.5	15.7	+ 0.1	+ 0.1
North	227.9	+ 2.0	18.1	+ 0.2	+ 0.2
Wales	173.1	-	16.2	-	+ 0.2
Scotland	338.1	+ 1.0	15.0	-	+ 0.5
GREAT BRITAIN	3055.6	+13.1	12.9	+ 0.1	+ 0.3
Northern Ireland	125.7	+ 1.6	21.6	+ 0.3	+ 1.4
UNITED KINGDOM	3181.3	+14.7	13.2	+ 0.1	+ 0.3
MALES AND FEMALES					
UK Males	2196.3	+10.2	15.7	+ 0.1	+ 0.2
UK Females	985.0	+ 4.5	9.5	-	+ 0.4

The effect of special employment and training measures on the adult unemployment count.

Community Programme (CP) continues to be the measure most directly affecting the short term trend in the adult count. The enclosed chart shows the numbers of adults unemployed, together with our estimate of what these figures would have been without CP. CP has clearly accounted for part of the improvement in the unemployment trend over recent months. The effect over the last 6 months is estimated to be a reduction in unemployment of an extra 6,000 per month. The large increase of 9,000 in the CP in November reflects a drive to meet the Christmas target of 180,000 participants. The increase in December is likely to be smaller because of low recruitment during the holiday period, and this has been taken into account when interpreting the latest unemployment figures.

Table A gives the overall effect on the count, which needs to be considered when assessing the longer term trend, together with the separate figure for the effect of CP,which is more relevant in assessing the impact of the measures on the short term trend in unemployment. Table B shows the detail of the latest monthly figures on employment and training measures.

Unemployment and Community Programme:GB



Note: The lower line illustrates the trend in adult unemployment, while the higher line which allows for the estimated effect of the Community Programme on the count, shows what the underlying trend is estimated to be in the absence of the Community Programme.

Table A

EMPLOYMENT AND TRAINING MEASURES
ESTIMATED EFFECT ON UNEMPLOYMENT COUNT (EXCLUDING SCHOOL LEAVER)

GREAT BRITAIN THOUSAND

	TOTAL		CHANGE	
	All	of which CP	All	of which CP
1983				
Jan	148	28	+ 2	+ 5
Feb	152	32	+ 4	+ 4
Mar	160	32	+ 8	–
Apr	171	37	+11	+ 5
May	170	43	– 1	+ 6
Jun	179	54	+ 9	+11
Jul	185	61	+ 6	+ 7
Aug	199	70	+14	+ 9
Sep	214	81	+15	+11
Oct	223	88	+ 9	+ 7
Nov	228	93	+ 5	+ 5
Dec	231	94	+ 3	+ 1
1984				
Jan	234	92	+ 3	– 2
Feb	234	92	–	–
March	239	94	+ 5	+ 2
Apr	240	94	+ 1	+ 1
May	243	96	+ 3	+ 3
Jun	254	100	+11	+ 1
Jul	244	100	–10	–
Aug	240	102	– 4	+ 2
Sept	237	102	– 3	–
Oct	237	105	–	+ 3
Nov	239	109	+ 1	+ 4
Dec	239	110	–	+ 1
1985				
Jan	242	113	+ 3	+ 3
Feb	238	114	– 4	+ 1
Mar	240	116	+ 2	+ 2
Apr	240	117	–	+ 1
May	240	120	–	+ 3
Jun	241	124	+ 1	+ 4
Jul	244	129	+ 3	+ 5
Aug	243	135	– 1	+ 6
Sep	251	141	+ 8	+ 6
Oct	256	148	+ 5	+ 7
Nov	263	157	+ 7	+ 9

Table B

Employment and Training Measures

	Number helped by measures (published)		Estimated effect on count* (not published in detail)	
	End of November	Change since end October	End of November	Change since end October
Youth Training Scheme	339,000	- 7,000	255,000	- 8,000
Community Programme	168,000	+ 8,000	157,000	+ 9,000
Job Release Scheme	49,000	- 2,000	43,000	- 3,000
Enterprise Allowance Scheme	51,000	+ 1,000	17,000	+ 1,000
Young Workers Scheme	58,000	+ 4,000	16,000	+ 1,000
Community Industry	8,000	-	8,000	-
TOTAL	**673,000**	**+ 4,000**	**495,000**	**- 2,000**
Excluding school leavers (not published)			263,000	+ 7,000

* The effect of the measures on the unemployment count is the estimated number of people who were in jobs, training, or early retirement instead of an equivalent number claiming unemployment benefit.

5.63

FROM: MRS M HENSON
DATE: 7 January 1986

MR G P SMITH

ECONOMIC POLICY: A EUROPEAN FORUM

The Chancellopr has seen and was grateful for your minute of 6 December.

Meena Henson
MEENA HENSON

27:2

SECRET AND PERSONAL
Until 11.30am on Thursday 9 January
then RESTRICTED

FROM: K VERNON
DATE: 7 January 1986

1. MISS O'MARA

2. CHANCELLOR OF THE EXCHEQUER

The increase is bound to be received badly after a good run of figures but DE's explanation looks convincing. There may be a case for looking at the timing of the count next December – but the argument can cut both ways with pre-Christmas recruitment.

MOM 7/1

cc Chief Secretary
Financial Secretary
Minister of State
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Monck
Mr Evans
Mr Scholar
Mr Culpin
Mr S Davies
Mr Dyer (+1 for No.10)
Mr Hunt
Mr Pickering
Mr King
Mr Cropper
Mr H Davies
Mr Lord
HB/01

UNEMPLOYMENT AND VACANCIES FIGURES FOR DECEMBER 1985

(to be released at 11.30am, Thursday 9 January)

Given that the agenda for the NEDC meeting tomorrow includes the Director General's progress report on jobs, you might like to have an early warning of these unemployment figures, although they will not be released until the following day.

2. Seasonally-adjusted adult unemployment (excluding school-leavers) rose by 15,000 in December to 3,181,000 (13.2 per cent of the employee labour force). The stock of unfilled vacancies, seasonally adjusted, fell by 8,000, to stand at 162,000.

3. The average monthly increases in unemployment in the three months and six months to December were 1,000 and 2,000 respectively. The DE assessment remains that the monthly trend in unemployment is broadly stable, compared with an increase of 10-15,000 over the last two years. They regard the large increase in the December count as erratically high: the count was taken later than usual in December and given the two week Christmas break, employers will have been reluctant to take on new personnel.

	November to December	Average monthly changes 6 mnths to December (previous six months in brackets)	thousands 3 mnths to December (previous three months in brackets)
Seasonally adjusted	+15	+2 (+10)	+1 (+3)

4. Other features compared with November are shown below (figures not seasonally adjusted except where indicated):

Thousands (rounded)

	Levels November	Levels December	Change
Stock of Unfilled Vacancies (s.a.)	170	162	-8
Effect of Employment and Training Measures on headline count	495 (Oct)	495 (Nov)	0
Headline total	3259	3273	+14
less claimant school leavers	110	99	-11
less seasonal factors	-16	-7	+9
Adult unemployment (seasonally adj): of which	3167	3181	+15
- Males	2186	2196	+10
- Females	981	985	+4

5. Points of interest are:

(a) Headline total up 14,000 (to 13.5 per cent of employee labour force.)

(b) Trend in seasonally adjusted adult count still estimated to be broadly stable compared with 10-15,000 over past two years.

(c) Both male and female unemployment levels rose, having fallen in each of the three previous months.

(d) Effect of employment, training measures on headline count in November unchanged. While an increase in Community Programme places took an additional 9,000 off count, this was largely offset by a decrease in YTS places for seasonal reasons.

Forthcoming Employment Gazette

6. You might like to be aware of an article due to be published in January's Employment Gazette on January 30 called "Classification of Economic Activity". This article is a largely descriptive and uncontroversial piece on the complexity behind divisions of the population into 'in employment', 'unemployed' and 'economically inactive' using Labour Force Survey findings but does contain one or two sensitive points on which briefing will be provided in advance of publication. These are:

(a) If the UK were to follow the practice of EC countries and classify as unemployed all those who had looked for work in the last four weeks, rather than in the single preceding week, the unemployment total would have risen by 407,000 in spring 1984. But if the labour force is redefined to include both the unemployed and those whom DE class as "marginally active" (eg those who believe no jobs available or those looking after family or home) then even if those who have searched for a job in the last 4 weeks are included among the unemployed, the unemployment rate calculated on this basis remains around the 13 per cent yielded by the current definition.

(only) (b) 20 per cent of men working part time and 7½ per cent of women working part-time had taken a part-time job because they could not find a full time job.

We originally spotted a trailer for this article in the DE Gazette back in June, but Young also made a speech about

7. You may recall questioning in the summer whether Lord Young would be prepared to see in print the suggestion that there was a case for increasing the unemployment total by 400,000 ((a) above). But we are assured the Gazette article has been approved by DE Ministers. the [illegible] of dismissing W/E

Assessment

8. The December rise in the seasonally adjusted count looks disappointing at first sight and is bound to be received unfavourably by the media. However, DE genuinely believe that the figure is erratically high, because of the later date of the count and the reluctance of employers to hire personnel just before a working break of two weeks.

9. The best assessment of the trend in unemployment is that it remains broadly flat, although since employment and training measures are taking around 5,000 a month off the count, the underlying trend is still probably upwards. (Internal Treasury calculations suggest the effect of the employment measures on seasonally adjusted adult unemployment may be closer to a range of 3-4,000. But DE believe that the calculation is subject to such uncertainty that the effect of the Community Programme in taking people off the adult count of around 5,000 a month, over past six months is the best assessment of the effect of the measures on the adult count.)

10. The vacancies level was down in December. But the vacancy count was taken earlier than the unemployment count and so no special factors apply here. Nevertheless the level remains above those recorded earlier in 1985.

Line to take

11. (a) On unemployment: Increase in December adult count erratically high due to special factors associated with Christmas holiday period. Trend remains broadly stable compared with increases of 10-15,000 seen six months ago. Employment and trainingmeasures now taking around 5,000 off the adult count whereas six months ago effect was broadly flat.

(b) The bulk of improvement in the unemployment trend therefore may be attributed to the response to higher economic activity with most of the effect of the Budget measures still to be felt.

(c) On vacancies: "Though December level down, figures for unfilled vacancies are erratic. Average over last three months well above levels seen earlier in 1985."

K Vern

K VERNON

SECRET UNTIL 11.30 am ON 9 JANUARY 1986

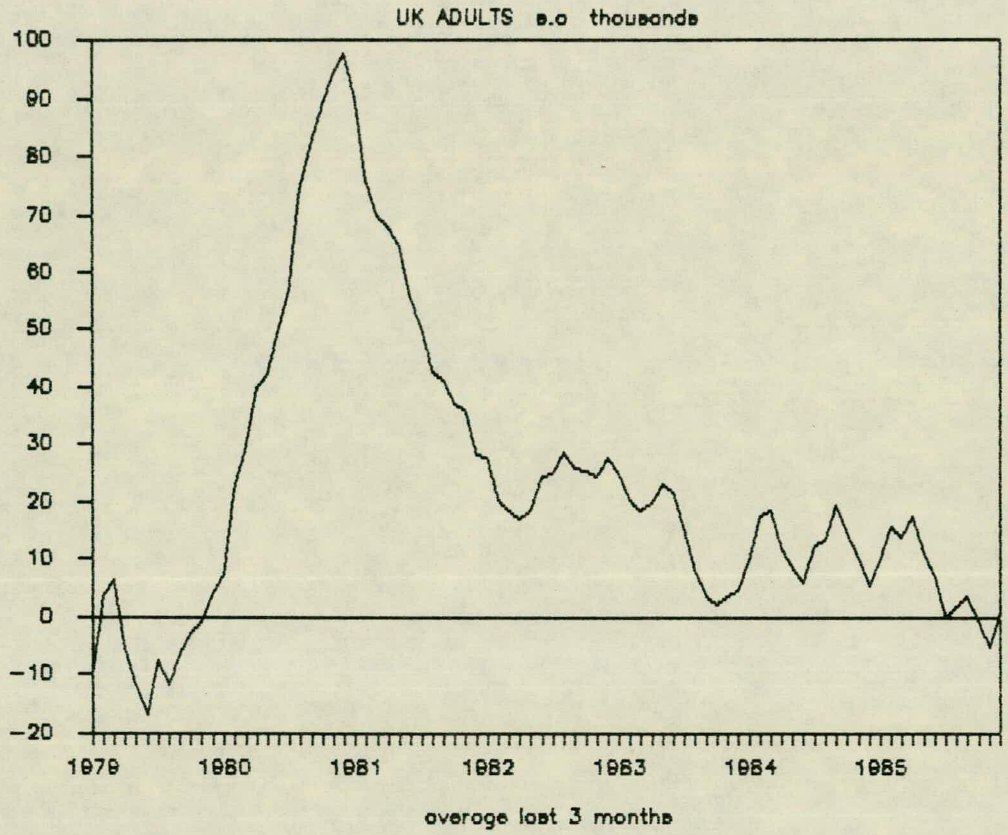
LABOUR MARKET TRENDS

all figures seasonally adjusted

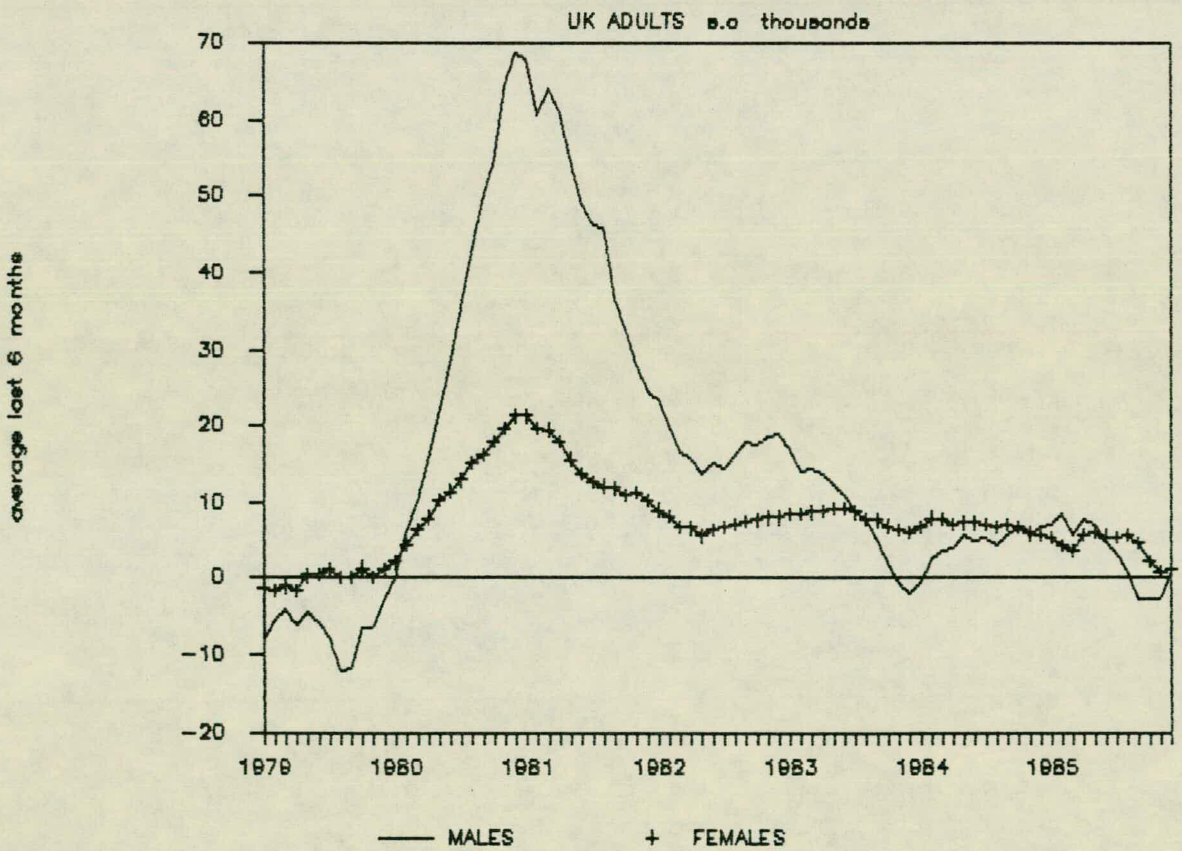
	Whole Economy (UK)				Manufacturing (GB)			
	Adult Unemployment changes (excluding 1983 Budget effects)	Stock of Notified Vacancies	Employed Labour Force ** Changes (Quarterly)	Employees in Employment Changes (Quarterly)	Employees in Employment Changes	Short-time (operatives)	Overtime (operatives)	Average Weekly Hours per operative
	000s, monthly average change in 3 Months ended	000s, average of 3 months ended	000s	000s	000s, monthly average in 3 months ended	millions of hours lost	millions of hours worked	Index 1980=100
1981 Mar	75	90	-245	-272	-55	5.9	8.5	96.8
June	60	82	-223	-250	-45	4.6	9.2	98.6
Sept	46	90	-109	-122	-27	2.6	9.9	100.2
Dec	25	102	-149	-159	-28	1.9	10.0	100.1
1982 Mar	20	113	-51	-60	-18	1.8	10.3	100.6
June	28	113	-121	-130	-31	1.8	10.2	100.6
Sept	31	113	-156	-167	-29	1.6	9.8	100.4
Dec	28	116	-101	-113	-29	1.6	9.7	100.7
1983 Mar	26	123	-69	-81	-21	1.3	9.8	101.0
June	25	133	23	9	-16	1.1	9.7	101.0
Sept	4	145	122	51	-12	0.7	11.0	101.9
Dec	-2	148	137	68	-6	0.5	11.1	102.4
1984 Mar	18	146	75	5	-9	0.6	11.2	102.4
June	6	149	59	-8	-1	0.7	11.7	102.6
Sept	20	152	73	39	-4	0.7	11.6	102.5
Dec	5	154	131	101	1	0.5	11.8	103.2
1985 Mar	14	156	24	-6	-9	0.5	11.9	102.9
June	7	163	28	-4	-2	0.3	12.5	103.2
Sept	3	167			-4	0.4	12.4	102.9
Oct	-1	173			-6	0.4	11.8	102.8
Nov	-5	170						
Dec	1	162						

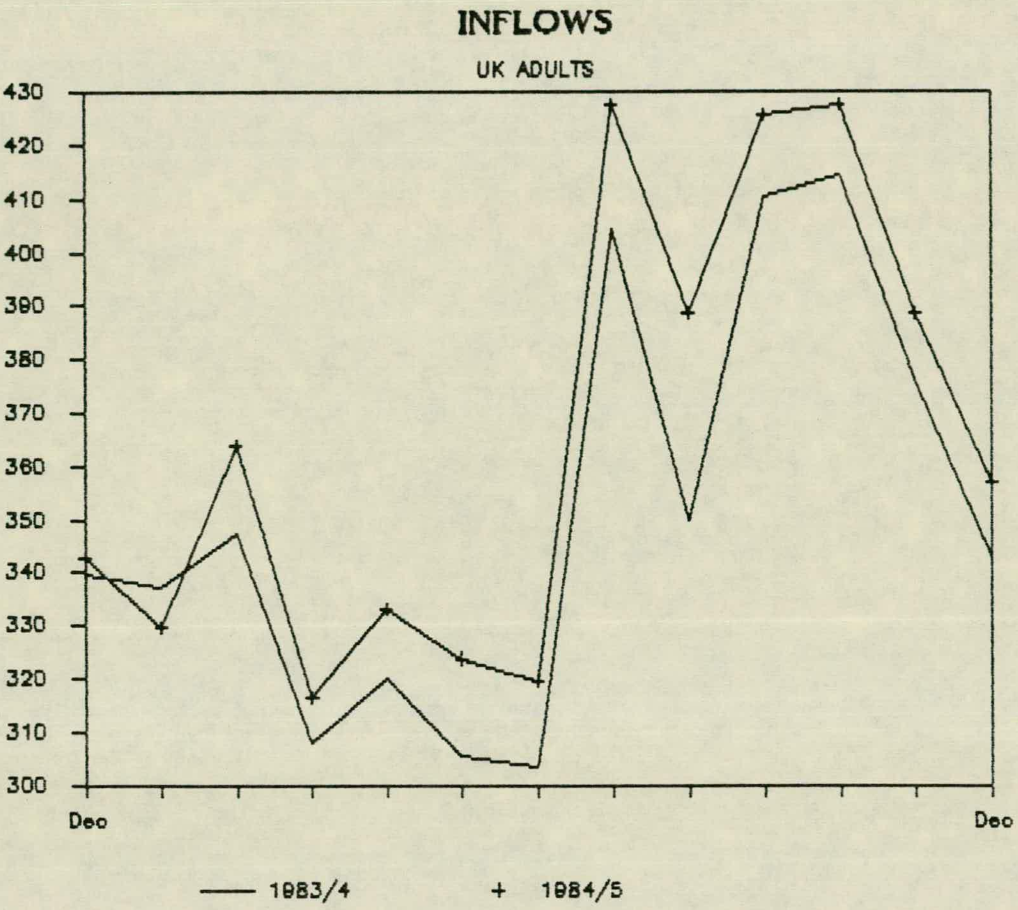
**UK employees in employment, armed forces, plus an assumed 31,000 increase per quarter in self employment from 1984Q3

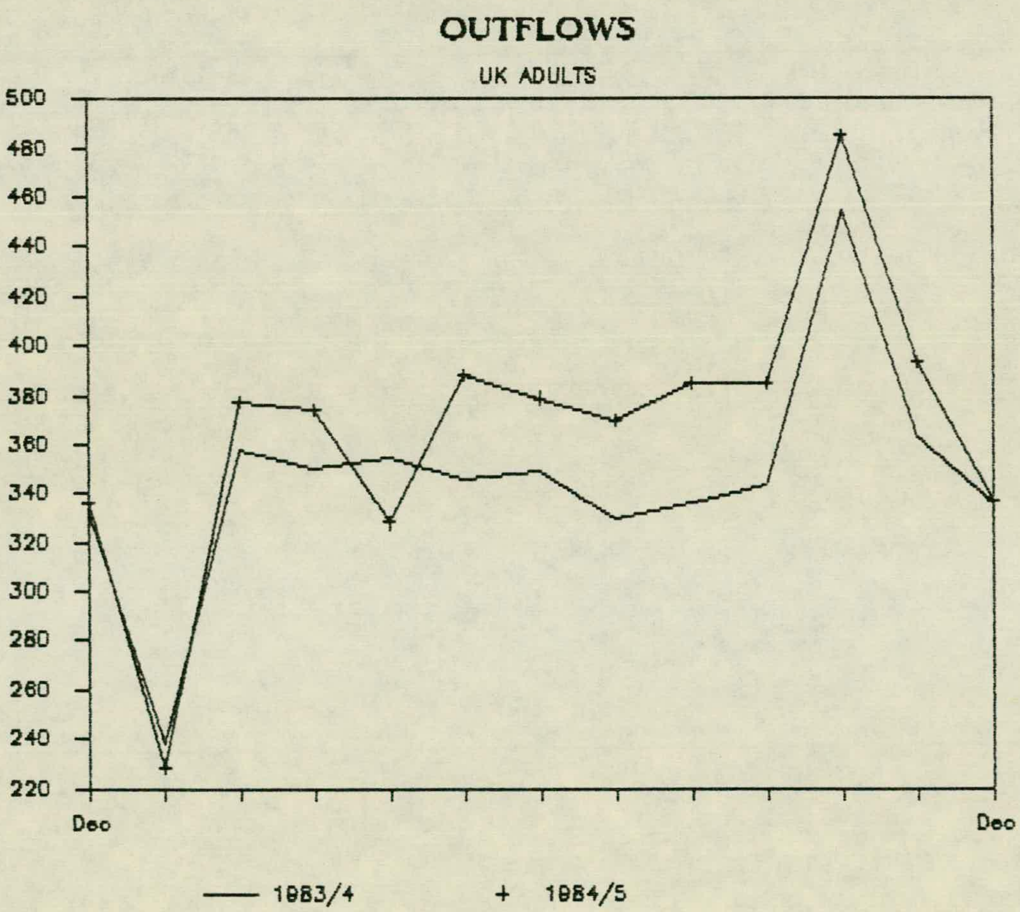
CHANGES IN UNEMPLOYMENT



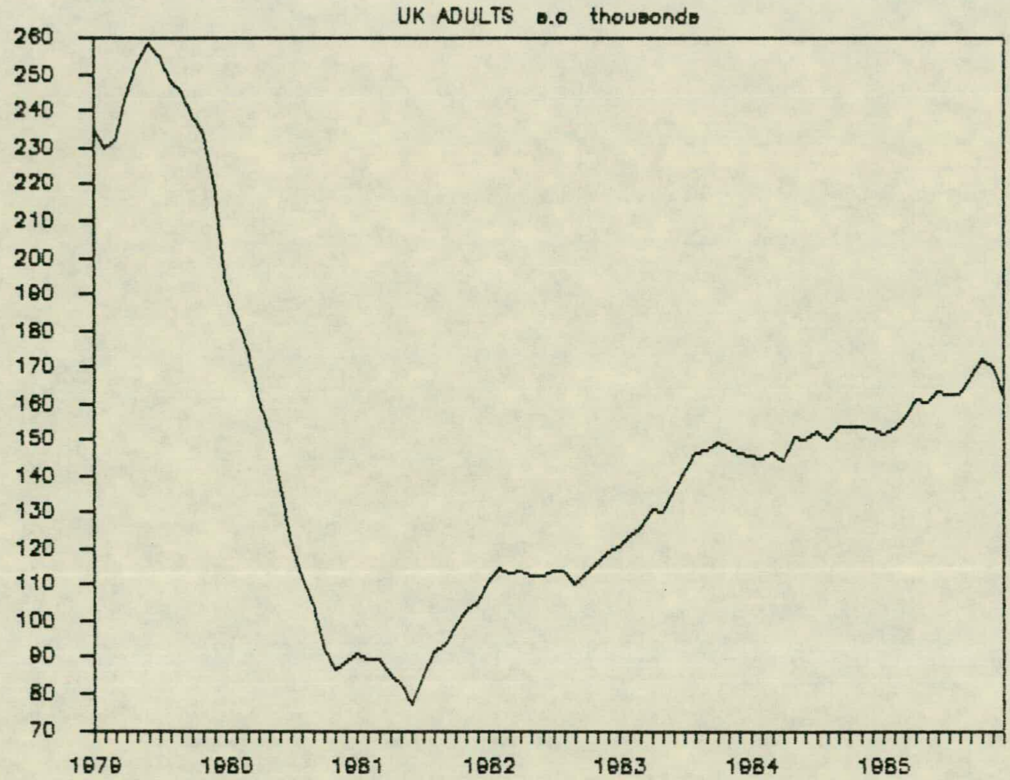
CHANGES IN UNEMPLOYMENT BY SEX




INFLOWS
UK ADULTS
430
420
410
400
390
380
370
360
350
340
330
320
310
300
Dec
Dec
1983/4
+ 1984/5


OUTFLOWS
UK ADULTS
500
480
460
440
420
400
380
360
340
320
300
280
260
240
220
Dec
Dec
1983/4
+ 1984/5

VACANCIES



UK ADULTS s.a thousands
260
250
240
230
220
210
200
190
180
170
160
150
140
130
120
110
100
90
80
70
1979
1980
1981
1982
1983
1984
1985

SP/079

RJP

FROM: I C SEARS
DATE: 8 JANUARY 1986

MR VERNON

UNEMPLOYMENT AND VACANCIES FIGURES FOR DECEMBER 1986

The Chancellor has seen and was grateful for your minute of 7 January.

IAN SEARS

62:4

CONFIDENTIAL
until 11.30am 13 January
then UNCLASSIFIED

FROM: S D KING
DATE: 9 January 1986

1. MISS O'~~MA~~RA MOM 9/1
2. CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Mr Monck
Mr Evans
Mr Culpin
Mr S Davies
Mr Aaronson
Mr Brooks
Mr Pickering
Mr Vernon
Mr Cropper
Mr H Davies
Mr Lord
HE/01

PRODUCER PRICES FOR DECEMBER

These will be published at 11.30 on Monday 13 January and, following the trend of recent months, show encouraging prospects for inflation.

2. **PRODUCER PRICES**
(percentage change over year earlier)

	1984	1985 Q1	Q2	Q3	December
Output prices	6.1	5.9	5.6	5.6	5.0
Output prices (less food, drink, & tobacco)	5.6	6.4	6.4	6.5	5.9
Input prices	8.1	9.5	3.4	-0.7	-6.1
Input prices (less food, drink, & tobacco)	8.7	14.7	6.8	1.2	-6.1

Prices of materials and fuel bought by manufacturing industry fell by 6.1 per cent in the year to December, after a fall of 5.3 per cent in November - the best performance since the present series began in 1974. Between November and December the index rose by 2.2 per cent - only the third rise in ten months. More than three-quarters of this increase can be attributed to the usual seasonal increase in the cost of industrial electricity, reflecting the higher level of maximum demand charges in the winter months.

4. The index for materials and fuel purchased by manufacturing industry other than the food, drink and tobacco industries fell by 6.1 per cent in the year to December after having fallen by 5.1 per cent in the year to November. Between November and December the index rose by 2.9 per cent.

5. Only some of the improvement in input prices has so far fed through to producer output prices. Over the year to December they rose by 5.0 per cent - little changed from November (5.1) but down on those rates experienced in 1984. Between November and December the index rose by 0.2 per cent. Excluding food, drink and tobacco, the increase in the index for manufactured products fell to 5.9 per cent in the year to December from 6.0 per cent in November.

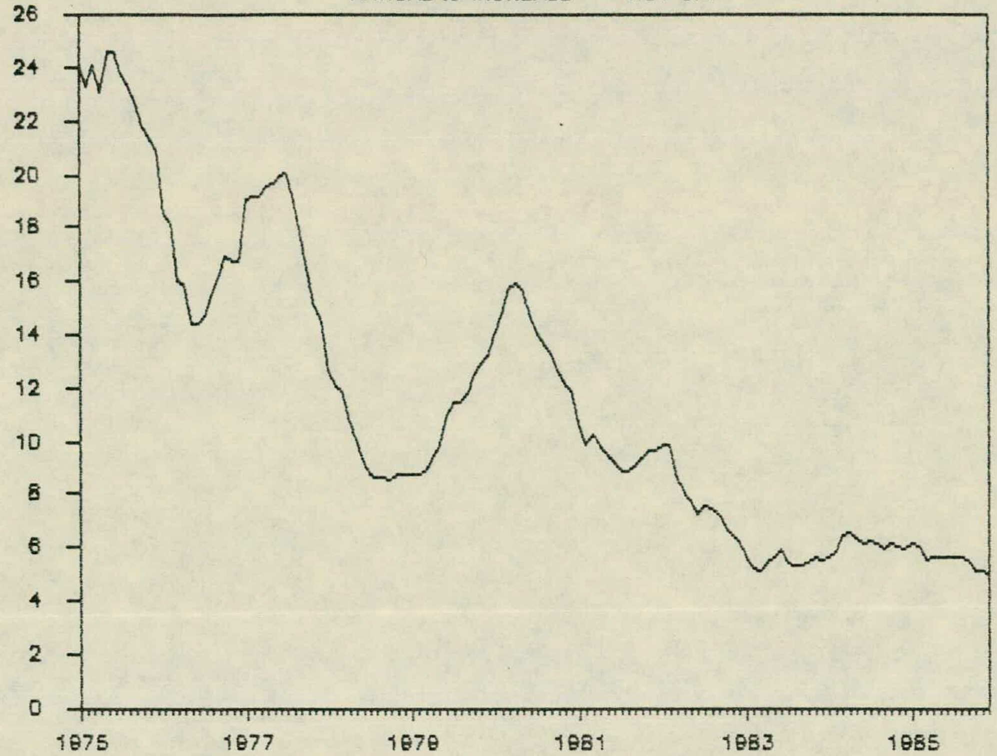
6. Movements in annual rates of producer input and output inflation from January 1975 are shown in the attached charts.

Stephen King

S D KING

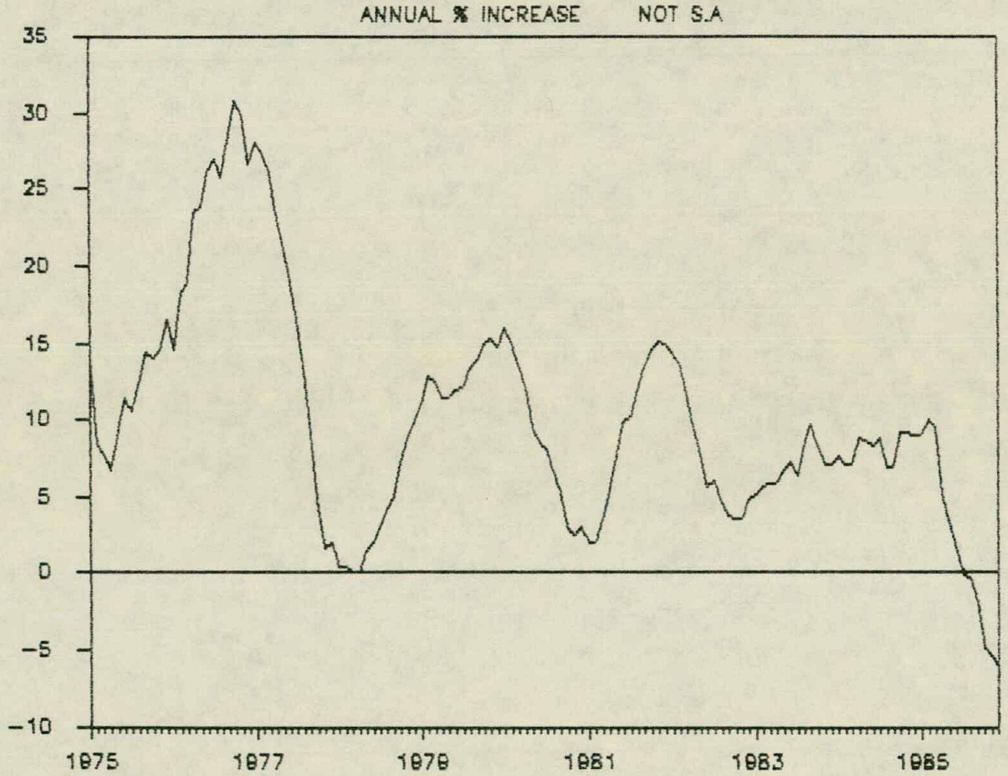
PRODUCER OUTPUT PRICES

ANNUAL % INCREASE NOT S.A



PRODUCER INPUT PRICES

ANNUAL % INCREASE NOT S.A



17/1/86 [handwritten, struck through] pmg

From: J ODLING-SMEE
10th January 1986

CHANCELLOR OF THE EXCHEQUER

cc Sir Peter Middleton
Sir Terence Burns
Mr Byatt
Mr Evans
Mr Scholar
Mr Sedgwick
Mr Culpin
Mr S Davies
Mr Melliss
Mr Riley
Mr Kelly
Mr Owen
Mr Cropper
Mr H Davies

FACTOR PRICES IN THE TREASURY MODEL

You asked about the other important changes to the Treasury model since September 1984. The most important ones, in terms of their effects on overall model properties, were to the equations for:

Trend productivity
Factor cost adjustment
Non-durable consumption
ICCs purchases of UK company securities
Borrowing requirement of ICCs
Exports of manufactures
UK exports margins
Relative unit costs of exports
Imports of manufactures
Domestic demand for manufactures
Other outward direct investment
Other inward direct investment
Inward direct investment

Outward direct investment
Building societies model
New house prices
Interest rate on building society shares and deposits
ICCs gross liquidity
Debt interest model
Banks holdings of notes and coins

2. Other changes were to the equations for:

Self-employment income
Housing RPI
Consumers expenditure on durables, clothing, etc
Consumers expenditure on food, drink, and tobacco
Other stocks
Personal investment in existing dwellings
Deflator for investment in existing dwellings
Equity in life and pension funds
ICCs purchases of overseas securities
Nationalised industries investment (current prices)
Banks gross euro-currency credits
Banks gross euro-currency debits
UK banks foreign currency deposit liabilities with overseas
Balance of payments financial model
External and foreign currency counterpart to £M3
Overfunding

3. When we are contemplating changes in important equations in the model, we usually look to see what effect the changes will have on the simulation properties of the model. We take these into account along with the latest empirical evidence and our view of how the economy works in deciding whether to change the relevant equations or not. Such simulations were not carried out for the set of factor demand equations discussed in our note of 3rd January, mainly because the equations were changed at different times. Thus it was necessary to carry out a special exercise in this case.

4. You commented that the enhanced response of stockbuilding in the simulation of a change in interest rates has the effect of exacerbating the stock cycle. While it is true that the response of stockbuilding to

interest rate changes is now more powerful in the model, its response to changes in economic activity is lower. In this sense, therefore, stockbuilding in the model is less rather than more destabilising in the context of cycles in economic activity.

Jdh OS

J ODLING-SMEE

R.26.19

FROM: P WYNN OWEN
DATE: 13 January 1986

Bilateral on 17/1

p.s.p

Debbie

When is next Sir T. Burns bilateral?
R 14/1

SIR T BURNS

WOOD, MACKENZIE ECONOMIC MONITOR

The Chancellor would like to know whether you believe there is any significance in the central graph on the back page of the attached Economic Monitor.

R.

P WYNN OWEN

Ch.

Ignatia Terry had a precautionary word with you this afternoon. As I understand it, the decision was to go ahead with the Controller expectations prepared to hang on to feedback rules at least until after the Budget. Can you confirm pl?

RL 17/11

Confirmed. I did like Sir Peter's present views on the 2nd paper on debt control. (It on the question of generality & caution). L b/f 17/1 for Rachel

From: J ODLING-SMEE

14th January 1986

CHANCELLOR OF THE EXCHEQUER

cc Sir Peter Middleton
Sir Terence Burns
Mr Evans
Mr Scholar
Mr Melliss
Mr Riley
Dr R James
Mr Bredenkamp
Mr Whittaker
Mr Westaway

TREASURY WORKING PAPER ON CONSISTENT EXPECTATIONS IN THE TREASURY MODEL

One of the more difficult aspects of estimating the impact of changes in Government policies or other events on the economy is deciding how the changes will affect expectations of economic agents, especially financial markets. The theory of rational expectations suggests that one way of taking account of expectations is to assume that agents will expect those outturns that the model itself would predict. While we and a number of other modellers would wish to incorporate such an assumption, it has until recently proved very difficult. We have therefore made a number of ad hoc adjustments designed to take account of sharp changes in expectations when policy changes are announced or other events occur.

2. Over the last two or three years, considerable advances have been made in methods of solving large models under the assumption of consistent expectations, that is that the outcome that agents expect to occur is equal to the outcome that the model itself predicts. The LBS, the National Institute and ourselves have all developed methods of consistent expectations solutions. The attached paper by Rod Whittaker and Peter Westaway explains for a technical audience what we have done in the Treasury. It discusses some of the technical and other problems that have arisen in using consistent expectations. Its scope and main conclusions can be found in paragraphs 1-5 and 70-71.

3. The work is still at a fairly early stage, but we are beginning to take account of it in policy analysis. In particular, we are replacing the ad hoc adjustments for expectations by consistent expectations in the work that underlies our estimates of the PSBR and macro-economic effects of possible Budget changes.

4. We would like to publish the paper as a Treasury Working Paper, as a contribution to the debate on how to operate models in this way and how to interpret the results. An earlier version was discussed by the Academic Panel who were enthusiastic about the work and at a Warwick Modelling Bureau seminar. Sir Terence Burns has seen the paper and approves.

J ODLING-SMEE

b/f 17/1 for Rachel

From: J ODLING-SMEE
14th January 1986

CHANCELLOR OF THE EXCHEQUER

cc Sir Peter Middleton
Sir Terence Burns
Mr Evans
Mr Scholar
Mr Melliss
Mr Riley
Mr Whittaker
Mr Westaway

TREASURY WORKING PAPER ON EXPERIMENTS WITH FEEDBACK RULES

One of the more hopeful developments in the theory of economic policy making in recent years has been in the design of simple feedback rules. This work has partly been a response to the dissatisfaction that economists have felt with a full optimal control approach to policy making. The optimal policy rules that are derived from full control experiments are often rather sensitive to the precise specification of policy objectives and of how the economy works; they may also be very complex, and therefore not likely to be used in practice. By contrast, simple feedback rules, which relate the response of a policy instrument such as interest rates to deviations of some target variable, such as inflation or money GDP, from its desired level may prove more useful in practice. The attached paper by Peter Westaway, who worked on control rules as a member of Professor Meade's team before joining us, is the first attempt to explore the implications of such rules with the Treasury model.

2. The results at this stage are interesting, although we need to do more work before we have something that can be used in practical policy making. They show that it is possible to derive a simple rule for changing the interest rate in response to deviations of money GDP from a desired path. Moreover, a single rule will suffice for a range of different situations in which money GDP is disturbed from its original path. This makes this approach potentially more useful than the optimal control approach, since it does not require a full knowledge of why money GDP is performing in the way that it is. The work also shows that the control of money GDP in the face of disturbances can be improved if intermediate variables, such as the

exchange rate or long-term interest rates, that contain forward-looking information, are also taken into account in setting interest rates. But if these indicators do not contain information about the future, there is no gain in taking them into account.

3. The paper is briefly summarised in paragraphs 66-68; the context and some of the results are also summarised a little more fully in paragraphs 1-2 and 47-49.

4. The paper was presented at a conference in June, and we would now like to publish it as a working paper so as to make it more accessible to others working in this area. I would be grateful for your agreement. Sir Terence Burns has seen the paper and approves.

JOL OS

J ODLING-SMEE

CONFIDENTIAL

pmp

FROM: S BROOKS
DATE: 14 JANUARY 1986

1. MR S J DAVIES ✓ sgd 15/1

2. CHACELLOR OF THE EXCHEQUER

CC : PS/CHIEF SECRETARY
PS/FINANCIAL SECRETARY
PS/ECONOMIC SECRETARY
PS/MINISTER OF STATE
SIR PETER MIDDLETON
SIR TERENCE BURNS
MR F E R BUTLER
MR F CASSELL
MR N MONCK
MR KEMP
MR ODLING-SMEE
MR SEDGWICK
MR SCHOLAR
MR BOTTRILL
MR CULPIN
MR GILHOOLY
MR MOWL
MISS O'MARA
MR PICKFORD
MR HAACHE
MR HALLIGAN
MR P DAVIS
MR ROSS-GOOBEY
MR CROPPER
MR TYRIE

And inflation for calendar 1985 as a whole must also be around 3½% (pse confirm), – 3.4 the lowest (presumably) since 1967. (Mr.

Yes (2.5 in that year)

Thanks

THE DECEMBER RPI (TO BE PUBLISHED AT 11:30 A.M. ON FRIDAY 16 JANUARY)

The level of the RPI rose by 0.3 per cent between November and December. The twelve month rate of inflation rose to 3.7 per cent in December from 3.5 per cent in November. This was in line with what we expected last month.

2. Excluding mortgage interest payments, the twelve month rate of increase was 3.5 per cent in December (provisional), 0.2 per cent higher than in November.

3. The residual effects of the rise in mortgage rates in November increased the RPI in December. Price rises for some foods also contributed to the increase, while pre-Christmas discounts meant that prices of wines and spirits fell.

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4. The increase in the RPI in the year to 1986Q4 was 3.4 per cent, just above the Autumn Statement forecast of 3 1/4 per cent.

5. We expect the twelve month rate of inflation to increase a little in January in the range 3 3/4 - 4 per cent.

6. The RPI figures are in line with City expectations. Alexanders Laing and Cruickshank, James Capel and Wood MacKenzie all correctly anticipate an increase of Ø.3 per cent between November and December, while Philips and Drew expect Ø.2 per cent.

S BROOKS

EA1 DIVISION

EXT 54Ø1

EOF:97
Ø:>

b/f 17/1 with relevant ppr

From: K F MURPHY
Date: 15 January 1986

MR ODLING-SMEE

cc PPS
Sir T Burns
Mr H Evans
Mr Scholar
Mr Melliss
Mr Riley
Mr Whittaker
Mr Westaway

TREASURY WORKING PAPER ON EXPERIMENTS WITH FEEDBACK RULES

Sir Peter Middleton has seen your note of 14 January to the Chancellor and the accompanying paper. He would like to discuss this at Second Secretaries on Friday. But he has commented that it clearly impinges on sensitive territory at a sensitive time. He would like to know what a simple feedback rule would indicate as the most hostile reaction following publication and what the policy implications if any are of this work.

K F Murphy

K F MURPHY
Private Secretary

CONFIDENTIAL

FROM: S J DAVIES
DATE: 15 JANUARY 1985

CHANCELLOR OF THE EXCHEQUER

cc: Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir Peter Middleton
Sir Terence Burns
Mr F E R Butler
Mr Anson
Mr F Cassell
Mr Kemp
Mr N Monck
Mr H P Evans
Mr Mountfield
Mr Odling-Smee
Mr Scholar
Mr Turnbull
Mr P Gray
Mr Mowl
Miss Peirson
Mr Riley
Mr Cropper
Mr H Davies

Ch.
Good.
On X - I don't see any evidence here you had comments - but would you like to look again, before I minute out that you were content?
RL 15/1

No comments - Content.

ECONOMIC ASSUMPTIONS FOR PUBLIC EXPENDITURE: PRE-BUDGET REVISIONS

The purpose of this submission is to let you know that we are not proposing to send out to Departments this January any revisions to the economic assumptions issued in October.

2. Assumptions sent out now would be used by Departments to update their PES figures for the Budget forecast. At the stage in the current forecastng round that we have now reached - the subject of Mr Evans minute to you of 10 January - we see no changes that are big enough to warrant sending out revisions. By the time we finalise the Budget forecast there will doubtless be changes both from the October assumptions and from any revised assumptions that we might now propose. But we will be able to cope with them within the Treasury, using ready-reckoners.

EAsdb

3. We therefore propose to inform Departments that we see no need to send them revised economic assumptions now. The next set of economic assumptions - for use in the 1986 survey - will be issued to Departments in April.

S J DAVIES

EAsda

ECONOMIC ASSUMPTIONS ISSUED IN OCTOBER

		1985-86	1986-87	1987-88	1988-89
1.	Unemployment, GB narrow (millions)	3.05	3.0	3.0	3.0
2.	Average earnings per head (% change on year earlier)	8	7	6	5½
3.	GDP deflator (% change on year earlier).	5	4½	3½	3

		Jan 86 / May 85	Sept 86 / Jan 86	Sept 87 / Sept 86	Sept 88 / Sept 87
4.	RPI assumptions for new uprating periods	1	2¼	3¼	3

INTEREST RATE ASSUMPTIONS (UNPUBLISHED)

		1985-86	1986-87	1987-88	1988-89
5.	3-Month Sterling LIBOR (financial year average)	11¾	10¾	10¼	9½
6.	Sterling 20 Year Gilt Rate (financial year averages)	10½	10½	10¼	9½
7.	6-Month Dollar LIBOR Rate (financial year average.)	8½	9½	9	9

EAsd

32

CONFIDENTIAL

PST

From: K F MURPHY

Date: 15 January 1986

NOTE OF A MEETING HELD ON FRIDAY 10 JANUARY 1986, IN SIR PETER MIDDLETON'S ROOM, HM TREASURY

Present:

Sir Peter Middleton
Sir Terence Burns
Mr F E R Butler
Mr Anson
Mr Monck
Mr Turnbull
Mr Odling-Smee
Mr Spackman
Mr Scholar
Mr Riley

Chy
You might like to see this record of where the official discussions have got to. (Peter has referred to these meetings he has been holding at several of his bilaterals)
RC
15/1

CAPITAL EXPENDITURE AND THE MTFS

The meeting had before it Mr Scholar's agenda of 9 January and the supporting background papers. Sir Peter Middleton said that there was a need to examine the work which had been done on capital expenditure to see if there were practical conclusions which could be drawn from it. He proposed to use Mr Scholar's note as an agenda.

2. Sir Peter Middleton said that the first question was point 4 of Mr Scholar's agenda viz. whether we still believed that no worthwhile capital projects had been squeezed out of programmes. Mr Monck said that maintenance expenditure was probably being squeezed, particularly in housing. But maintenance was of course classified as current expenditure. Mr Spackman said that as the rate of growth of public expenditure had been changed as over the last few years, it was to be expected that the rate of net investment would fall. Mr Turnbull said there had been big changes within the total of capital expenditure; while defence had increased from some £4 billion to nearly £5½ billion, many other programmes had fallen. Capital expenditure was forecast to fall in real terms

over the next three years such that by 1988-89, total public sector capital expenditure would be the same in real terms as a decade earlier even though the economy overall would have grown by up to a quarter over that time. He did not himself believe that there were no worthwhile capital projects which were being squeezed out. More important was the impact on maintenance. He thought it likely that the squeeze on expenditure over the last few years was causing maintenance expenditure to be reduced thus changing what had been essentially maintenance problems into problems which would require expenditure of capital for their solution. He cited as an example the upkeep of inner city housing estates. Mr Anson pointed out that this view was predicated on the assumption that the level of capital expenditure in the past was in some sense "right". It was arguable that past capital expenditure had been excessive. Mr Turnbull agreed; there had been a number of examples of excessive investment in the early 1970s, not least in the electricity industry.

3. Mr Scholar pointed out that expenditure groups had been asked for examples of whether capital expenditure had been squeezed out of programmes. Over a period of time, the volume of such expenditure identified had gradually increased. Mr Monck referred to evidence adduced by NEDO also. Sir Terence Burns pointed out that much of the NEDO evidence referred to maintenance expenditure. Departments under expenditure pressure traditionally responded in one of two ways; either to cut new capital expenditure or to postpone maintenance expenditure.

4. Mr Odling-Smee said that in some areas, in particular housing, it could be argued that a fall in public sector capital expenditure was not detrimental. The Government's policy was to transfer the provision of housing from the public to the private sector as much as possible. To reduce expenditure on maintaining the public sector stock would be expected to lead over the long term to a shift towards the provision of housing in the private sector. It could perhaps be argued that the Government was doing the same in other areas such as health.

5. Sir Peter Middleton said that, even if it could be argued that in the face of a reduction in the public expenditure total

overall, a fall in capital expenditure was to be expected, it was questionable whether private sector investment was satisfactory. He wondered whether a fall in public sector investment ought not to be matched by a compensating increase in private sector capital expenditure. Mr Monck said that fixed investment by the private sector was low. Mr Odling-Smee, however, pointed out that the investment-output ratio had been constant in the private sector as a whole over the last few years. Fixed investment in manufacturing had dropped, but investment in non-manufacturing areas had increased. Continuing, Mr Odling-Smee said that compensating increases in private sector expenditure could only be expected if it was thought that there was a long term steady state of capital spending in the economy as a whole. If the Government was trying to shift the boundary between the public and private sector, it was arguable that a reduction in public sector investment in that area should be matched by a compensating increase in the private sector. (The fall in public sector housing construction expenditure, however, had not been made up by increases in private sector investment). But in areas where the Government did not have such an objective, a fall in capital expenditure in the public sector needed to be examined on its own merits.

6. Sir Peter Middleton asked whether the fall in maintenance expenditure was a real problem. Mr Monck said that, while it was difficult to quantify, there was evidence that this was causing difficulties in a number of areas, including housing, schools and local authority roads. Sir Peter Middleton argued that this might point to attempting, in the course of the public expenditure survey, to take the line of allowing more maintenance expenditure on economic grounds. Mr Spackman pointed out, however, that it was no accident that the three main areas referred to were all under the control of local authorities where central control over expenditure was weakest. There was nothing to prevent local authorities viring money from one area to another, and therefore no means of obliging them to spend money on capital expenditure, or even maintenace, in these areas.

7. Sir Terence Burns said that it would be difficult to imagine a simple rule which demonstrated the "right" level of maintenance

expenditure. Arguably, there might be some sort of "right" ratio of maintenance expenditure to capital stock in important areas. Mr Spackman added that it would be possible to look at the trend of such expenditure over time. Mr Monck suggested that it might be possible to ask public expenditure divisions to take this sort of analysis into account. Indeed, it might be possible to ask departments for information on areas where maintenance expenditure had been delayed. But it was very difficult to undertake such a review without signalling to departments that these were areas where increases in expenditure might be more easily accepted by the Treasury. Mr Turnbull said that one solution to this might be for the Treasury to indicate that savings elsewhere might be channelled into departmental expenditure on maintenance rather then being remitted to the Exchequer in the usual way. Mr Butler said that GEP already had in hand a survey within the Treasury of what divisions knew about departments' information systems and procedures for capital and maintenance expenditure and were reviewing last year's experiment of asking departments for rate of return information to back PES bids. When this information had been collated, it would be possible to see what further work was necessary. There might then be a case for going to departments.

8. Mr Odling-Smee suggested that it might be profitable to concentrate on information systems within departments for the future as well as looking at the current backlog of expenditure. This might be less damaging to overall public expenditure control. For example, it might be possible to ask departments to provide, within the overall appraisal for each new capital project submitted for approval, the projected path of maintenance expenditure on the project. This was an area which would need considerable further thought. **Concluding this part of the discussion, Sir Peter Middleton said that he would be interested to see the results of the work GEP had already in hand. He hoped it would be possible to take this forward, perhaps by approaching departments for further information and considering the sort of information systems proposed by Mr Odling-Smee.**

9. Turning to item 2 on the agenda, Sir Peter Middleton wondered whether there was anything to be said for charging departments

for their capital. Mr Butler said that he thought this area was worth thinking about. But he was concerned that the net effect would be to increase capital expenditure; departments would be only too keen to worry about the servicing of capital expenditure in the future. Mr Anson said that the nearest equivalent within the public sector to such a system was the PRS system in PSA. This would be undoubtedly the way that departments would see such a proposal. And the PRS system was in a mess. Continuing, Mr Anson said that such a system would need an in-year cost of capital figure to act as a capital ration. But it was not clear how such a figure could be derived. Mr Turnbull added that such a development would make cash planning and Estimates more complicated. **Concluding this discussion, Sir Peter Middleton said that it would repay further thought. But it would be premature to act quickly. He would like to return to this subject in the longer term once the work discussed in previous paragraphs had been concluded. It would certainly be desirable to have thought about this area further before considering any changes which might bias the survey process in favour of capital. He asked GEP to investigate whether any other countries operated charging systems for capital.**

10. On the question of whether there was a device which could be built into the expenditure planning system to correct its bias against capital, Sir Peter Middleton enquired whether the Treasury was content with the current required rate of return, which dated from the 1978 White Paper. Mr Odling-Smee said that the rate of return figure equated in long term capital programmes, to the social time preference figure. This did not change rapidly over time, despite changes in short and longer term interest rates. Mr Spackman added that it would be possible to make a case for a figure greater than 5%. But it would not make a considerable difference to the overall level of capital expenditure if the figure was moved either up or down slightly. And the cost of such a change would be high. It was also likely that frequent changes in the number would reduce departments' confidence in it. **Sir Peter Middleton said, in concluding this discussion, that it would be possible to look again at this issue once the study of information on capital and maintenance expenditure had been concluded.**

11. Mr Odling-Smee asked whether much work had been done on other governments' approach to the control of capital expenditure. Mr Anson said that he doubted whether work had been done specifically on that question. But his experience with the IMF suggested that other countries control systems were similar to our own. Mr Turnbull referred to moves in North America towards public sector balance sheets. **Sir Peter Middleton said that it would be useful to discover which other countries operated separate budgets for planning and controlling capital and current expenditure. He asked Mr Turnbull if this could be pursued together with the implications of efforts in North America to improve reporting on public sector capital transactions.**

12. Sir Peter Middleton turned briefly to the question of accounting issues. In a brief discussion, there was little enthusiasm for changing table 6.5 of the FSBR along the lines suggested by Mr Lord in his minute of 18 December. It would be possible to distinguish current and capital expenditure but this amounted to little more than punctuating the existing table with side headings. Mr Odling-Smee added that it would be possible to split out capital expenditure on defence also, but only on the NATO definition. **Sir Peter Middleton concluded that there was little merit in changing the table in this way. It would be possible to offer the Chancellor a split between capital and current expenditure as Mr Anson suggested. It would also be possible to offer a split of defence expenditure; but, since defence capital expenditure was projected to fall over the next three years, the Chancellor might well not find this solution attractive.**

KF Murphy

~~K~~ F MURPHY
Private Secretary

Circulation: Those present
Miss Peirson
Mr Lord
Mrs Lomax

SECRET AND PERSONAL until release of press notice on 28/1/86 at 11.30 am

S.10389/12

Copy No .3.(24)

To:

MINISTER FOR TRADE

From:

P J STIBBARD
US/S2
Room V/258 - 215-5574

16 January 1986

C/To note

OVERSEAS TRADE FIGURES FOR DECEMBER 1985: EXPORTS

The value of exports in December, seasonally adjusted on a balance of payments basis, is estimated at £6425 million, £117 million (2 per cent) higher than in November. Exports of oil fell by £48 million while exports of the erratic items were virtually unchanged. The value of exports of manufactures (excluding the erratic items) increased by £195 million (5 per cent) between the two months; about half of the rise resulting from higher deliveries of capital goods.

In the fourth quarter of 1985, export volume was 4 per cent higher than in the third quarterand about the same level as the fourth quarter of 1984. Excluding oil and the erratic items, export volume increased by 2 per cent in the latest quarter; there are now signs that the underlying level of non-oil export volume has risen a little in recent months.

Between 1984 and 1985 as a whole, export volume is provisionally estimated to have increased by 6 per cent.

Recent figures are shown in the attached table. Graphs showing movements in export volume over the past two years are also attached.

Import data for December are not yet available. A further note describing imports and exports in December will be circulated on Wednesday, 22 January.

PJS

P J STIBBARD

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EXPORTS
(Balance of payments basis: seasonally adjusted)

		---TOTAL TRADE---		EXCLUDING --OIL & ERRATICS--	
		VALUE £m	VOLUME (1980=100)	VALUE £m	VOLUME (1980=100)
1984	Q4	19312	119.6	13990	115.4
1985	Q1	20295	120.5	14641	116.7
	Q2	20251	120.6	14584	115.4
	Q3	18481	115.0	14148	113.6
	Q4	19050	119.6	14395	116.2
1985	JUL	6334	117.0	4818	115.4
	AUG	6040	113.4	4714	113.7
	SEP	6107	114.6	4617	111.9
	OCT	6317	119.1	4690	114.0
	NOV	6308	118.9	4771	115.5
	DEC	6425	120.7	4934	119.1

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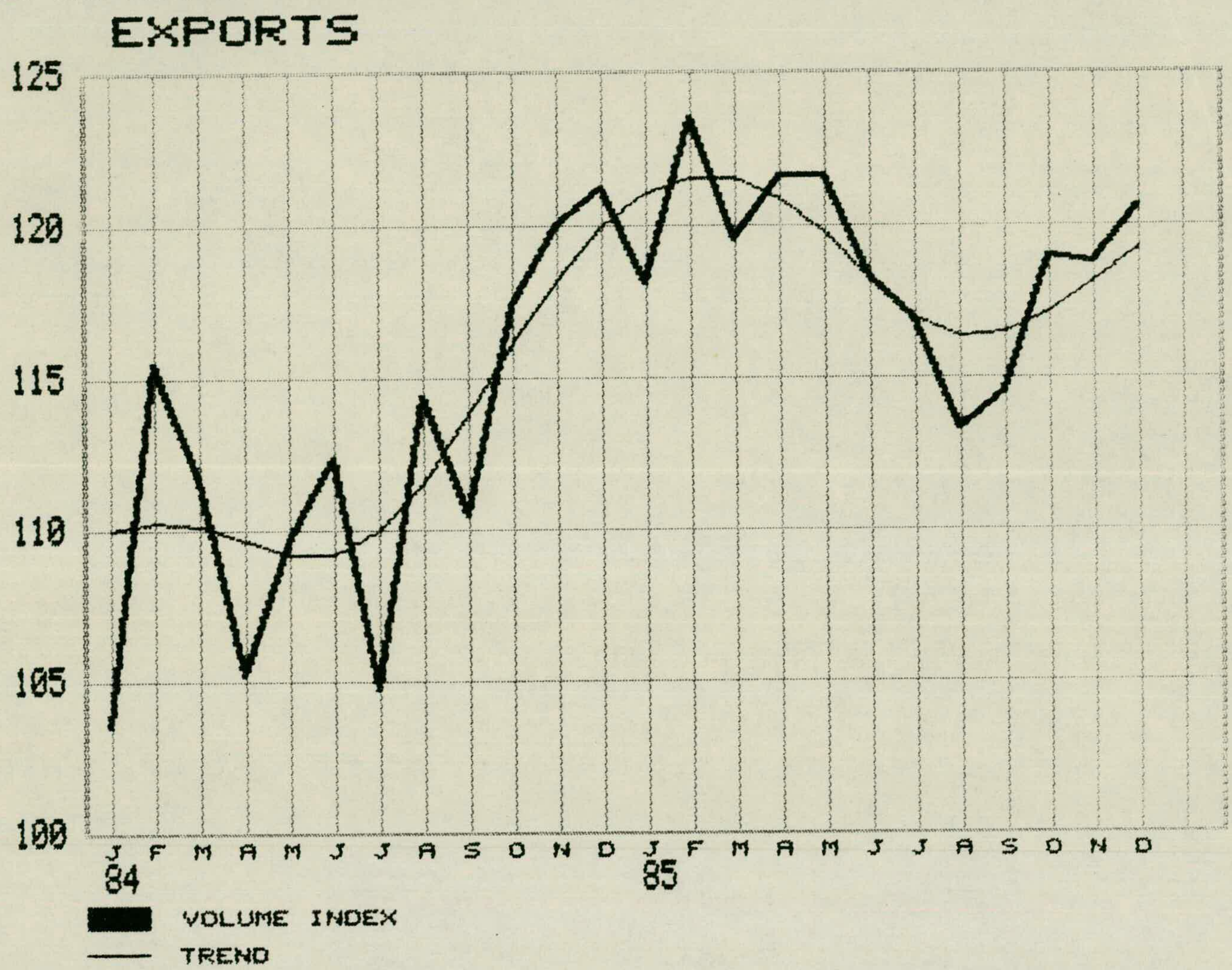

ON A BALANCE OF PAYMENTS BASIS, 1980 = 100, SEASONALLY ADJUSTED

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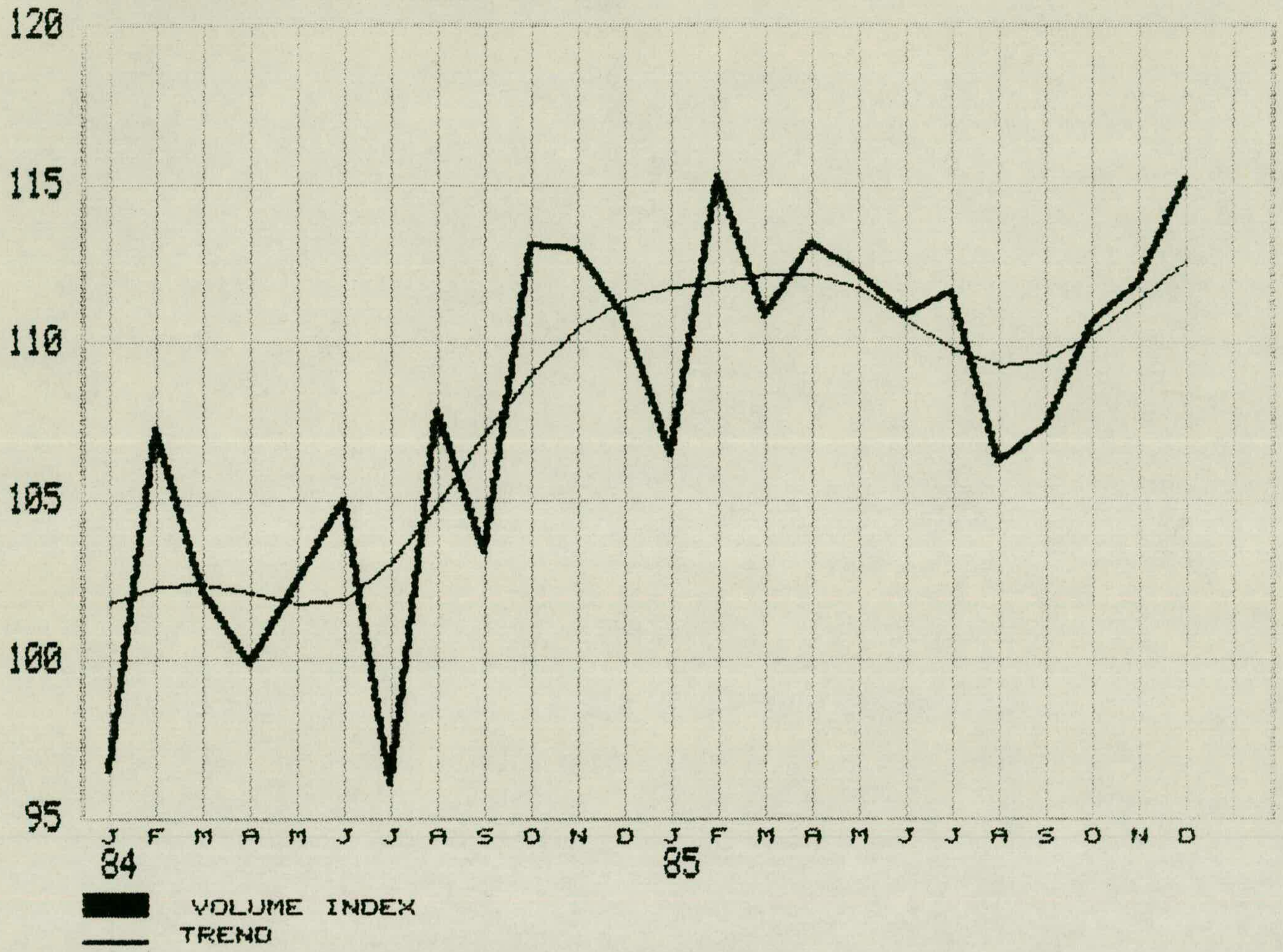
EXPORTS LESS OIL



ON A BALANCE OF PAYMENTS BASIS, 1980 = 100, SEASONALLY ADJUSTED

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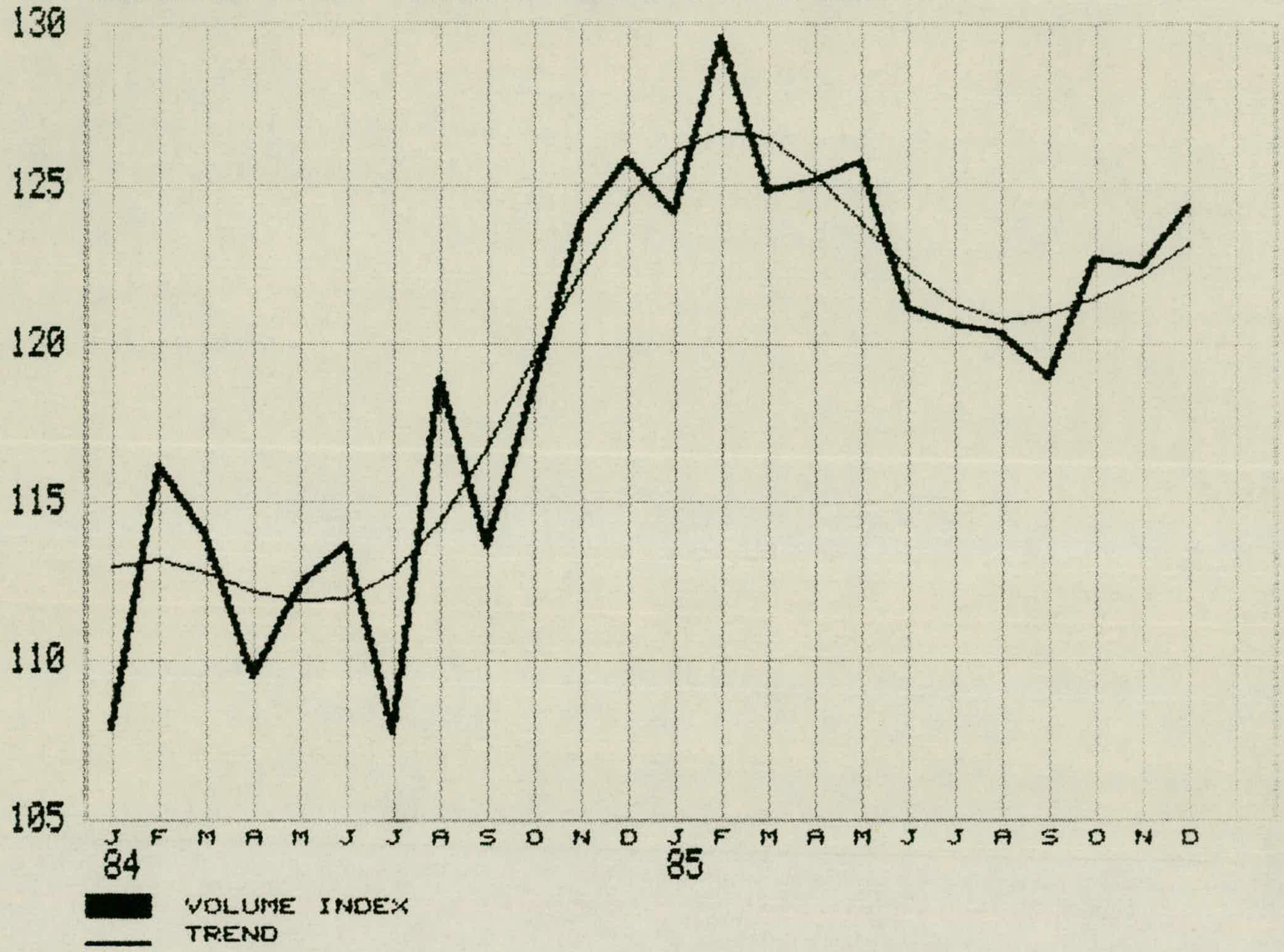
EXPORTS LESS ERRATICS



ON A BALANCE OF PAYMENTS BASIS, 1980 = 100, SEASONALLY ADJUSTED

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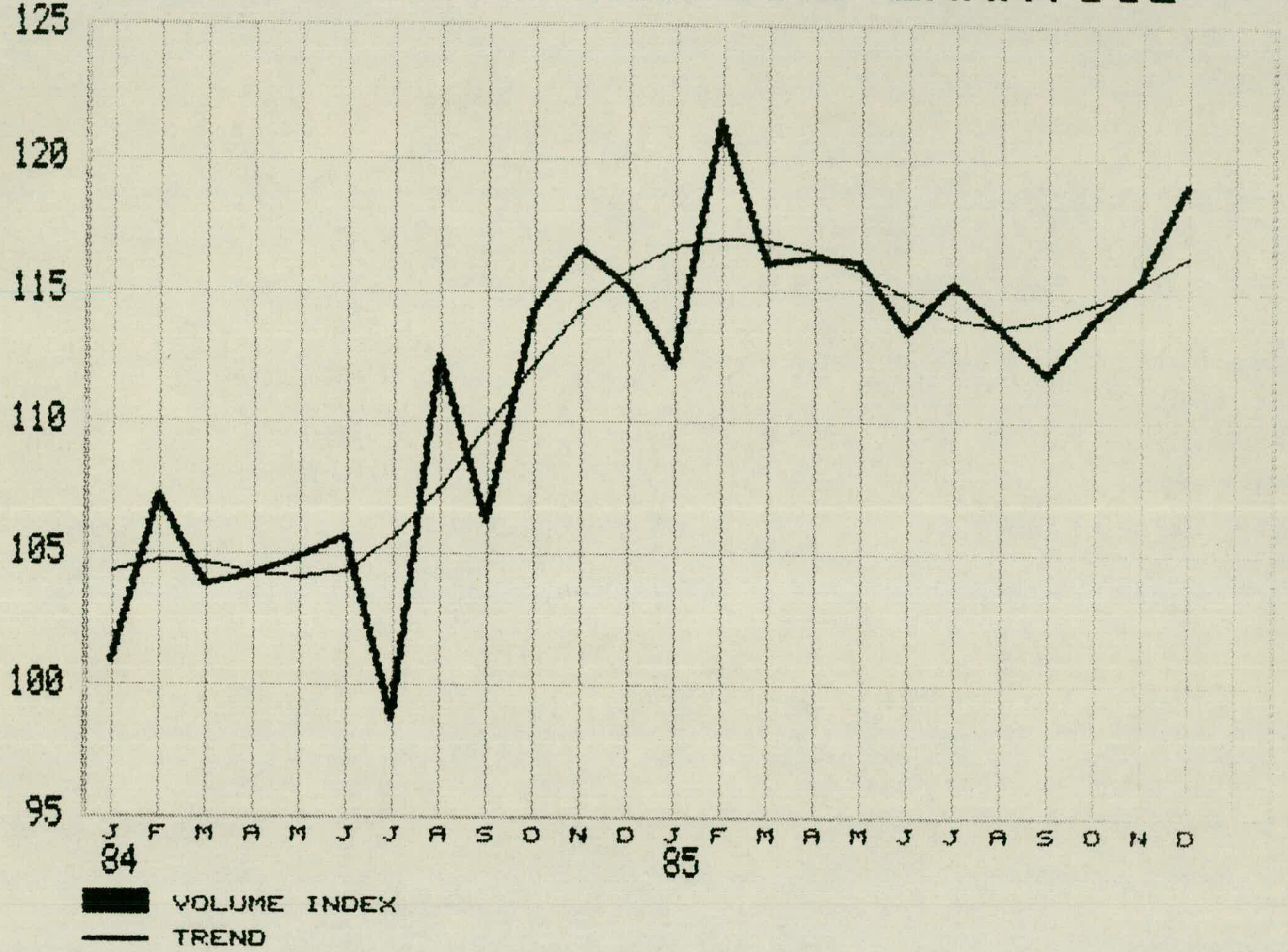
EXPORTS LESS OIL AND ERRATICS



ON A BALANCE OF PAYMENTS BASIS, 1980 = 100, SEASONALLY ADJUSTED

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CONFIDENTIAL

FROM: S BROOKS
DATE: 16 JANUARY 1986

1. MR S J DAVIES SJD 16/1
2. CHANCELLOR OF THE EXCHEQUER

cc: PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
PS/Minister of State
Sir Peter Middleton
Sir Terence Burns
Mr F E R Butler
Mr F Cassell
Mr N Monck
Mr Kemp
Mr H P Evans
Mr Odling-Smee
Mr M Scholar
Mr Culpin
Miss O'Mara
Mr Gilhooly
Mr Page
Mr Vernon
Mr Halligan
Mr P Davis
Mr Westwater
Mr H Davies
Mr Cropper

I take it that 5.7% will be the indexation factor for tax purposes (allowances etc): what difference in practice will this make to the AS figures on the basis of 5½%? or above £100

THE DECEMBER RPI (to be published at 11.30 am on Friday 17 January)

The level of the RPI was only 0.1 per cent higher in December than in November. However, because the level of the RPI actually fell between the corresponding two months in 1984, the twelve-month rate of inflation rose to 5.7 per cent in December from 5.5 per cent in November.

2. In the year to 1985Q4 the RPI increased by 5.5 per cent as forecast in the Autumn Statement. Comparing the calendar years 1985 and 1984, the RPI increased by 6.1 per cent. Over the first seven of the eight months relevant to the next social security uprating the RPI has risen in total by 0.9 per cent.

n6sb

3. In December, food prices increased by more than ½ per cent reflecting sharp seasonal increases in vegetable prices; coal and telephone charges both increased by about 1¼ per cent as further effects of previously announced price rises came through to the index. The costs of motor insurance went up by 1.7 per cent. Petrol prices fell by 0.6p per gallon between November and December and there were also small falls recorded in the prices of alcoholic drink, clothing and footwear, and motor vehicles.

4. We expect that the twelve month rate of inflation in January will be about the same as in December with a fall likely in February reflecting, amongst other things, the rise in mortgage rates in February 1984.

5. The increase in the RPI is just below what is expected in the city - Simon & Coates, Phillips & Drew, and Wood Mackenzie are all expecting a twelve-month rate of 5.8.

S Brooks

S BROOKS

EA1

n6asb

082

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FROM: A W KUCZYS
DATE: 17 JANUARY 1986

CHANCELLOR

DECEMBER RPI

Yes: the indexation factor will be 5.7 per cent. Because of rounding, the figures for the basic married and single allowances are unchanged from the Autumn Statement. The married and single age allowances will now be £10 higher than in the Autumn Statement; and the age allowance income limit and the basic rate limit will both be £100 higher. The width of the higher rate bands will be the same - but each band will start £100 higher.

2. All these increases together cost about £15 million in 1986/87, and £25 million in 1987/88. This is not of course a "nibble" off the fiscal adjustment, but rather a small shift in the base against which other changes are costed.

3. Incidentally, the costs of basic rate changes in the Scorecard are not comparable to the figures in the Autumn Statement. The main reason is that the Autumn Statement assumes that the "composite rate" would be adjusted downwards immediately: in fact there is a one-year lag.

A W KUCZYS

26/2269

FROM: J ODLING-SMEE

DATE: 17 January 1986

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Minister of State
Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Byatt
Mr Cassell
Mr Evans
Mr Scholar
Mr Sedgwick o.r
Mr Culpin
Mr Melliss
Dr James
Mr Cropper
Mr H Davies

Cx/ Just to note
RL
17/1

Thanks
N

RELEASE OF THE TREASURY MODEL

We are obliged by the Industry Act 1975 to make the Treasury model available to the general public. In practice this means that we release the latest version of the model once a year, around December/January, to the licenced computer bureaux and to a few university computing centres. The last version was released in January 1985, and we are hoping to release the present version within the next week.

2. The actual release involves handing over a few computer tapes and explanatory documents to our contacts at the bureaux and universities. These are private exchanges and receive no publicity. Later in the year we are intending to publish a model manual which explains the properties of the new model to a wide audience. The last full manual was published in 1982, although there was a supplement in 1984.

3. There has been very little public reaction to the performance of the model which was released last year. However, the Warwick Bureau, as part of their regular model comparison work, have published simulation results based on the model, and it was used by the Parliamentary Unit in their evidence to the TCSC on the Autumn Statement.

4. As usual there have been a large number of changes to the model this year, many of them minor. The most important changes from the point of view of the properties of the model as a whole are: the incorporation of cost of stocks effects into the stock building equations (discussed in the recent factor price working paper); a new system for the determination of the demand for personal sector liquid assets; a re-structuring of the building societies model; and a change to the method whereby the volume of manufactured exports is determined. The other changes over the somewhat longer period since September 1984 were listed in my minute of 10 January.

5. The overall properties of the model are broadly unchanged. However, crowding out of a fiscal expansion with unchanged money supply occurs a little more rapidly than in last year's model. For example, in the case of an increase in government expenditure, the initial increase in output disappears about six months earlier than it did before. This is primarily due to changes in the behaviour of consumption resulting from changes in the liquid assets system.

Obh OS

J ODLING-SMEE

CONFIDENTIAL

cpwp

FROM: MRS R LOMAX
DATE: 17 January 1986

MR S J DAVIES

cc: PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
PS/Minister of State
Sir P Middleton
Sir T Burns
Mr F E R Butler
Mr H P Evans
Mr Scholar
Mr Turnbull

ECONOMIC ASSUMPTIONS FOR PUBLIC EXPENDITURE: PRE-BUDGET REVISIONS

The Chancellor has seen your minute of 15 January and is content with what is proposed.

RL

RACHEL LOMAX

8:2

PERSONAL AND CONFIDENTIAL
until 11.30am Monday 20 January
then UNCLASSIFIED

pxx

FROM: K VERNON
DATE: 17 JANUARY 1986

1. **~~MISS~~ O'MARA**

2. **CHANCELLOR OF THE EXCHEQUER**

Good news after the 1/4 per cent fall in the index published last month. This is the first time the CSO have made their new bias adjustment to the manufacturing figures; the series now looks rather healthier
MOM
17/1

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir Peter Middleton
Sir Terence Burns
Mr Cassell
Mr Monck
Mr Burgner
Mr H P Evans
Mr Scholar
Mr Shaw
Mr Culpin
Mrs Davies
Mr Aaronson
Mr Naisbitt
Mr Pickering
Mr Dyer (+1 for No 10)
Mr King
Mr Cropper
Mr H Davies
Mr Lord
Mr Mansell - CSO
Mr Kingaby - CSO
Mr Lang - CSO
HB/02

INDEX OF OUTPUT OF THE PRODUCTION INDUSTRIES - NOVEMBER 1985

This will be published at 11.30am on Monday, 20 January.

2. The index of production increased by 2 per cent in the 3 months to November 1985 and was 6½ per cent higher than a year ago. Within production, manufacturing output rose by ¾ per cent in the 3 months to November.

3. Between October and November 1985 the index of production rose by 1¼ per cent. Manufacturing output rose by ¾ per cent but output of the energy and water supply industries rose by 2¼ per cent - this substantial increase was due to increased electricity and gas output in an exceptionally cold November.

4. Recent movements

percentage changes	1985 (Sept-Nov) on 1985 (June-Aug)	1985 (Sept-Nov) on 1984 (Sept-Nov)	November on October
Index of Production	+2	+6½	+1¼
within which:			
Manufacturing	+ ¾	+3¼	+ ¾
Energy and Water	+4½	+14½	2¼
underlying figures **adjusted for coal strike:**			
Index of Production	+1¾	+2¾	+1¼
Manufacturing output	+ ¾	+3¼	+ ¾

5. The CSO Press Notice will state that the effects of the coal strike on the level of industrial production were negligible in the three months to November.

6. The CSO have now introduced a series of bias adjustments, based primarily on CBI survey responses, to correct for the acknowledged under-recording of early estimates of manufacturing output. These adjustments are applied to the indices for the most recent six months which are those that in the past have borne the brunt of upward revisions. Routine revisions to the historical production indices, based on revised seasonal factors, have also been made.

7. Manufacturing output growth was sluggish around the middle of the year but is now growing steadily and growth in the three months to November 1985 was around 3 per cent at an annual rate. In the first eleven months of 1985 manufacturing output was up 3¼ per cent on the same period of 1985.

8. In the three months to November the index of production was 2½ per cent above its average 1979 level and only ¼ per cent below the all time high for a three month period reached in May-June 1979. November's monthly production index was the second highest ever - only ¼ per cent below the record level of June 1979.

PERSONAL AND CONFIDENTIAL
until 11.30am Monday 20 January
then UNCLASSIFIED

Industrial detail

9. Oil and gas extraction in the three months to November 1985 was 8½ per cent above the previous three months but remains below the peak level reached in January 1985. Good increases in output in the three months to November 1985 compared with a year earlier were recorded by Mechanical engineering [+7 per cent], textiles [+8½ per cent], Motor vehicles [+7½ per cent.]

Assessment

10. Manufacturing output has risen strongly, over the past two years and continues to grow in underlying at terms around 3 per cent a year.

11. Press comment is likely to be favourable. There may be some reference to the bias adjustments but, given earlier criticism of the series, these should be generally well received and not regarded as a fiddling of the statistics.

12. Growth of manufacturing output so far in 1985 - up 3¾ per cent in the first eleven months of the year over the same period last year - suggests that the outturn for 1985 will be growth of around 3 per cent. The Industry Act Forecast of 2½ per cent growth is now on the low side.

Lines to take

13. Possible lines to take for IDT are:

14. Positive:-

(i) Industrial production increased by 6½ per cent in the year to the three months to November.

(ii) Manufacturing output has shown good growth well into 1985 and best assessment is that it continues to grow at annual rate of around 3 per cent.

(iii) Manufacturing output up by around 3 per cent in 1985 and Industry Act Forecast projects growth of 2½ per cent this year. This will imply uninterrupted growth since 1981 - longest period since 1973.

(iv) Manufacturing output up by 13 per cent on 1981Q1 trough and 11 per cent since June 1983 election.

Defensive:-

(v) Recent measured manufacturing growth purely result of 'bias adjustments'. Bias adjustments based on a well researched system to correct for long, acknowledged, tendency of initial estimates of manufacturing output to under record true level.

K Ver

K VERNON
EB

PERSONAL AND CONFIDENTIAL
until 11.30am, Monday 20 January

TABLE 1

OUTPUT OF PRODUCTION AND CONSTRUCTION INDUSTRIES

1980 = 100, seasonally adjusted

	Production * (Divisions 1-4) *	Energy and Water Supply (Division 1)	Manufacturing (Divisions 2-4)	Construction (Division 5)
1979	107.1	100.5	109.5	105.8
1980	100.0	100.0	100.0	100.0
1981	96.6	103.9	94.0	89.9
1982	98.4	110.0	94.2	91.6
1983	101.9	115.8 R	96.9	95.3
1984	103.2 R	110.1	100.7 R	98.6
1983 Q3	102.8	117.6	97.6 R	97.7
Q4	104.1 R	118.3 R	98.9 R	97.8
1984 Q1	104.3	117.7 R	99.5 R	97.0
Q2	102.2 R	107.9 R	100.1 R	98.1
Q3	102.6 R	105.4	101.6 R	100.5
Q4	103.5	109.5 R	101.4 R	98.7
1985 Q1	106.3 R	115.8 R	102.9 R	99.3
Q2	108.2	121.0 R	103.6 R	100.2
Q3	108.4 R	121.4 R	103.8 R	100.1 R
1984 August	102.1 R	103.4 R	101.7 R	
September	103.4 R	106.6 R	102.2 R	
October	103.3 R	110.2 R	100.8 R	
November	103.3 R	109.0 R	101.3	
December	104.0	109.4	102.0 R	
January	105.9 R	115.8 R	102.4 R	
1985 February	105.6 R	113.9 R	102.6 R	
March	107.4 R	117.7 R	103.7 R	
April	108.5 R	122.3 R	103.5 R	
May	108.6 R	123.0 R	103.4 R	
June	107.6 R	117.6 R	104.0 R	
July	107.7 R	120.0	103.3 R	
August	108.1 R	119.2 R	104.1 R	
September	109.4 R	124.9 R	103.9 R	
October	109.4 R	122.5 R	104.7 R	
November	110.7 R	125.3	105.4	
% changes				
Latest 3 months on previous 3 months	1.9	4.5	0.8	-0.1
Latest 3 months on year earlier	6.3	14.4	3.2	-0.4
Latest 3 months on 1981 Q1 (trough)	15.5	19.8	12.9	8.3
Latest 3 months on 1979 Q2 (peak) +	0.6	19.2	-6.9	-6.6

Notes

* Within the total 'production' index energy and water supply industries accounts for 26 per cent, and manufacturing for the remaining 74 per cent

'R' signifies revised figure   + Energy & Water Supply peak is 1979 Q3

PERSONAL AND CONFIDENTIAL
until 11.30am, Monday 20 January

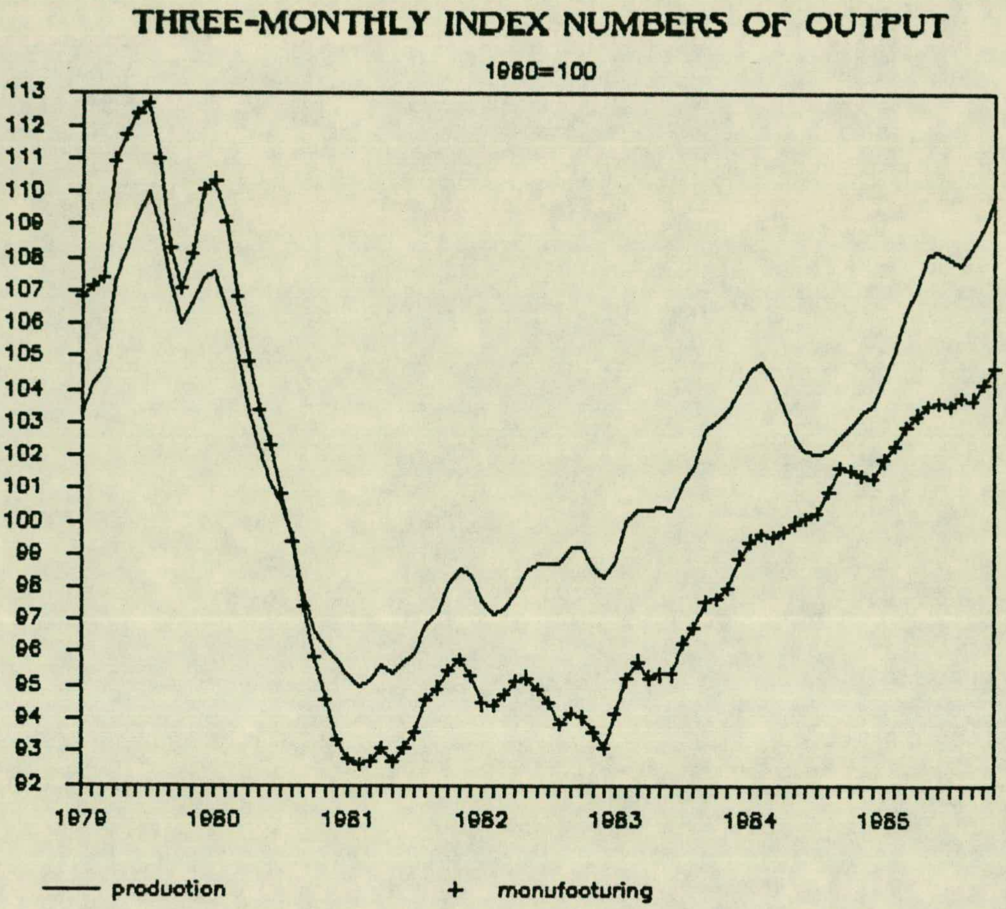
TABLE 2

OUTPUT OF PRODUCTION INDUSTRIES CHANGES IN DETAIL

Percentage change, latest 3 months* on:

	Previous 3 months	Same 3 months last year	1981 Q1 (trough of output of production industries)
Total Production Industries	1.9	6.3	15.5
Energy & Water Supply	4.5	14.4	21.8
o.w. extraction of oil & gas	8.8	2.6	42.6
coal and coke	3.9	209.4	-16.5
Total Manufacturing	0.8	3.2	12.9
o.w. Metals	-2.0	7.8	16.5
Other minerals +	0.9	0.1	6.8
Chemicals (and man-made fibres)	-0.9	1.6	22.3
Engineering	1.1	3.8	16.0
Food, drink, tobacco	1.0	0.8	3.7
Textiles etc.	0.9	4.6	14.5
Other ++	1.9	3.9	8.5

* September, October & November 1985
\+ Mainly building materials
++ Paper, printing, publishing, timber, furniture, rubber, plastics


THREE-MONTHLY INDEX NUMBERS OF OUTPUT
1980=100
113
112
111
110
109
108
107
106
105
104
103
102
101
100
99
98
97
96
95
94
93
92
1979
1980
1981
1982
1983
1984
1985
production
+ manufacturing

2

JO709

MR D NORGROVE
Prime Minister's Office

INDEX OF OUTPUT OF THE PRODUCTION INDUSTRIES - NOVEMBER 1985

The provisional index of output of the production industries for November 1985 will be issued at 11.30 am on Monday 20 January. A copy of the Press Notice is attached.

Latest figures

The November 1985 index of output of the production industries, that is energy (including coal) and manufacturing, is provisionally estimated at 110.7 (1980=100, seasonally adjusted), up 1 per cent on October. For manufacturing the index was 105.4, up ½ per cent on October (see section on Bias Adjustments below). In the three months to November output of the production industries was 2 per cent higher than in the previous three months and manufacturing output was 1 per cent higher. Some industry detail is given in the attached table.

Assessment

Manufacturing output has continued to grow steadily. Output in the three months to November was 3 per cent above the level of a year earlier.

Oil extraction was low between June and August, due to maintenance work, but has since recovered.

Output of the production industries in the latest three months was 15½ per cent higher than at its trough in the first quarter of 1981.

Bias adjustments for manufacturing output

One feature of this month's Press Notice which may attract some press attention is that we are introducing a new series of adjustments to the figures to try to make better allowance for a downwards bias in the provisional estimates. The adjustments cover the latest six months and range from about +¼ per cent in June to +1 per cent in November and replace our present procedure where we adjust only the most recent month's estimates. The adjustments, which are being made with wide Departmental agreement, will lead to better information, on average, than hitherto. Note 12 of Notes to Editors in the Press Notice summarises the adjustment procedure. Appropriate press briefing on the new adjustments has been prepared.

Revisions

Reflecting the new adjustment procedure and other improvements, figures for recent months are higher than previously published.

Impact of the dispute in the coal mining industry

In terms of the three month comparisons in the Press Notice, the after-effects of the dispute on production industries in both the latest and previous three months were only negligible. In the three months to November 1984, the impact of the dispute was nearly 3½ per cent.

Figures for December

Figures for December are scheduled for publication on Friday 14 February 1986.

KM

K MANSELL

Central Statistical Office
17 January 1986

Table A

Copy No.

PERSONAL AND CONFIDENTIAL until release of Press Notice at 11.30 am on January 20 1986 and thereafter unclassified

Index of output of the production industries 1980=100

SUMMARY	Total production industries	Energy and water supply	Total manufacturing industries	Metals	Other minerals and mineral products	Chemicals and man-made fibres	Engineering and allied industries	Food, drink and tobacco	Textiles, footwear, clothing and leather	Other manufacturing
1983	101.9	115.8	96.9	104.5	93.9	107.5	94.9	101.0	94.6	93.6
1984	103.2	110.1	100.7	108.4	95.1	113.9	99.2	102.1	98.0	97.6
1984 2	102.2	107.9	100.1	106.0	95.1	112.0	98.3	102.7	97.3	98.0
3	102.6	105.4	101.6	109.4	95.9	116.2	100.7	102.2	98.5	97.5
4	103.5	109.5	101.4	106.5	95.0	116.0	100.3	101.7	99.4	97.9
1985 1	106.3	115.8	102.9	110.2	92.4	119.0	103.1	101.8	100.0	97.7
2	108.2	121.0	103.6	116.3	94.1	119.5	104.1	101.1	100.5	97.7
3	108.4	121.4	103.8	118.0	93.9	118.3	102.8	102.2	103.7	100.3
1985 S	109.4	124.9	103.9	117	93	119	103	102	103	100
O	109.4	122.5	104.7	114	96	118	105	103	104	101
N	110.7	125.3	105.4	116	97	118	105	104	106	103
Percentage change latest 3 months on:										
previous 3 months	+1.9	+4.5	+0.8	-2.0	+0.9	-0.9	+1.1	+1.0	+0.9	+1.9
a year earlier	+6.3	+14.4	+3.2	+7.8	+0.1	+1.6	+3.8	+0.8	+4.6	+3.9
1st quarter 1981(a)	+15.5	+21.8	+12.9	+16.5	+6.8	+22.3	+16.0	+3.7	+14.5	+8.5
1st half 1979(b)	+2.7	+25.9	-4.7	-11.3	-11.7	+8.6	-5.1	+3.2	-13.0	-8.7

DETAILED ANALYSIS	Coal and coke	Extraction of mineral oil and natural gas	Mineral oil processing	Other energy and water supply		Metals	Other minerals and mineral products	Chemicals	Man-made fibres	Metal goods not elsewhere specified
1983	89.5	137.6	95.2	100.7		104.5	93.9	108.4	78.0	94.7
1984	33.8	147.1	98.5	95.8		108.4	95.1	114.9	78.8	100.7
1984 2	22.8	143.5	99.8	99.2		106.0	95.1	113.0	79.9	101.9
3	23.7	144.3	98.4	89.9		109.4	95.9	117.3	79.3	102.5
4	27.6	151.8	99.3	90.1		106.5	95.0	117.1	76.8	98.8
1985 1	35.7	155.5	99.3	100.3		110.2	92.4	120.4	73.1	97.4
2	70.4	148.5	99.7	109.3		116.3	94.1	120.8	75.5	97.7
3	79.6	147.2	98.8	108.2		118.0	93.9	119.5	75.9	97.7
1985 S	81	156	97	106		117	93	120	74	98
O	81	154	95	102		114	96	119	72	97
N	82	151	97	114		116	97	119	76	99
Percentage change latest 3 months on:										
previous 3 months	+3.9	+8.8	-4.2	-2.1		-2.0	+0.9	-0.9	-2.3	+0.5
a year earlier	+209.4	+2.6	-4.8	+18.9		+7.8	+0.1	+1.8	-5.9	-2.0
1st quarter 1981(a)	-16.5	+42.6	-	+10.8		+16.5	+6.8	+23.3	-17.9	+10.6
1st half 1979(b)	-14.7	+63.8	-14.9	+2.3		-11.3	-11.7	+10.6	-46.4	-20.4

DETAILED ANALYSIS continued	Mechanical engineering	Electrical and instrument engineering	Motor vehicles and parts	Other transport equipment	Food	Drink and tobacco	Textiles	Clothing, footwear and leather	Paper, printing and publishing	All other manufacturing
1983	87.5	108.1	83.9	95.0	103.8	95.1	91.3	97.4	92.1	95.2
1984	87.3	122.9	81.3	91.5	104.7	96.7	93.8	101.5	96.1	99.3
1984 2	86.7	120.0	80.6	91.9	104.2	99.5	93.4	100.8	96.6	99.8
3	87.7	126.4	81.8	91.7	104.9	96.7	94.1	102.3	95.7	99.5
4	87.6	128.6	77.6	92.6	104.8	95.5	94.4	103.7	97.5	98.4
1985 1	90.1	130.6	86.2	96.7	104.8	95.6	97.1	102.4	97.9	97.4
2	93.3	129.9	86.6	96.8	103.7	95.7	96.2	104.1	97.5	97.9
3	91.0	128.3	88.7	93.9	105.4	95.7	99.9	107.0	99.9	100.7
1985 S	91	129	90	94	105	96	100	106	100	101
O	93	133	84	97	106	98	102	105	101	101
N	95	131	82	97	106	98	104	107	103	103
Percentage change latest 3 months on:										
previous 3 months	+2.1	+1.8	-3.4	+1.1	+0.7	+1.6	+2.9	-0.7	+2.1	+1.6
a year earlier	+6.9	+2.4	+7.6	+4.1	+0.6	+1.3	+8.3	+1.7	+4.3	+3.3
1st quarter 1981(a)	+6.6	+41.6	+10.8	-9.0	+7.5	-4.0	+12.6	+16.0	+6.6	+10.8
1st half 1979(b)	-15.4	+27.0	-30.9	+2.4	+6.2	-3.1	-18.3	-8.1	-5.4	-12.2

(a) Last trough for production industries (b) Last peak for production industries

Personal numbered copies of the minute and attachment to:

Treasury	(Principal Private Secretary (Sir Peter Middleton
Cabinet Office	(Mr Jack Hibbert
Department of Trade and Industry	(Private Secretary Secretary of State's Office
	(Private Secretary to Mr Geoffrey Pattie
	(Private Secretary to Mr Peter Morrison
	(Private Secretary to Mr John Butcher
	(Sir Brian Hayes (Mr H Liesner
	(Mr Whiting (Mr Harvey (Mr Wright
Bank of England	(Mr R Leigh-Pemberton

LR2.1

pw?

FROM: MRS R LOMAX

DATE: 20 January 1986

MR ODLING-SMEE

cc Sir P Middleton
Sir T Burns
Mr Evans
Mr Scholar
Mr Melliss
Mr Riley
Dr R James
Mr Bredenkamp
Mr Whittaker
Mr Westaway

TREASURY WORKING PAPERS: CONSISTENT EXPECTATIONS AND FEEDBACK RULES

The Chancellor has seen your two minutes of 14 January, and Mr Murphy's minute of 15 January, recording Sir Peter Middleton's concern about the working paper on experiments with feedback rules. He is content for you to go ahead and publish the working paper on consistent expectations, but he would prefer to defer publication of the working paper on feedback rules at least until after the Budget. He would be interested in Sir Peter Middleton's personal views on the second paper - including the question of whether it should be published - in due course.

RL.

RACHEL LOMAX

LR2.2

FROM: MRS R LOMAX
DATE: 20 January 1985

PSV

MR ODLING-SMEE

cc Chief Secretary
Financial Secretary
Minister of State
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Evans

RELEASE OF THE TREASURY MODEL

The Chancellor was grateful for your minute of 17 January. He has noted that you will be releasing the latest version of the Treasury model during the course of this week.

RL

RACHEL LOMAX

2603/007

Thanks. Surprised at the rather van W's theory that the US budget deficit is expansive for the Community (see fig X).

FROM: P S CARPINTER
S J PICKFORD
DATE: 21 JANUARY 1986

CHANCELLOR

As requested — the second Annex is interesting.

Rs 24/1

cc: Sir T Burns
Mr Byatt
Mr Mountfield
Mr Odling-Smee
Mr Scholar
Mr Sedgwick O/R
Mr Spackman
Mrs Case
MrsMatthews
Mr Riley
Mr H Davies

ECONOMIC POLICY: A EUROPEAN FORUM

You asked (Mrs Lomax's minute to Sir T Burns of 22 November) for assessments of the other articles in this journal by Buiter and King, and whether there was anything of interest in the other articles.

2. You have already received assessments of the articles named. Attached to this minute are comments on two of the articles in the journal, which you may find of interest, since they are relevant to the international debt problem.

3. The Cohen article derives a solvency ratio for debtors which indicates the continuing proportion of exports required to service existing debt. With an assumed fall in world interest rates and growth in exports from debtors, he comes up with much lower numbers than the more conventional indicators of debt service ratios, mainly because he allows the possibility of some interest due in the short term being capitalised and repaid in the longer term. However, our assessment is that Cohen's index is sensitive to small changes in assumptions and based on a more optimistic view than is taken by creditors. Nevertheless his work has already received some exposure in Anatole Kaletsky's article in the FT (8 January - attached).

4. The article by van Wijnbergen is more substantial. He formulates and estimates an interesting model which stresses the interdependencies between countries, in particular between LDCs and industrialised countries. The model can no doubt be improved on, but even at this stage the results are

interesting. He presents estimates which show the costs which would be imposed on LDCs if the industrialised countries increased their fiscal deficits (causing real interest rates to rise, and LDCs' terms of trade to deteriorate); or if they raised protection (the cost being largely shifted onto LDC producers).

P. S. Carpinter
Stephen Pickford

P S CARPINTER
S J PICKFORD

Daniel Cohen (CEPREMAP, Paris; and World Bank, Washington)
'How to evaluate the solvency of an indebted nation'

Cohen defines 'solvency' as the ability of a country to make a flow of repayments that over time at least matches the face value of its external debt. The author calculates an index that indicates the proportion of export earnings which will, if continued over time, completely service a particular country's existing debt. This contrasts with the more usual indicator, the proportion of exports necessary to pay all interest on outstanding debt without making any capital repayments. The index is derived from an individual country's initial export earnings and its outstanding stock of debt, and from explicit assumptions about export growth and real interest rates. Cohen assumed that exports from debtor countries would grow in line with most other forecasts, about 5-6 per cent pa, while real interest rates facing borrowers were assumed to fall from 12 per cent pa to 9 per cent pa in 1986.

2. Cohen's solvency index for the three most important debtors is set out below, alongside the more traditional indicator of the percentage of export earnings needed to pay all interest due on outstanding debt:

	Cohen's Solvency Index	Debt Interest as Percentage of Export Earnings (1984)
Brazil	15.0	39
Argentina	16.40	50
Mexico	12.11	35

The table illustrates perhaps the most important feature of Cohen's index as it was published. In the short term, it produces numbers that are a good deal lower than those of more conventional indicators. The index is based on the view that countries will not have to pay all interest as it falls due, since their growth in exports, along with the assumed fall in real interest rates, would enable a proportion of existing interest payments to be capitalised and repaid later. Based on his index, Cohen argues that most debtors adjusted sufficiently in 1983, and that some, including Brazil, adjusted too far in 1984.

There are two serious objections to this view. The first is that the index is very sensitive to small changes in assumptions: a one per cent difference in either real interest rates or export growth will lead to index values changing by about twenty five per cent. If real interest rates were not to fall, the proportion of exports required to service debt would rise sharply.

Secondly, solvency is usually measured by lenders rather than borrowers. Commercial banks make up the bulk of lenders to the major debtors, and the evidence seems clear that their view of the world is not as optimistic as Cohen's. In particular, their views on the likely movements in interest rates may well be different and to date, they have strongly resisted the capitalisation of interest in debt rescheduling exercises.

The index is based on a particular view of the world, and is sensitive to minor changes in that view. The article may have been more useful had it set out to discuss the evidence for the assumptions used to derive the index.

ECONOMY POLICY NO.1 (NOVEMBER 1985)

S van Wijnbergen (World Bank) "Interdependence revisited: a developing countries perspective on macroeconomic management and trade policy in the industrial world"

Summary

The paper is in three main sections. The first section presents a summary of trade developments. It stresses the links between industrial country protectionism against LDCs and the debt crisis; it also presents some 'back-of-the-envelope' calculations of the effects of policy changes by OECD countries on LDCs' welfare (broadly equivalent to their real national income). These calculations, based on estimates in other articles, show that:

(i) the direct terms of trade effect (ie assuming real commodity prices remain constant) of 1 percentage point faster GDP growth in OECD would have improved LDCs' welfare by $1.3 bn in 1984;

(ii) the indirect effect from higher commodity prices (assumed to arise because of differential movements in the dollar and other industrial country currencies) would have added a further $2.2 bn to LDCs' welfare;

(iii) a 1 percentage point rise in real interest rates would have increased LDCs' debt-servicing costs (and hence their welfare) by $2.3 bn in 1984.

From these calculations he concludes that:

- balanced recovery in OECD would be preferable to the current US-led boom; and
- expansionary US fiscal policy has reduced the flow of resources to LDCs (because US external indebtedness

has increased), and increased the cost of servicing their existing stock of debt (by raising real interest rates).

2. The second section describes the world model van Wijnbergen has constructed. The model identifies three groups of countries - OECD, OPEC, and LDCs. It contains equations for private consumption and the current account, as well as an aggregate supply curve. Market-clearing conditions ensure that there is no excess demand for OECD goods and that the world current account is zero. The main prices which adjust to give market-clearing are real interest rates and the terms of trade between OECD and LDCs.

3. Van Wijnbergen then investigates the properties of his model by

(a) consideration of its theoretical properties

(b) estimation of the model's equations, and quantitative solution of the model (in the third section of the paper).

The results of the simulations (which broadly back up the theoretical conclusions) are that

(i) an increase in the OECD fiscal deficit of \$60 bn at 1984 prices (financed by bond issues) would cause real interest rates to rise by over 2 percentage points, and the LDCs' terms of trade to deteriorate by 2.3 points. As a result LDCs' output would be 2.5 per cent lower after 4 years.

(ii) an increase in protectionism by OECD against the LDCs (in the form of a 10 per cent import surcharge) would be largely shifted on to the LDC producers, so that LDCs' terms of trade would deteriorate by 7 percentage points. Again, real interest rates would rise by 2 points, and the LDCs would suffer a reduction in economic growth of 1.5 percentage points.

4. Van Wijnbergen concludes that reversal of the US' current policy stance of lax fiscal and tight monetary policy would lower interest rates, lead to a recovery in commodity prices, and reduce the risk of increasing industrial country protectionism. X

<u>Comments</u>

5. Also published with the article are comments by Rudiger Dornbusch (MIT), Mike Wickens (Southampton) and others. Dornbusch (a well-known critic of the case-by-base approach and an advocate of writing-off LDC debts) has a number of criticisms, of which the main are:

- Van Wijnbergen presents no new evidence for his view that the rise in real interest rates is due to fiscal expansion

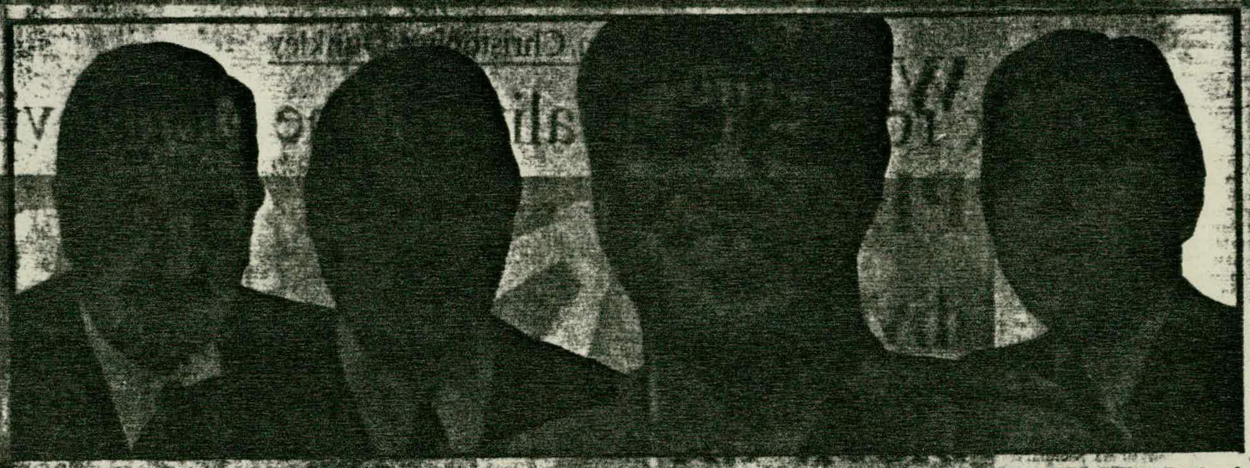
- lumping together all LDCs into one aggregate loses much important detail.

Wickens' comments are more technical in nature, concentrating on the theoretical specification of the model, and the estimation techniques.

6. This work seems a promising approach to the question of interdependence. It is also useful to have new estimates of the effects of industrial country policies on LDCs. Attention has been concentrated up to now on Cline's estimates. Van Wijnbergen arrives at rather different results from Cline. In particular his "back-of-the-envelope" calculations imply that the welfare effects on LDCs of faster OECD growth are much smaller than Cline's, in part because Cline equates <u>all</u> increases in exports with a welfare gain, whereas van Wijnbergen only counts that part associated with a terms of trade improvement.

7. The work is clearly still at an early stage and no doubt

can be improved on. It would be wrong to put too much reliance on the detailed quantitative results, but they do suggest substantial interlinkages between the economic performance of the industrial countries and debtor countries.



Presidents Alfonsin of Argentina and Sarney of Brazil (left and centre left)—defiance of the IMF. Presidents Babangida of Nigeria and Garcia of Peru (centre right and right)—imposing a solution on the banks.

For crisis, read problem

By Anatole Kaletsky

THE Third World debt crisis may at last be over. The [illegible] propitious signal may [illegible] been an odd one, but [illegible]pressive nonetheless. It came on New Year's day.

When President Ibrahim Babangida of Nigeria announced that his country would limit its foreign debt payments in 1986 to 30 per cent of its export earnings, the financial community far from reacting with alarm and outrage raised hardly a murmur of protest.

Developing countries' massive debts will doubtless remain an endless source of difficulties for many years ahead; but they are losing their capacity to shock the international system. Third World debt is maturing from a crisis into a mere problem.

Back in 1983, the fate of the whole world economy was thought to hang on a flimsy thread of mutual dependence which bound the great international banks, the IMF and the debtor countries of Latin America, Africa and Asia. Each time this thread was stretched — by an intransigent debtor, an unyielding bank or a deterioration in economic conditions — the dreaded word "default," along with its attendant bank runs, trade wars and monetary panics, would be exhumed from the vocabulary of financial crisis.

Against this background hardly anyone dared to contemplate what might occur if the debtors started to seize the initiative from the IMF and the banks. It was unthinkable that confidence and stability might actually be *increased* as the balance of power shifted in favour of the debtor governments. Yet this is exactly what has been gradually happening over the past year.

Nigeria's decision to limit its debt servicing to 30 per cent of exports — little more than half the money required to pay all of the interest and principal coming due this year — may be less radical than the ceiling of 10 per cent of export earnings imposed by President Alan Garcia of Peru. President Babangida's plan is not, apparently, a non-negotiable ultimatum. It comes from a country which has serviced all its medium-term debts on time and has accorded banks preferential treatment in relation to other creditors. Furthermore, as Nigerian officials have been at pains to point out, the 30 per cent target would still leave room for Nigeria to repay its debts much faster than most Latin American countries.

Nevertheless, the two countries' actions have a principle in common, which is more fundamental than all these differences; a principle which suggests that the increasingly self-confident debtor nations may have passed a turning point in their relations with the banks and the IMF.

Until last year, debt negotiations had been based on an axiom which was almost never questioned. Existing loan agreements were held to be inviolable, except when creditors *chose* to grant reschedulings or concessions to the debtors.

It was then up to the debtor government to "adjust" its economy in order to stay within its financing constraint.

When a country like Nigeria or Peru sets a target rate of debt servicing this procedure is effectively reversed. The country's ability and willingness to spend its foreign exchange earnings on debt servicing, rather than consumption or investment, becomes the dominant constraint in the negotiations. It is now the banks that have to "adjust" to this constraint—either by lending the country more money or by rolling over some of their interest payments.

As a by-product of this, the IMF has been losing its power over economic policies in debtor countries. For the first three years of the debt crisis, Mr Jacques de Larosiere, the Fund's managing director, was the only man who could harness the lending power of the banks on behalf of an approved debtor.

Today, the IMF's assistance seems less indispensable. The "basket cases" like Peru and Bolivia are effectively borrowing more from their banks than they would have got under IMF programmes, simply by withholding interest payments.

Richer countries like Brazil, Venezuela and Nigeria, on the other hand, are calling the bluff of bankers who insist that an IMF agreement is a precondition for any rescheduling.

Why is it that both groups of countries can now routinely defy the IMF and ignore the legally binding repayment schedules in their loan agreements? There is a mixture of good and bad reasons.

On the negative side, there is first the IMF's mixed record of achievement with its adjustment programmes.

Second, it has become steadily clearer over the last three years that banks cannot force sovereign debtors to stick to the letter of their loan agreements. Although the practical difficulty of enforcing sovereign loan contracts has long been taken for granted by the banks' own lawyers, it has only gradually been recognised by the bank managers and the debtor governments themselves.

More recently, even the "moral" link between punctilious debt servicing and financial probity has begun to fray. First there was South Africa, a country widely respected by bankers for its financial management, unilaterally suspending its principal repayments. Then came the governments of such unquestionable repute as Germany, the Netherlands and France, casually denying responsibility for the debts contracted on their behalf by the International Tin Council. Their ultimate defence appears to be sovereign immunity.

No Third World government has yet seen fit to use such arguments, but the worldwide trend towards greater flexibility in the treatment of sovereign obligations must be contributing something to the shift in the balance of power towards the debtor governments.

Fortunately, there is also a positive side to this shift. The IMF's *power* may have declined, but the *influence* of its ideas has spread even to countries which vehemently denounce it as an institution.

At the same time, financial markets in the industrialised world have gradually become less alarmist about the threat of Third World debt to the international banking system.

In combination, all these trends are making the debtor countries more self-assertive and the traditional style of debt negotiation less successful. However, their net effect may ultimately prove stabilising, rather than disruptive.

Why have financial markets not been alarmed by Nigeria's announcement of a debt service limit, or by Brazil's refusal to come to terms with the IMF? Largely because they are increasingly looking at the actual policies which countries are pursuing and the actual amounts of cash which they are likely to pay the banks.

Partly as a result, attention is also shifting from the financial to the economic implications of the debt crisis. This is the real significance of the call by Mr James Baker, the US Treasury Secretary, for "growth-oriented adjustment" in the debtor countries.

In the end, growth-oriented adjustment is bound to mean reducing the amount of money which Third World nations spend at present on servicing their debts. For it is clear that the present rate of debt repayment, involving very large net transfers of capital from Third World countries with huge unexploited investment opportunities to industrial countries with savings surpluses, is undesirable.

How these perverse investment flows can be reversed without disrupting the international financial system will be the central question in the next phase of the Third World debt problem.

Nigeria's and Peru's idea of setting debt service ceilings in relation to export earnings has been widely discussed by other debtors at the Cartagena Group summits.

What would be the implications of such a move? The table shows several ways of gauging debt servicing-to-export ratios.

At first sight, any of the debtors' ceilings might seem to have horrendous implications for bankers. In 1985 Mexico, for example, was in theory supposed to spend 67 per cent of its export earnings on interest and capital payments (column 1), according to the detailed debt records compiled by American Express Bank. Against this figure, ceilings like the 30 per cent suggested by Nigeria, the 20 per cent discussed by the Cartagena Group or the 10 per cent proclaimed by Peru would seem tantamount to outright default.

In practice, however, the banks have invariably been willing to reschedule all the principal repayments for debtors accepting IMF programmes.

Given full rescheduling of principal, Mexico had to spend only 33 per cent of its export earnings on interest in 1985, according to American Express.

In fact Mexico did slightly better than this last year. Its current account surplus excluding interest—a figure which measures the amount of cash flow available for making debt payments—was equivalent to 35 per cent of export earnings (see column 2).

In relation to the figures for Mexico and most other countries in column 2, a debt service ceiling of 30 per cent would imply very little relief for most countries and few problems for the banks.

A 20 per cent ceiling, on the other hand, would involve a substantial reduction in debt servicing burdens and would reduce significantly the capital flow from the Third to the First World.

But would such a ceiling threaten the stability of the international banking system? This depends partly on whether debt payments above the ceiling were simply repudiated, or whether they were rolled over into new borrowing. In the latter case the banks could theoretically survive in the short term, as they did in the 1970s, when developing countries regularly borrowed more money each year than they repaid.

Nobody can say for sure how much additional borrowing the Third World counteries could now undertake without jeopardising their own solvency even further, and the banking system's with it. Surprisingly to many laymen, however, most theoretical studies which have looked at this question conclude that the sustainable—and economically efficient—level of new borrowing would be very much higher than it has been over the past three years.

The third column in the table shows the most recent such set of results, based on work done at the World Bank by Mr Daniel Cohen.* The figures show the percentage of export earnings which various countries would have to devote to debt servicing in order to keep their total debt to export ratio on a declining trend.

The author's assumptions were deliberately extremely pessimistic—real interest rates of 9 per cent from 1985 onwards and export growth 1.5 percentage points below the World Bank's main forecasts. Yet his results still show that spending 20 per cent of exports earnings on debt service would be more than enough to keep all Third World debtors solvent, by his definition. The 10 per cent ceiling proposed by President Garcia, on the other hand, would be too low for Argentina, Brazil, Mexico and Peru itself.

Such calculations may not cut much ice with bankers terrified of total default by some crazed Third World dictator. They may also seem over-optimistic to Latin American politicians determined never to put their nations in hock to foreign creditors again. But they do suggest that a wide range of rational compromises must exist to reconcile the needs of both the debtors and the banks.

How to evaluate the solvency of an indebted nation, by Daniel Cohen. Economic Policy Vol. 1. Cambridge University Press.

DEBT SERVICE INDICATORS

(As % of total export earnings, 1985)

	Debt service ratio*	Cash flow ratio†	Solvency ratio‡
Argentina	136	24	16
Brazil	47	39	15
Mexico	67	35	12
Nigeria	37	17	3
Peru	87	22	11
Venezuela	37	42	5

* Interest and capital repayments due in 1985 as percentage of export earnings. † Current account surplus, excluding interest payments, as percentage of export earnings. ‡ Total debt payments required to maintain long-run solvency (see text).

Source: American Express estimates and "Economic Policy," Vol. 1.

SEAADG/SE

SECRET AND PERSONAL UNTIL RELEASE OF PRESS NOTICE ON 28 JANUARY 1986 AT 11.30 AM

To:
MINISTER FOR TRADE

Copy No ..3.. (24)

From:
P J STIBBARD
US/S2
Room V/258 215-5574

22 January 1986

C/ To note.
Ro 22/1

OVERSEAS TRADE FIGURES FOR DECEMBER

THE CURRENT ACCOUNT

In December exports were valued at £6425 million and imports at £6300 million, so that visible trade seasonally adjusted on a balance of payments basis, showed a surplus of £125 million compared with a deficit of £132 million in November.

The Central Statistical Office project a surplus of £566 million for invisibles in December so that the current account is provisionally estimated to have been in surplus of £691 million compared with a surplus of £268 million in November. For 1985 as a whole the current account shows a surplus of £3.5 billion.

Table 1

CURRENT ACCOUNT

(£ million)

	Visible Trade Balances Oil	Non-oil	Total	Invisibles Balance	Current Account Balance
1984	+7136	-11237	-4101	+5222	+1121
1985	+8248	-10302	-2054	+5603	+3549A
1985 Q3	+1932	-2474	- 543	+1705	+1162
1985 Q4	+2087	-2094	- 7	+1366	+1359A
1985 Oct	+ 760	- 759	0	+ 400A	+ 400A
Nov	+ 675	- 807	- 132	+ 400A	+ 268A
Dec	+ 652	- 528	+ 125	+ 566A	+ 691A

A = Projection

In the fourth quarter of 1985 visible trade was broadly in balance - a surplus on trade in oil of £2.1 billion being offset by a deficit of similar size on non-oil trade. Between the third and fourth quarters, the visible trade balance improved by £0.5 billion - the surplus on oil increased by £0.1 billion and the deficit on non-oil trade was reduced by £0.4 billion.

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In the year 1985, visible trade showed a deficit of £2.1 billion compared with a deficit of £4.1 billion in 1984. The improvement of £2 billion between 1984 and 1985 reflects a £1.1 billion increase in the surplus on oil and £0.9 billion reduction in the deficit on non-oil trade.

EXPORTS

The value of exports in December was £117 million (2 per cent) higher than in November. Exports of the erratic items were little changed while exports of oil fell by £48 million. Excluding these, exports increased by 3½ per cent between the two months. The value of exports of manufactures (excluding the erratic items) increased by £195 million (5 per cent) in December; about half the rise resulting from higher deliveries of capital goods.

Table 2

EXPORT VOLUME INDEX NUMBERS (1980 = 100)

Seasonally adjusted

	BOP BASIS	OTS BASIS		-Manufactures excluding erratics-				
	Total Trade	Basic Materials	Fuels	Semis	Passenger Motor Cars	Other Consumer	Inter-mediate	Capital
1984	112.3	106.6	159.1	112.1	82.4	109.3	105.1	102.4
1985	118.9	109.5	170.7	119.0	99.0	114.6	121.1	107.8
1985 Q3	115.0	111	160	115	97	114	121	104
Q4	119.6	111	166	120	97	118	124	107
1985 Oct	119.1	106	176	119	106	112	119	104
Nov	118.9	108	165	119	92	119	125	102
Dec	120.7	120	158	123	95	121	128	114

In the fourth quarter of 1985, export volume was 4 per cent higher than in the third quarter and about the same level as the fourth quarter of 1984. Excluding oil and the erratic items, export volume increased by 2 per cent in the latest quarter; there are now signs that the underlying level of non-oil export volume has risen a little in recent months.

Between 1984 and 1985 as a whole, export volume is provisionally estimated to have increased by 6 per cent.

By value, exports increased by 3 per cent in the latest quarter. Exports to the developed countries increased by 3 per cent while exports to developing countries fell by 1 per cent. Within the total for developed countries, exports to North America increased by 10 per cent in the fourth quarter.

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IMPORTS

The value of imports in December was £139 million (2 per cent) lower than in November. Imports of the erratic items fell by £33 million and imports of oil fell by £26 million. Excluding oil and the erratic items imports were 1½ per cent lower than in November reflecting a 6 per cent fall in imports of finished manufactures.

Table 3 IMPORT VOLUME INDEX NUMBERS (1980 = 100)

Seasonally adjusted

	BOP BASIS Total Trade	OTS BASIS Basic Materials	Fuels	-Manufactures excluding erratics- Semis	Passenger Motor Cars	Other Consumer	Inter-mediate	Capital
1984	121.6	101.8	85.4	137.1	120.0	140.9	161.5	173.0
1985	126.3	102.7	83.9	144.7	128.2	141.8	173.7	188.2
1985 Q3	123.7	100	71	147	123	140	171	184
Q4	127.1	110	76	151	125	149	180	192
1985 Oct	125.7	113	79	149	109	141	170	185
Nov	129.1	103	76	151	150	156	189	195
Dec	126.5	114	73	154	114	151	180	195

Between the third and fourth quarters of 1985, total import volume increased by 3 per cent to a level 1½ per cent lower than in the fourth quarter of 1984. Excluding oil and the erratic items, import volume increased by 3½ per cent in the latest quarter. The underlying level of non-oil import volume continues to rise.

Between 1984 and 1985 as a whole, total import volume is provisionally estimated to have risen by 4 per cent.

By value, imports were unchanged in the latest quarter. Imports from the developed countries as a whole increased by 2 per cent with imports from the European Community countries increasing by 4 per cent and imports from the 'other developed' countries - primarily Japan - rising by 6½ per cent.

TERMS OF TRADE AND UNIT VALUES

The terms of trade increased by 1½ per cent between the third and fourth quarters of 1985. The export unit value index fell by 1 per cent and the import unit value index fell by 2 per cent. Compared with the same period a year ago, the export unit value index is unchanged while the import unit value index has fallen by 5 per cent. As a result, the terms of trade index is now 5 per cent higher than a year ago.

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Table 4

TERMS OF TRADE AND UNIT VALUES (1980 = 100)
BOP BASIS

	Unit value indices		Terms of Trade
	Exports	Imports	
1984	136.0	139.5	97.5
1985	143.9	145.0	99.2
1985 Q3	142.0	141.2	100.6
Q4	140.8	138.1	101.9
1985 Oct	140.8	139.1	101.2
Nov	140.7	137.1	102.6
Dec	140.8	138.1	102.0

Export unit values for basic materials fell by 5½ per cent in the latest quarter while those for fuels fell by 2 per cent. Lesser falls were recorded in the unit values for semi-manufactured goods while those for finished manufactures increased slightly.

For imports unit values too, the basic materials and fuels (down 6½ per cent and 4 per cent respectively) continue to lead the fall. Import unit values for semi-manufactures fell by 1½ per cent in the latest quarter and those for finished manufactures fell by 1 per cent.

TRADE IN MANUFACTURES

Estimates of trade in manufactures on a balance of payments basis for the fourth quarter of 1985 and for 1985 as a whole will be published in the press notice covering December. In the fourth quarter of 1985 there was a deficit on trade in manufactures of £0.4 billion compared with a deficit of £0.8 billion in the third quarter. For 1985 as a whole, trade in manufactures is provisionally estimated to have been in deficit by £3.1 billion an improvement of £0.7 billion compared with 1984.

SECRET AND PERSONAL UNTIL RELEASE OF PRESS NOTICE ON 28 JANUARY 1986 AT 11.30 AM

Table 5

TRADE IN MANUFACTURES (SITC 5-8)
(Balance of payments basis)

£ million
Seasonally adjusted

	Exports		Imports		Balance
1984	46573	+12.2%	50358	+9.9%	- 3786
1985	52257		55335		- 3078
1985 Q3	12582		13415		- 833
Q4	13177		13579		- 402
1985 Oct	4288		4396		- 107
Nov	4349		4686		- 337
Dec	4539		4497		+ 42

PUBLICATION

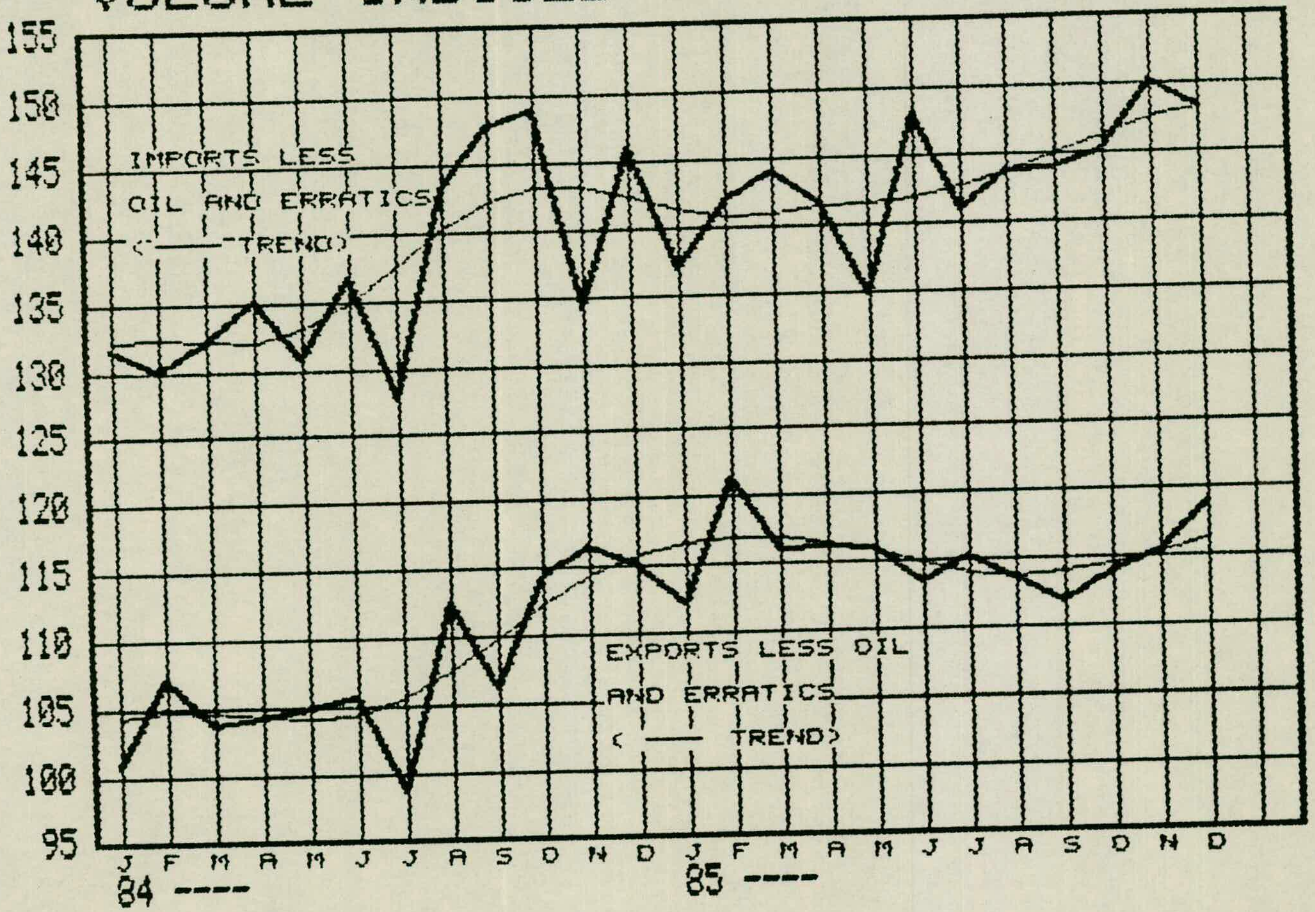
The release of the press notice containing the December figures is scheduled for Tuesday 28 January at 11.30am.

PJS

P J STIBBARD

SECRET AND PERSONAL UNTIL RELEASE OF PRESS NOTICE AT 11.30AM 28.1.86

VOLUME INDICES OF UK VISIBLE TRADE



ON A BALANCE OF PAYMENTS BASIS, 1980 = 100, SEASONALLY ADJUSTED

INTERNAL NOTE

CIRCULATION LIST

Copy No 1	Minister for Trade	
2	Prime Minister	
3	Chancellor of the Exchequer	
4	Secretary of State for Trade and Industry	
5	Sir Robert Armstrong (Cabinet Office)	
6	Sir Brian Hayes (Dept of Trade and Industry)	
7	Sir Peter Middleton (HM Treasury)	
8	Governor of the Bank of England	
9	Chairman of the Board of HM Customs and Excise	
10	Mr J Hibbert (CSO)	
11	Mr Finlinson (HM Customs and Excise)	
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20	Mr E J Wright)	Dept of Trade and Industry
21	Mr A R Hewer)	
22	Ms F Deuchars)	
23	Mr C Webb)	
24	Mr D B Packer	

COVERING SECRET AND PERSONAL

DEPARTMENTS OF INDUSTRY AND TRADE
– COMMON SERVICES
1 Victoria Street London SW1H 0ET
Telephone Direct Line 01-215 3055
Switchboard 01-215 7877

Mrs R Lomax
Principal Private Secretary
Chancellor of the Exchequer
H M Treasury
Parliament Street
LONDON
SW1P 3AG

OK

23 January 1986

C
/ OK?

RO 23/1

I am attaching a copy of the draft Press Notice on the Current Account of the United Kingdom Balance of Payments in December. The draft was agreed earlier today at the usual interdepartmental meeting.

Publication is set for Tuesday 28 January at 11.30 am and I should be grateful if you would arrange for the Notice to be cleared by 12.00 noon Monday 27 January and to inform me accordingly.

A copy of this letter and draft Press Notice is being sent to Sir Peter Middleton.

Yours sincerely

W. E. Boyd

W E BOYD

COVERING SECRET AND PERSONAL

V3119

BC/4

Pwp

FROM: P WYNN OWEN ✓27/1

DATE: 27 JANUARY 1986

MR CARPINTER

MR PICKFORD

cc Sir T Burns
Mr Byatt
Mr Mountfield
Mr Odling-Smee
Mr Scholar
Mr Sedgwick O/R
Mr Spackman
Mrs Case
Mr S Matthews
Mr Riley
Mr H Davies

ECONOMIC POLICY: A EUROPEAN FORUM

The Chancellor has seen and was grateful for your minute of 21 January. He was rather surprised at van Wijnbergen's theory that the US Budget deficit is responsible for the fall in commodity prices (see, for example, paragraph 4 of your annex on his work).

Rs.

P WYNN OWEN

155/13

SECRET AND PERSONAL
until 11.30 am on Tuesday 28 January 1986
then CONFIDENTIAL

Apro today pl

Offensive 3 messages the main point, which is that the underlying trade deficit fell by 20% in 1985 (over 1984).

FROM: J E FLITTON
DATE: 27 JANUARY 1986

1. MR KELLY
2. CHANCELLOR

cc as attached list

£3½b 1985 current account surplus.
Content with press briefing attached?
RO 27/1

DECEMBER TRADE FIGURES

The December trade figures will be released on 28 January. The current account was in surplus by £691 million (cf £268 million surplus in November).

Summary

2. Visible trade was in surplus by £125 million and invisibles £566 million. The current account surplus for 1985 as a whole is now put at £3.5 billion, well above the Autumn Statement forecast of £3 billion. Export volumes are rising again, but the terms of trade deteriorated in the month.

Main points

3. (i) the underlying level of non-oil export volume has begun to rise again from the low summer 1985 levels (see chart). Export volume (excluding oil and erratics) was 2 per cent higher in Q4 than in Q3 and ½ per cent above Q4 1984;

(ii) non-oil import volume fell by 2 per cent in the month but rose by 3½ per cent in Q4 as a whole and was also 3½ per cent above the same period in 1984.

(iii) The terms of trade also deteriorated in the month. For the quarter as a whole they were still 1½ per cent better than in Q3 and 5 per cent better than a year ago. Import unit value indices (UVIs) for most categories of goods rose in December after a period of continual falls. Only basic materials prices fell while food, drink and tobacco prices were stable. If the exchange rate remains at its current level further rises in import UVIs can be expected. Export UVIs for most categories of goods have barely moved since February.

(iv) manufacturing trade was in deficit by £400 million in Q4. This was, however, a marked improvement on the £800 million deficit in Q3. The deficit for the year as a whole was £3.1 billion, substantially better than the Autumn Statement forecast of £3.5 billion;

(v) the oil trade surplus of £652 million was a little below November; the main factor was a fall of £96 million in crude oil exports following a reduction in North Sea oil production. There was a surplus in 1985 of £8.2 billion (c.f. 1984 £7.1 billion).

(vi) the invisibles estimate of £566 million includes £166 million received in December from the EC as part of the UK's VAT abatement. The remainder of the £610 million was received in the first week of January.

Comparison with Autumn Statement

4. The first estimate of the current account balance for 1985 is £550 million better than the Autumn Statement forecast. The visible balance is £50 million worse and the invisible surplus £600 million better - partly because of data revisions and partly because of the EC rebate; within the trade balance, the oil surplus is £250 million worse and the non-manufactures balance £200 million worse, and the manufactures balance £400 million better (because of better than anticipated terms of trade in Q4.)

Effect on markets

5. The markets are expecting a current account surplus of the order of £200 million. There is unlikely to be any significant market impact from the better figures. But they certainly will not do any harm.

Press Briefing

6. I should be grateful for clearance of the attached press briefing.

John Flitton

J E FLITTON
EF1

155/17

SECRET AND PERSONAL
until 11.30 am on Tuesday 28 January 1986
then UNCLASSIFIED

Draft briefing for IDT

Positive

1. The current account was again in surplus, by £691 million.

2. Current account surplus in every month in 1985 apart from the erratic March deficit which reflected coal strike effects.

3. Current account surplus of £3.5 billion for 1985 well above Autumn Statement forecast of £3 billion

4. Surplus of £125 million on visible trade. 1985 deficit of £2.1 billion half that in 1984 (£4.1 billion)

5. Fall in import unit value index of 2 per cent in latest 3 months will maintain downward pressure on UK inflation.

Defensive

1. Export volumes falling

[Export volumes down 2½ per cent since February peak].

Export volumes in Q4 1985 virtually unchanged from Q4 1984. Some fall from the peak recorded in early 1985 was to be expected, but volumes have been rising from the low summer 1985 levels (+6½ per cent since August low point).

2. Autumn Statement forecast

[As forecasts £3 billion current account surplus for 1985. Actual surplus of £3.5 billion.]

Forecast achieved easily. Precise outcome depends on size and timing of revisions to invisibles account (Q4 1985 figures to be published in March).

3. <u>Manufacturing trade deficit</u>

[Autumn Statement forecasts £3½ billion deficit for 1985. Actual deficit £3.1 billion.]

Sharp improvement in Q4 with manufacturing deficit of £400 million compared with deficit of £800 million in Q3. Deficit for year £400 million better than forecast. Deficit more than offset by substantial surplus on oil and invisibles. Oil surplus bound to mean some adjustment to structure of balance of payments. UK manufacturing output (up 4 per cent in 1984, 3 per cent in 1985 and forecast to grow another 2½ per cent in 1986) a more important indicator of industrial performance than trade balance.

4. <u>Invisible projection</u>

December figure includes £166 million received from EC as part of VAT abatement. The remainder of the £610 million abatement was received in the first week of January.

SECRET AND PERSONAL

ANNEX 1

until 11.30 am on Tuesday 28 January 1986

then CONFIDENTIAL

TABLE 1: CURRENT ACCOUNT

	1984	1985 Q3	Q4	Oct	Nov	Dec	1985
Oil	+ 7.1	+ 1.9	+ 2.1	+ 0.8	+ 0.7	+ 0.7	+ 8.2
Non-oil	- 11.2	- 2.5	- 2.1	- 0.8	- 0.8	- 0.5	- 10.3
Total visible trade -6.0	- 4.1	- 0.5	0	0	- 0.1	+ 0.1	- 2.1 -4.7
o/w trade in manufactures (BOP basis)	- 3.8	- 0.8	- 0.4	- 0.1	- 0.3	0	- 3.1
Invisibles	+ 5.2	+ 1.7	+ 1.4	+ 0.4*	+ 0.4*	+ 0.6*	+ 5.6
Current Account	+ 1.1	+ 1.2	+ 1.4	+ 0.4	+ 0.3	+ 0.7	+ 3.5

*projection

Note: figures may not sum correctly due to rounding

TABLE 2: EXPORTS AND IMPORTS (percentage change)

	1985 Dec on Nov	1985 Q4 on Q3	Q4 1985 on Q4 1984
i. Exports			
Total value	+ 2	+3	- 1½
Total volume (BOP basis)	+ 1½	+4	0
Total volume excl oil and erratics (BOP basis)	+ 3	+ 2	+ ½
Manufactures volume (excl erratics) OTS basis	+ 4	+ 3½	+ 1
Fuels (Volume)	- 4	+ 4	0
ii Imports			
Total value	- 2	0	- 7½
Total volume (BOP basis)	- 2	+ 3	- 1½
Total volume excl oil and erratics (BOP basis)	- 1	+ 3½	+ 3½
Manufactures volume (excl erratics) OTS basis	- 3	+ 4½	+ 6
Fuels (volume)	- 4½	+ 6½	- 26½

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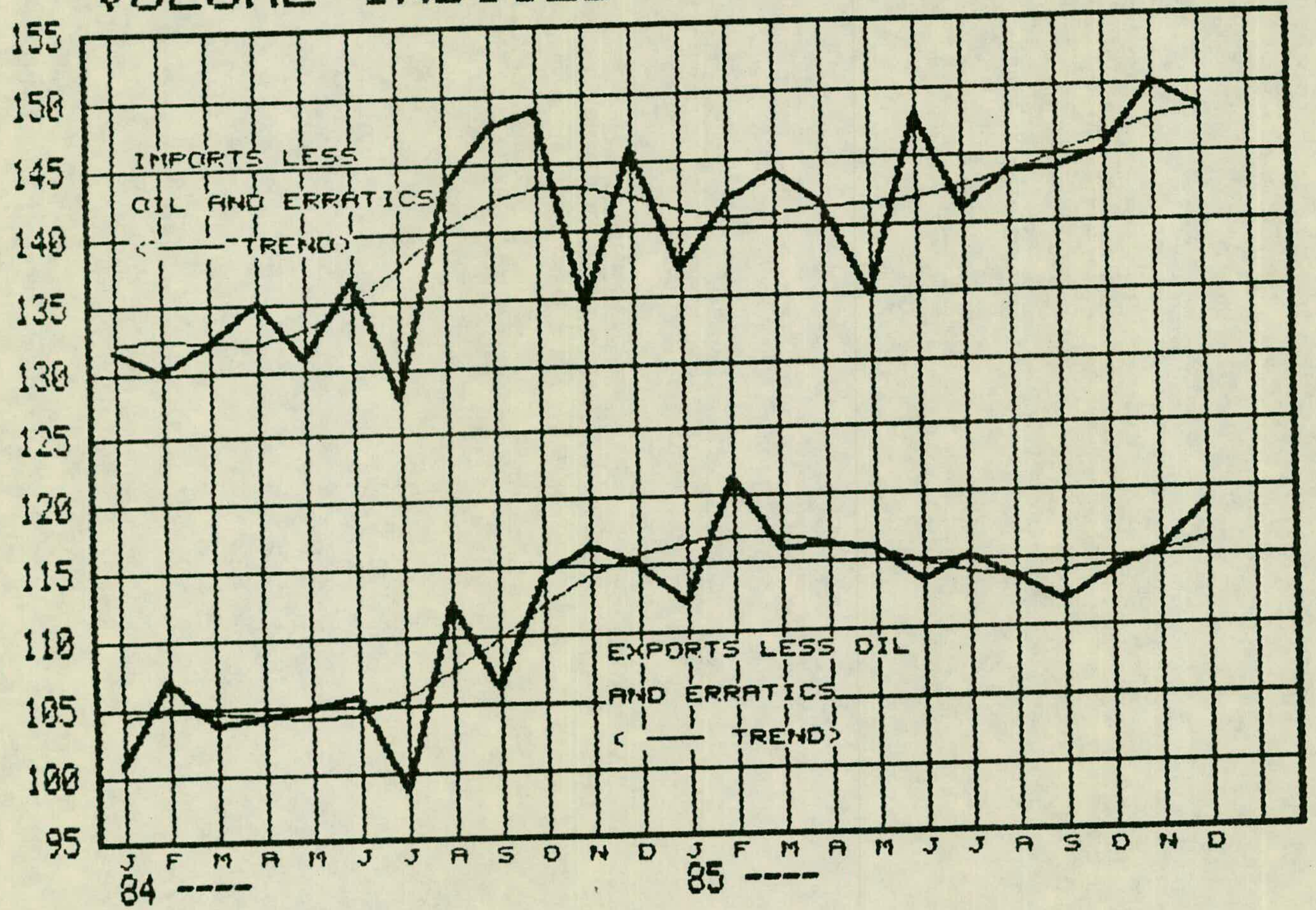
VOLUME INDICES OF UK VISIBLE TRADE



ON A BALANCE OF PAYMENTS BASIS, 1980 = 100, SEASONALLY ADJUSTED

TRADE FIGURES FOR DECEMBER 1985

Advance Circulation

Chancellor of the Exchequer
Chief Secretary
Economic Secretary
Sir P Middleton
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Mr Lavelle
Mr Cassell
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THE CURRENT ACCOUNT OF THE UNITED KINGDOM BALANCE OF PAYMENTS

DECEMBER AND YEAR 1985

The current account for December is estimated to have been in surplus by £691 million compared with a surplus of £268 million in November. In 1985 as a whole, the current account is provisionally estimated to have been in surplus by about £3½ billion.

Exports in December amounted to £6425 million and imports to £6300 million so that trade in goods was in surplus by £125 million. In 1985 as a whole visible trade is estimated to have been in deficit by about £2 billion.

The balance on invisibles in December is projected to be in surplus by £566 million, a large surplus on the transactions of the private sector and public corporations being partly offset by a deficit on Government transactions.

FOURTH QUARTER 1985

In the fourth quarter of 1985 the current account showed a surplus of £1.4 billion compared with a surplus of £1.2 billion in the third quarter. Visible trade was broadly in balance in the fourth quarter compared with a deficit of £0.5 billion in the third quarter. The surplus on invisibles is projected at £1.4 billion.

CURRENT ACCOUNT

TABLE 1 — £ million, Seasonally adjusted

		Current Balance	Visible Trade Balance	Visible Trade Exports fob	Visible Trade Imports fob	Invisibles Balance c
1984		+ 1121	- 4101	70409	74510	+ 5222
* 1985		+ 3549 a	- 2054	78077	80131	+ 5603 a
1984	Q4	+ 459	- 1313	19312	20625	+ 1772
1985	Q1	- 408	- 1283	20295	21578	+ 875
	Q2	+ 1435	- 222	20251	20473	+ 1657
	Q3	+ 1162	- 543	18481	19024	+ 1705
	Q4	+ 1359 a	- 7	19050	19057	+ 1366 a
1985	July	+ 491	- 77	6334	6411	+ 568 b
	Aug	+ 333	- 236	6040	6276	+ 569 b
	Sept	+ 338	- 230	6107	6337	+ 568 b
	Oct	+ 400 a	0	6317	6317	+ 400 a
	Nov	+ 268 a	- 132	6308	6440	+ 400 a
	Dec	+ 691 a	+ 125	6425	6300	+ 566 a

a Invisibles for October to December are projections and subject to revision as information becomes available. VAT abatements received from the EC [illegible] December amounted to £166 million and have been included in the projecti[illegible] December

b One-third of the appropriate calendar quarter's estimate.

c Information relating to credits and debits can be found in Table 3.

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VISIBLE TRADE IN DECEMBER 1985

There was a surplus on visible trade in December of £125 million compared with a deficit of £132 million in November. The surplus on oil fell by £22 million while the deficit on non-oil trade decreased by £279 million.

At £6425 million, exports in December were 2 per cent higher than in November. Exports of the erratic items were little changed while exports of oil fell by £48 million. Excluding these, exports increased by 3½ per cent between the two months. The value of exports of manufactures (excluding the erratic items) increased by £195 million (5 per cent) in December, about half the rise resulting from higher deliveries of capital goods.

Total imports were £139 million (2 per cent) lower than in November. Imports of the erratic items fell by £33 million and imports of oil fell by £26 million. Excluding oil and the erratic items, imports were 1½ per cent lower than in November reflecting a 6 per cent fall in imports of finished manufactures partly offset by increases in other categories.

The terms of trade index fell marginally in December as the export unit value index remained unchanged and the import unit value index showed a slight rise.

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RECENT TRENDS

Visible balance

In the fourth quarter of 1985 visible trade was broadly in balance compared with a deficit of £0.5 billion in the third quarter. Between the two quarters, the surplus on oil increased by £0.1 billion and the deficit on non-oil trade fell by £0.4 billion. Visible trade in the year 1985 is estimated to have been in deficit by £2.1 billion compared with a deficit of £4.1 billion in 1984.

Exports

Exports were valued at £19.1 billion in the fourth quarter, 3 per cent higher than in the third quarter. Exports of oil increased by £0.1 billion and exports of the erratic items by £0.2 billion. Excluding these, exports were £0.2 billion (2 per cent) higher than in the third quarter.

The volume of total exports increased by 4 per cent in the latest quarter to a level similar to that of a year ago. Excluding oil and the erratic items, export volume rose by 2 per cent in the latest quarter. The underlying level of non-oil export volume has risen a little in recent months.
By volume exports increased by 6 per cent between 1984 and 1985. The corresponding increase in manufactures excluding the erratic items was 8½ per cent.

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Imports

Imports, valued at £19.1 billion in the fourth quarter of 1985, were little changed compared with the third quarter. Imports of the erratic items fell by £0.2 billion and imports of oil fell by £0.1 billion but these reductions were offset by a £0.3 billion rise in imports of other goods.

Import volume increased by 3 per cent in the fourth quarter of 1985 but is 1½ per cent lower than a year earlier. Excluding oil and the erratic items, import volume rose by 3½ per cent in the latest quarter. The underlying level of non-oil import volume has been rising in recent months.

Between 1984 and 1985 as a whole, total import volume is provisionally estimated to have risen by 4 per cent. The corresponding increase in imports of manufactures excluding the erratic items was 6 per cent.

Terms of trade and unit values

The terms of trade increased by 1½ per cent between the third and fourth quarter of 1985. The export unit value index fell by 1 per cent and the import unit value index fell by 2 per cent. Compared with the same period a year ago, the export unit value index is unchanged while the import unit value index has fallen by 5 per cent. As a result, the terms of trade index is now 5 per cent higher than a year ago.

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Export unit values for basic materials fell by 5½ per cent in the latest quarter while those for fuels declined by 2 per cent. Smaller falls were recorded in the unit values for semi-manufactured goods while those for finished manufactures increased slightly.

For import unit values too, the basic materials and fuels indices (down 6½ per cent and 4 per cent respectively) continue to lead the fall. Import unit values for semi-manufactures fell by 1½ per cent in the latest quarter and those for finished manufactures fell by 1 per cent.

Analysis by Area

By value, exports to the developed countries increased by 3 per cent between the third and fourth quarters of 1985, while exports to the developing countries fell by 1 per cent. Within the total for developed countries, exports to North America increased by 10 per cent in the fourth quarter.

Imports from the developed countries increased by 2 per cent in the fourth quarter with imports from the European Community countries increasing by 4 per cent and imports from the 'other developed' countries - primarily Japan - rising by 6½ per cent.

NOTES TO EDITORS

1 REVISIONS

The revision to exports anticipated in last months press notice has now been fully incorporated.

2 SPAIN/PORTUGAL

As from January 1986 EC trade will include Spain and Portugal. In this press notice all references to EC excludes these two countries.

~~1~~4 **STANDARD NOTES**

The standard notes describe the differences between the Balance of Payments (BOP) and the Overseas Trade Statistics (OTS) bases of compilation. Copies can be obtained from the address below.

3 **AREA DATA (tables 11 and 15)**

Low value consignments ie items of an individual value less than £200, are not analysed by country. Area figures in tables 11 and 15 are therefore deficient to the extent of these consignments.

In addition the data by area are seasonally adjusted independently leading to further differences between the sum of areas and figures for total trade.

~~4~~5 **MONTHLY REVIEW OF EXTERNAL TRADE STATISTICS**

The Monthly Review of External Trade Statistics, a publication containing charts and tables on the current account of the UK balance of payments, UK exports and imports of goods by commodity and area, and certain international comparisions, is available, (price £3 per copy) from the Department of Trade and Industry at the address given below.

~~5~~6 **ROUNDING**

The figures published in this Press Notice expressed in £ million have each been independently rounded to the nearest whole number. These figures may therefore not sum to the aggregates, and balances may not derive exactly from the export and import figures shown.

Index numbers of volume and unit value are shown rounded either to the nearest whole number, or to one place of decimals. Although the figures should not be regarded as accurate to the last digit shown, the degree of rounding is intended to be indicative of the relative reliability of the different figures. Where period to period changes are shown these have been calculated from unrounded estimates, the resulting percentage changes being rounded to the nearest half point if less than 10 and the nearest whole number if 10 or greater.

Enquiries about the Standard Notes, and the Monthly Review, should be addressed to S2A, Room 255, Department of Trade and Industry, 1 Victoria Street, London SW1H OET, Telephone: 01-215 5703.

7 From 10 February the telephone number for non-press enquiries will be 01 215 4894/4895.

Table 2

CURRENT BALANCE, VISIBLE TRADE AND INVISIBLES
(Balance of Payments basis)

£ million seasonally adjusted

	Current Balance	Visible Trade					Invisible Balance
		Exports fob	Imports fob	Visible Balance	of which Oil	of which Non-Oil	
1984	+ 1121	70409	74510	- 4101	+ 7137	- 11238	+ 5222
1985	+ 3549 a	78077	80131	- 2054	+ 8248	- 10302	+ 5603 a
1984 Q4	+ 459	19312	20625	- 1313	+ 1468	- 2781	+ 1772
1985 Q1	- 408	20295	21578	- 1283	+ 1862	- 3144	+ 875
Q2	+ 1435	20251	20473	- 222	+ 2368	- 2589	+ 1657
Q3	+ 1162	18481	19024	- 543	+ 1932	- 2474	+ 1705
Q4	+ 1359 a	19050	19057	- 7	+ 2087	- 2094	+ 1366 a
1985 Apr	+ 294	6918	7177	- 259	+ 687	- 945	+ 552 b
May	+ 805	6803	6551	+ 252	+ 838	- 586	+ 553 b
June	+ 336	6529	6745	- 216	+ 843	- 1059	+ 552 b
July	+ 491	6334	6411	- 77	+ 663	- 740	+ 568 b
August	+ 333	6040	6276	- 236	+ 626	- 862	+ 569 b
Sept	+ 338	6107	6337	- 230	+ 644	- 873	+ 568 b
Oct	+ 400 a	6317	6317	0	+ 760	- 759	+ 400 a
Nov	+ 268 a	6308	6440	- 132	+ 675	- 807	+ 400 a
Dec	+ 691 a	6425	6300	+ 125	+ 652	- 528	+ 566 a
% Change							
Latest 3 months on - previous 3 months		+ 3	-				
Same 3 months one year ago		- 1½	- 7½				

a Invisibles for October to December are projections and subject to revision as more information becomes available.

b One third of the appropriate calendar quarter's estimate, except for budget refunds received from the European Community which are allocated to the month they are known to have been received.

Table 3

INVISIBLES

£ million seasonally adjusted

	All Sectors						Private Sector and Public Corporations[d]		
	Credits	Debits	Balance	of which Services	of which Interest Profits Dividends	of which Transfers	Credits	Debits	Balance
1982	64676	62974	+ 1702	+ 2645	+ 1058	- 2001	60178	54382	+ 5796
1983	65199	61237	+ 3962	+ 3671	+ 2431	- 2140	60588	52385	+ 8203
1984	76499	71277	+ 5222	+ 4186	+ 3340	- 2304	71601	61671	+ 9930
1983 Q4	16458	15675	+ 783	+ 900	+ 609	- 726	15398	13329	+ 2069
1984 Q1	17576	16547	+ 1029	+ 1003	+ 558	- 532	16314	14176	+ 2138
Q2	17927	16820	+ 1107	+ 984	+ 871	- 748	16926	14465	+ 2461
Q3	19461	18147	+ 1314	+ 1129	+ 917	- 732	18470	15793	+ 2677
Q4	21535	19763	+ 1772	+ 1070	+ 994	- 292	19891	17237	+ 2654
1985 Q1	21308	20433	+ 875	+ 1164	+ 749	- 1038	20122	17513	+ 2609
Q2	20104	18447	+ 1657	+ 1643	+ 719	- 705	19097	16036	+ 3061
Q3	19467	17762	+ 1705	+ 1763	+ 881	- 939	18305	14913	+ 3392

d ie excluding general Government transactions and all transfers.

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EXPORT AND IMPORT UNIT VALUE AND VOLUME INDEX NUMBERS

Table 4

(Balance of Payments basis)

Indices 1980 = 100

		Unit Value (Not seasonally adjusted)			Volume (seasonally adjusted)	
		Exports	Imports	Terms of Trade[e]	Exports	Imports
1984		136.0	139.5	97.5	112.3	121.6
1985		143.9	145.0	99.2	118.9	126.3
1984	Q4	140.9	145.4	96.9	119.6	129.4
1985	Q1	146.7	152.0	96.5	120.5	128.5
	Q2	146.0	148.7	98.2	120.6	126.0
	Q3	142.0	141.2	100.6	115.0	123.7
	Q4	140.8	138.1	101.9	110.6	127.1
1985	Apr	147.7	151.8	97.3	121.8	130.2
	May	145.8	148.4	98.3	121.7	121.0
	June	144.6	146.0	99.1	118.4	126.9
	July	142.4	143.2	99.4	117.0	123.0
	Aug	141.9	140.1	101.3	113.4	123.3
	Sept	141.7	140.2	101.1	114.6	124.7
	Oct	140.8	139.1	101.2	119.1	125.7
	Nov	140.7	137.1	102.6	118.9	129.1
	Dec	140.8	138.1	102.0	120.7	126.5
% Change Latest 3 months on - previous 3 months		- 1	- 2	+ 1½	+ 4	+ 3
- same 3 months one year ago		-	- 5	+ 5	-	- 1½

[e] Export unit value index as a percentage of the import unit value index.

VALUE AND VOLUME OF EXPORTS AND IMPORTS EXCLUDING THE MORE ERRATIC ITEMS[f]

Table 5

(Balance of Payments basis)

seasonally adjusted

		Value £ million fob		Volume Index 1980 = 100	
		Exports	Imports	Exports	Imports
1984		65784	71069	115.3	128.8
1985		73821	76652	123.4	134.1
1984	Q4	18042	19624	122.9	136.5
1985	Q1	19396	20476	126.3	135.2
	Q2	18962	19439	124.1	132.8
	Q3	17569	18264	120.0	132.0
	Q4	17894	18473	123.2	136.6
1985	Apr	6474	6747	125.2	135.9
	May	6407	6194	125.9	127.0
	June	6081	6498	121.2	135.4
	July	5941	6038	120.7	129.3
	Aug	5863	6136	120.4	133.4
	Sept	5764	6091	119.0	133.2
	Oct	5927	6077	122.8	134.3
	Nov	5926	6252	122.5	138.9
	Dec	6041	6145	124.4	136.7
% Change Latest 3 months on - previous 3 months		+ 2	+ 1	+ 2½	+ 3½
- same 3 months one year ago		- 1	- 6	+ ½	-

[f] These are defined as ships, North Sea installations, aircraft, precious stones, and silver.

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TRADE IN OIL[9]
(Balance of Payments basis)

seasonally adjusted

	Balance of Trade in oil	Exports of Oil					Imports of Oil				
		Total	Crude Oil [SITC (REV 2) 333.0]			Rest of Division 33	Total	Crude Oil [SITC (REV 2) 333.0]			Rest of Division 33
	£ million fob	£ million fob	£ million fob	million tonnes	Avg value per tonne £ fob	£ million fob	£ million fob	£ million fob	million tonnes	Avg value per tonne £ fob	£ million fob
1984	+ 7136	14910	12228	75.8	161.4	2682	7774	3755	24.2	155.4	4018
1985	+ 8248	16502	12906	78.7	163.9	3147	7805	4082	25.7	159.1	3723
1984 Q4	+ 1468	4051	3426	20.6	166.0	625	2584	997	6.0	167.1	1586
1985 Q1	+ 1862	4755	3936	21.5	182.7	819	2893	1236	7.0	177.9	1657
Q2	+ 2368	4378	3510	20.1	174.4	868	2011	1224	7.4	166.1	787
Q3	+ 1932	3421	2607	17.5	148.9	813	1489	843	5.8	145.8	646
Q4	+ 2087	3499	2853	19.6	145.9	646	1412	779	5.6	140.1	633
1985 Apr	+ 687	1530	1290	7.1	181.7	240	843	597	3.5	172.4	247
May	+ 838	1510	1238	7.2	172.7	272	672	421	2.6	163.3	251
June	+ 843	1338	982	5.9	167.6	356	495	206	1.3	155.1	289
July	+ 663	1124	810	5.3	152.6	313	461	233	1.5	152.0	228
Aug	+ 626	1149	855	5.8	148.7	294	524	310	2.2	142.4	213
Sept	+ 644	1148	942	6.5	146.0	206	504	300	2.1	144.8	205
Oct	+ 760	1237	1033	7.1	146.1	204	477	266	1.9	141.6	211
Nov	+ 675	1155	958	6.6	146.0	197	480	243	1.8	135.7	237
Dec	+ 652	1107	862	5.9	146.6	245	455	270	1.9	142.9	184
% Change Latest 3 months on - previous 3 months		+ 2½	+ 9½	+12	- 2	-21	- 5	- 7½	- 4	- 4	- 2
- same 3 months one year ago		-14	-17	- 5½	-12	+ 3½	-45	-22	- 7	-16	-60

[9] Trade in petroleum and petroleum products. These figures differ from those published by the Department of Energy which are on a time of shipment basis (see paragraph 7 of the standard notes).

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TRADE IN GOODS OTHER THAN OIL
(Balance of Payments basis)

	Total								Excluding Erratics[f]			
	Value, £ million, fob (seasonally adjusted)			Unit value index 1980 = 100 (not seasonally adjusted)			Volume index 1980 = 100 (seasonally adjusted)		Value, £ million fob (seasonally adjusted)		Volume index 1980 = 100 (seasonally adjusted)	
	Balance of non oil trade	Exports	Imports	Exports	Imports	Terms of Trade[e]	Exports	Imports	Exports	Imports	Exports	Imports
1984	- 11237	55499	66736	133.3	136.0	98.0	104.9	128.1	50875	63296	107.6	137.2
* 1985	- 10302	62024	72326	142.1	141.9	100.2	111.1	133.5	57768	68847	115.5	143.5
1984 Q4	- 2781	15261	18041	137.8	141.3	97.5	112.4	134.3	13990	17041	115.4	143.2
1985 Q1	- 3144	15541	18685	142.5	146.8	97.1	110.9	132.7	14641	17583	116.7	141.1
Q2	- 2589	15872	18462	143.1	145.0	98.7	112.2	133.0	14584	17428	115.4	141.7
Q3	- 2474	15060	17534	141.8	139.2	101.9	108.5	132.3	14148	16775	113.6	143.0
Q4	- 2094	15551	17645	140.9	136.5	103.2	112.7	135.9	14395	17061	116.2	148.0
1985 Apr	- 945	5388	6333	143.7	147.2	97.6	113.3	134.7	4944	5903	116.4	141.8
May	- 586	5293	5879	143.0	144.7	98.8	112.3	127.3	4897	5522	116.2	135.0
June	- 1059	5191	6250	142.6	143.0	99.7	111.0	137.0	4743	6003	113.5	148.2
July	- 740	5210	5950	141.8	140.7	100.8	111.7	132.7	4818	5577	115.4	141.1
Aug	- 862	4890	5752	141.8	138.5	102.4	106.3	131.1	4714	5612	113.7	143.9
Sept	- 873	4959	5832	141.8	138.3	102.5	107.4	133.1	4617	5587	111.9	144.0
Oct	- 759	5081	5840	140.9	137.4	102.5	110.7	134.3	4690	5600	114.0	145.3
Nov	- 807	5153	5959	140.8	135.9	103.6	112.0	137.9	4771	5771	115.5	150.4
* Dec	- 528	5318	5846	140.9	136.3	103.4	115.3	135.6	4934	5691	119.1	148.5
% Change Latest 3 months on												
- previous 3 months		+ 3½	+ ½	- ½	- 2	+ 1	+ 4	+ 2½	+ 2	+ 1½	+ 2	+ 3½
- same 3 months one year ago		+ 2	- 2	+ 2	- 3½	+ 6	-	+ 1	+ 3	-	+ ½	+ 3½

f These are defined as ships, North Sea installations, aircraft, precious stones, and silver.

e Export unit value index as a percentage of the import unit value index.

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EXPORTS BY COMMODITY

(Overseas Trade Statistics basis)

Table 8

£ million, fob, seasonally adjusted

	Total	Food beverages and tobacco	Basic Materials	Fuels	Total Manufactures	Manufactures excluding erratics[h]: Total	Semi-manufactures excluding precious stones & silver (PS): Total	Semi-manufactures: Chemicals	Semi-manufactures: Other	Finished manufactures excluding ships, North Sea installations and aircraft (SNA): Total	Finished: Passenger Motor Cars	Finished: Other Consumer	Finished: Intermediate	Finished: Capital
SITC (REV 2)	0-9	0+1	2+4	3	5-8	5-8 less SNAPS	5+6 less PS	5	6 less PS	7+8 less SNA	j	j	j	j
1984	70511	4693	1989	15367	46668	42136	16332	8215	8117	25804	1051	4674	11178	8902
1985	78416	4999	2143	16739	52530	48496	18457	9420	9038	30038	1339	5255	13503	9942
1984 Q4	19407	1235	557	4206	12951	11717	4603	2298	2305	7114	293	1332	3115	2375
1985 Q1	20367	1221	591	4922	13176	12322	4762	2434	2328	7560	353	1301	3356	2550
Q2	20281	1286	527	4557	13401	12210	4699	2399	2300	7511	333	1289	3332	2557
Q3	18582	1284	522	3595	12653	11795	4432	2236	2197	7362	321	1309	3346	2386
Q4	19186	1208	503	3665	13300	12169	4564	2351	2213	7605	332	1356	3469	2449
1985 Oct	6365	415	160	1293	4332	3947	1502	767	736	2444	116	435	1102	792
Nov	6355	390	162	1209	4391	4014	1499	774	725	2515	105	453	1174	784
Dec	6466	403	181	1163	4577	4209	1563	811	752	2646	111	469	1193	873
Percentage Change Q4/Q3	+3	-6	-3½	+2	+5	+3	+3	+5	+½	+3½	+3½	+3½	+3½	+2½

h These are defined as ships, North Sea installations (together comprising SITC (REV 2) 793), aircraft (792) precious stones (667), and silver (681.1).

j Based on the United Nations Broad Economic Categories end-use classification.

EXPORTS BY COMMODITY: VOLUME INDICES

(Overseas Trade Statistics basis)

Table 9

INDICES 1980 = 100, seasonally adjusted

	Total	Food beverages and tobacco	Basic Materials	Fuels	Total Manufactures	Manufactures excluding erratics[h]: Total	Semi-manufactures excluding precious stones & silver (PS): Total	Semi-manufactures: Chemicals	Semi-manufactures: Other	Finished manufactures excluding ships, North Sea installations and aircraft (SNA): Total	Finished: Passenger Motor Cars	Finished: Other Consumer	Finished: Intermediate	Finished: Capital
SITC (REV 2)	0-9	0+1	2+4	3	5-8	5-8 less SNAPS	5+6 less PS	5	6 less PS	7+8 less SNA	j	j	j	j
Weights	1000	69	31	136	735	658	252	112	141	406	18	71	170	147
1984	112.6	117.4	106.6	159.1	104.4	107.1	112.1	124.3	102.4	103.9	82.4	109.3	105.1	102.4
1985	119.7	119.7	109.5	170.7	111.2	116.0	119.0	133.5	107.5	114.2	99.0	114.6	121.1	107.8
1984 Q4	120.5	122	112	166	113	116	123	136	112	112	86	123	115	107
1985 Q1	121.2	121	113	182	111	118	122	137	110	115	103	114	120	111
Q2	121.1	122	103	175	112	116	119	133	109	114	98	113	119	110
Q3	115.9	122	111	160	108	113	115	127	105	112	97	114	121	104
Q4	120.6	115	111	166	114	117	120	137	107	116	97	118	124	107
1985 Oct	120.2	118	106	176	111	115	119	135	106	112	106	112	119	104
Nov	119.9	111	108	165	113	116	119	136	105	115	92	119	125	102
Dec	121.7	115	120	158	117	121	123	140	109	120	95	121	128	114
Percentage Change Q4/Q3	+4	-6	-½	+4	+5½	+3½	+5	+8	+2	+3	-	+3	+3	+3

h These are defined as ships, North Sea installations (together comprising SITC (REV 2) 793), aircraft (792) precious stones (667), and silver (681.1).

j Based on the United Nations Broad Economic Categories end-use classification.

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EXPORTS BY COMMODITY: UNIT VALUE INDICES
(Overseas Trade Statistics basis)

INDICES 1980 = 100 not seasonally adjusted

	Total	Food beverages and tobacco	Basic Materials	Fuels	Total Manufactures	Manufactures excluding erratics[h]: Total	Semi-manufactures excluding precious stones & silver(PS): Total	Semi-manufactures: Chemicals	Semi-manufactures: Other	Finished manufactures excluding ships, North Sea installations and aircraft (SNA): Total	Finished: Passenger Motor Cars	Finished: Other Consumer	Finished: Intermediate	Finished: Capital
SITC (REV 2)	0-9	0+1	2+4	3	5-8	5-8 less SNAPS	5+6 less PS	5	6 less PS	7+8 less SNA	j	j	j	j
Weights	1000	69	31	136	735	658	252	112	141	406	18	71	170	147
1984	136.0	128	131	153	134	133	127	130	125	136	157	132	140	132
1985	143.8	135	138	155	143	143	136	140	133	147	162	144	151	142
1984 Q4	140.8	129	138	161	139	137	132	135	129	140	158	137	143	136
1985 Q1	146.6	133	147	173	144	142	136	140	133	145	161	142	149	140
Q2	146.0	135	146	165	144	143	137	141	134	147	162	143	151	142
Q3	141.9	135	134	143	143	143	136	140	133	147	162	145	152	142
Q4	140.7	135	127	140	143	143	134	138	132	148	164	146	153	142
1985 Oct	140.7	135	127	140	143	143	134	137	132	148	161	146	152	142
Nov	140.6	135	126	140	142	143	134	137	132	148	162	146	153	142
Dec	140.7	136	127	140	143	143	135	139	131	148	169	147	152	142
Percentage Change Q4/Q3	-1	-	-5½	-2	-½	-	-1½	-1½	-1	+½	+1½	+1	+½	+½

h These are defined as ships, North Sea installations (together comprising SITC (REV 2) 793), aircraft (792) precious stones (667), and silver (681.1).

j Based on the United Nations Broad Economic Categories end-use classification.

EXPORTS BY AREA
Table 11

(Overseas Trade Statistics basis)

£ million, fob, seasonally adjusted

	Total K	Developed Countries: Total	European Community	Rest of W Europe	North America Total	USA	Other	Developing Countries: Total	Oil exporting countries	Other	Centrally planned economies
1984	70511	55386	31568	8728	11406	10149	3684	13356	5807	7550	1630
1985	78416	62853	36277	9488	13280	11485	3808	13905	5960	7944	1589
1984 Q4	19407	15185	8765	2262	3218	2909	940	3622	1608	2014	444
1985 Q1	20367	16112	9603	2389	3133	2798	987	3824	1730	2094	372
Q2	20281	16297	9071	2500	3745	3265	981	3559	1472	2087	426
Q3	18582	15010	8737	2297	3052	2563	924	3275	1377	1898	394
Q4	19186	15434	8866	2302	3350	2859	916	3247	1381	1865	397
1985 Oct	6365	5167	3077	739	1066	909	286	1054	432	622	104
Nov	6355	5139	2891	754	1183	992	311	1060	448	612	126
Dec	6466	5128	2898	809	1101	958	319	1133	502	631	166
Percentage Change Q4/Q3	+3	+3	+1½	-	+10	+12	-1	-1	+½	-1½	+ ½

K See paragraph 3 of Notes to Editors.

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IMPORTS BY COMMODITY
(Overseas Trade Statistics basis)

Table 12

£ million cif seasonally adjusted

	Total	Food beverages and tobacco	Basic Materials	Fuels	Total Manufactures	Manufactures excluding erratics[h]: Total	Semi-manufactures excluding precious stones & silver (PS): Total	Semi-manufactures: Chemicals	Semi-manufactures: Other	Finished manufactures excluding ships, North Sea installations and aircraft (SNA): Total	Finished: Passenger Motor Cars	Finished: Other Consumer	Finished: Intermediate	Finished: Capital
SITC (REV 2)	0-9	0+1	2+4	3	5-8	5-8 less SNAPS	5+6 less PS	5	6 less PS	7+8 less SNA	j	j	j	j
1984	78705	8936	5420	10193	52886	49703	17923	6312	11612	31780	3671	8344	10222	9544
1985	84697	9281	5397	10311	58381	55055	19665	6922	12743	35392	4180	8894	11645	10674
1984 Q4	21499	2314	1513	3294	14040	13255	4797	1658	3139	8458	971	2219	2780	2488
1985 Q1	22782	2370	1485	3588	14975	13935	4846	1675	3171	9090	1018	2276	3010	2786
Q2	21663	2354	1365	2728	14886	13880	4919	1803	3116	8962	1135	2218	2936	2673
Q3	20035	2292	1271	1994	14174	13436	4902	1721	3181	8534	975	2165	2823	2571
Q4	20217	2265	1276	2001	14346	13804	4998	1723	3275	8806	1052	2235	2876	2644
1985 Oct	6697	805	452	698	4642	4425	1640	565	1075	2784	303	716	916	850
Nov	6827	721	399	650	4943	4768	1666	569	1098	3101	418	775	1014	894
Dec	6693	738	424	652	4761	4612	1691	589	1103	2920	331	743	946	900
Percentage Change Q4/Q3	+ 1	-1 ~~- ½~~	+ ½	+ ½	+ 1	+ 2½	+ 2	-	+ 3	+ 3	+ 8	+ 3	+ 2	+ 3

h These are defined as ships, North Sea installations (together comprising SITC (REV 2) 793), aircraft (792) precious stones (667), and silver (681.1).

j Based on the United Nations Broad Economic Categories end-use classification.

IMPORTS BY COMMODITY: VOLUME INDICES
(Overseas Trade Statistics basis)

Table 13

INDICES 1980 = 100 seasonally adjusted

	Total	Food beverages and tobacco	Basic Materials	Fuels	Total Manufactures	Manufactures excluding erratics[h]: Total	Semi-manufactures excluding precious stones & silver (PS): Total	Semi-manufactures: Chemicals	Semi-manufactures: Other	Finished manufactures excluding ships, North Sea installations and aircraft (SNA): Total	Finished: Passenger Motor Cars	Finished: Other Consumer	Finished: Intermediate	Finished: Capital
SITC (REV 2)	0-9	0+1	2+4	3	5-8	5-8 less SNAPS	5+6 less PS	5	6 less PS	7+8 less SNA	j	j	j	j
Weights	1000	124	81	138	626	543	217	63	154	326	42	94	96	94
1984	119.9	112.3	101.8	85.4	134.0	146.9	137.1	164.2	125.9	153.4	120.0	140.9	161.5	173.0
1985	124.8	113.7	102.7	83.9	141.6	155.6	144.7	177.0	131.5	162.8	128.2	141.8	173.7	188.2
1984 Q4	125.7	114	110	103	138	152	142	168	132	158	121	144	171	175
1985 Q1	126.7	112	103	104	141	153	139	168	128	162	124	139	173	191
Q2	124.5	112	97	85	142	154	142	181	126	162	141	139	171	186
Q3	121.8	116	100	71	140	154	147	179	134	159	123	140	171	184
Q4	126.1	115	110	76	144	161	151	180	139	168	125	149	180	192
1985 Oct	124.7	122	113	79	140	155	149	178	137	159	109	141	170	185
Nov	127.8	110	103	76	149	167	151	177	140	177	150	156	189	195
Dec	125.6	113	114	73	144	162	154	184	141	168	114	151	180	195
Percentage Change Q4/Q3	+ 3½	- ½	+ 9½	+ 6½	+ 3	+ 4½	+ 3	-	+ 4½	+ 5½	+ 1	+ 7	+ 5½	+ 4

h These are defined as ships, North Sea installations (together comprising SITC (REV 2) 793), aircraft (792) precious stones (667), and silver (681.1).

j Based on the United Nations Broad Economic Categories end-use classification.

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IMPORTS BY COMMODITY: UNIT VALUE INDICES
(Overseas Trade Statistics basis)

INDICES 1980 = 100 not seasonally adjusted

	Total	Food beverages and tobacco	Basic Materials	Fuels	Total Manufactures	Manufactures excluding erratics[h]: Total	Semi-manufactures excluding precious stones & silver(PS): Total	Semi-manufactures: Chemicals	Semi-manufactures: Other	Finished manufactures excluding ships, North Sea installations and aircraft (SNA): Total	Finished: Passenger Motor Cars	Finished: Other Consumer	Finished: Intermediate	Finished: Capital
SITC (REV 2)	0-9	0+1	2+4	3	5-8	5-8 less SNAPS	5+6 less PS	5	6 less PS	7+8 less SNA	j	j	j	j
Weights	1000	124	81	138	626	543	217	63	154	326	42	94	96	94
1984	137.8	132	134	167	134	133	126	134	123	137	144	133	145	128
1985	142.9	138	130	171	141	141	133	140	130	146	152	144	155	134
1984 Q4	143.8	135	138	179	140	138	131	139	128	143	149	142	151	133
1985 Q1	150.0	142	143	189	145	144	136	143	133	149	154	148	158	138
Q2	146.7	141	136	179	143	143	136	141	133	148	150	147	159	136
Q3	139.0	135	124	160	139	139	131	138	128	144	149	143	154	131
Q4	136.0	132	116	154	137	137	129	137	126	142	156	140	148	131
1985 Oct	136.9	132	118	157	137	137	130	137	127	142	154	142	149	130
Nov	135.1	132	116	150	136	136	129	137	126	141	155	139	148	131
Dec	136.0	132	114	156	137	137	129	137	126	142	159	140	147	132
Percentage Change Q4/Q3	- 2	- 2	- 6½	- 4	- 1	- 1	- 1½	- ½	- 1½	- 1	+ 4½	- 1½	- 4	-

h These are defined as ships, North Sea installations (together comprising SITC (REV 2) 793), aircraft (792) precious stones (667), and silver (681.1).

j Based on the United Nations Broad Economic Categories end-use classification.

IMPORTS BY AREA

Table 15

(Overseas Trade Statistics basis)

£ million cif seasonally adjusted

	Total K	Developed Countries: Total	European Community	Rest of W Europe	North America Total	North America USA	Other	Developing Countries: Total	Oil exporting countries	Other	Centrally planned economies
1984	78705	65102	35204	13254	11055	9356	5589	11429	2862	8568	2042
1985	84697	71455	38993	14375	11663	9875	6426	11140	2777	8363	1903
1984 Q4	21499	17600	9331	3503	3285	2805	1481	3377	738	2639	623
1985 Q1	22782	18950	10143	3527	3677	3134	1603	3332	855	2477	573
Q2	21663	18009	9613	3779	3005	2564	1612	2966	848	2118	431
Q3	20035	17087	9438	3632	2464	2097	1554	2408	474	1934	479
Q4	20217	17409	9799	3437	2517	2080	1657	2434	600	1834	420
1985 Oct	6697	5789	3224	1237	818	659	509	751	114	637	154
Nov	6827	5917	3307	1139	873	726	598	861	242	618	126
Dec	6693	5703	3268	1060	826	695	550	823	244	578	140
Percentage Change Q4/Q3	+ 1	+ 2	+ 4	- 5½	+ 2	- 1	+ 6½	+ 1	+ 27	- 5	- 12

K See paragraph 3 Notes to Editors.

SECRET and personal until release of press notice on 28 JAN 86 at 11.30 a.m.

COMMODITY ANALYSIS OF VISIBLE TRADE
(Balance of Payments basis)

£ million, seasonally adjustec

	Food Beverages and Tobacco			Basic Materials			Fuels		
SITC (R2)	0 + 1			2 + 4			3		
	Exports fob	Imports fob	Visible Balance	Exports fob	Imports fob	Visible Balance	Exports fob	Imports fob	Visible Balance
1984	4672	8199	- 3527	2014	4866	- 2852	15367	9776	+ 5590
1985	4962	8510	- 3548	2158	4814	- 2656	16716	10009	+ 6707
1984 Q1	1157	1967	- 810	447	1172	- 725	3779	1727	+ 2052
Q2	1169	2038	- 870	493	1182	- 689	3541	2372	+ 1169
Q3	1121	2065	- 944	513	1169	- 656	3842	2546	+ 1296
Q4	1227	2130	- 904	561	1343	- 782	4206	3132	+ 1074
1985 Q1	1215	2170	- 955	596	1333	- 737	4924	3460	+ 1464
Q2	1275	2158	- 883	532	1225	- 693	4549	2609	+ 1940
Q3	1273	2108	- 835	525	1126	- 601	3578	2024	+ 1554
Q4	1199	2074	- 875	506	1130	- 625	3665	1916	+ 1749

	Semi-Manufactures			Finished Manufactures			Total Manufactures		
SITC (R2)	5 + 6			7 + 8			5 - 8		
	Exports fob	Imports fob	Visible Balance	Exports fob	Imports fob	Visible Balance	Exports fob	Imports fob	Visible Balance
1984	18266	18405	- 138	28306	31953	- 3647	46573	50358	- 3786
1985	20006	20042	- 36	32250	35293	- 3042	52257	55335	- 3078
1984 Q1	4296	4403	- 107	6720	7228	- 507	11017	11631	- 614
Q2	4497	4426	+ 71	6689	7672	- 982	11186	12098	- 912
Q3	4473	4672	- 199	7030	8300	- 1269	11503	12971	- 1468
Q4	5001	4904	+ 97	7866	8755	- 889	12867	13658	- 792
1985 Q1	5091	4863	+ 229	8018	9366	- 1348	13109	14228	- 1119
Q2	5196	5050	+ 145	8194	9062	- 869	13389	14112	- 723
Q3	4750	5116	- 367	7832	8299	- 467	12582	13415	- 833
Q4	4970	5013	- 43	8207	8566	- 359	13177	13579	- 402

Monthly data at this level of detail are published in the Monthly Review of External Trade Statistics.

SECRET and personal
until release of press notice on 28 JAN 86 at [illegible] a.m.

2534/012

Thanks

FROM: S J PICKFORD
DATE: 28 January 1986

CHANCELLOR

cc: Sir T Burns
Mr Byatt
Mr Mountfield
Mr Odling-Smee
Mr Scholar
Mr Sedgwick o/r
Mr Spackman
Mrs Case
Mr S Matthews
Mr Riley
Mr Carpinter
Mr H Davies

C/ Clarification.

Ch/ There may be a more direct link between the rate of return on financial assets & commodity prices PC. 28/1

RO 28/1

ECONOMIC POLICY: A EUROPEAN FORUM

Mr Wynn Owen's minute of 27 January recorded your interest in the argument in Van Wijnbergen's paper that the US budget deficit is responsible for the fall in commodity prices.

2. The argument in my summary was very condensed. There are a number of interrelated steps in his argument:-

(i) a switch to more restrictive fiscal policy and more expansionary monetary policy in the US would lower real US interest rates (while maintaining a given level of demand for LDC exports);

(ii) lower US interest rates would cause the dollar to depreciate;

(iii) a lower dollar would lead to a recovery in commodity prices.

3. The last step is perhaps the most controversial, and is explained in earlier work by Dornbusch. The argument is essentially that if the world supply of a commodity is fixed, a fall in the dollar relative to the currencies of other commodity - importing countries (for example, the yen) would cause the world price of the commodity to rise in dollar terms (and fall in yen terms). This occurs because if the commodity price was initially unchanged in dollar terms, its price in yen would fall and tend to cause excess world demand for the commodity; this is choked off by a rise in price in both currencies, leaving it higher in dollar terms but lower in yen terms still. The effects on LDCs' terms of trade are ambiguous - those that import mainly

from the US would benefit, while those that relied mainly on Japan for imports would lose out. However, one very important consideration that would benefit most LDCs is that a large and growing proportion of their external debt (about 75% on average, of all long-term public debt, and almost 90% in Latin America) is denominated in dollars. LDCs would gain substantially in welfare terms as commodity prices rose in dollar terms, thus reducing the value of their external debts measured against their export earnings.

Stephen Pickford

S J PICKFORD

5.4

FROM: N G FRAY
DATE: 29 January 1986

MR S J PICKFORD

ECONOMIC POLICY: A EUROPEAN FORUM

The Chancellor has seen and was grateful for your minute of 28 January.

Nigel Fray

N G FRAY

[I have a few points, which we can discuss @ our prejudice mtg]

SECRET

COPY NO 1

FROM: H P EVANS

DATE: 30 January 1986

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
PCC Members
Mr Fitchew
Mr Monger
Mr Peretz
Mr Odling-Smee
Mr Turnbull
Mr S Davies
Mr Mowl
Miss Peirson
Mr Riley
Mr Cropper
Mr Lord
Mr H Davies
Sir L Airey (IR)
Sir A Fraser (C&E)

Ch.
You wanted to see this tonight in case there were any queries before you see the PM. The implications of the lower oil price variant for the fiscal adjustment are pretty sobering - with a PSBR virtually unchanged at £7½ bn (Can one interpolate between the 2 cases to get a f.a. of £1½ bn for oil prices of $17.50) I see why Terry thinks the package is too big. RL. 30/1

TREASURY ECONOMIC FORECAST

I attach a copy of our report on the internal forecast. While we base the main case on an oil price of around $20 a barrel, we look at the possible consequences of a $15 oil price.

2. Miss Peirson's report on Public Sector Finances is being circulated separately. It provides chapter and verse for our view that the lower oil revenues in the main case remain consistent with a sizeable, but reduced, fiscal adjustment in 1986.

3. With oil and financial markets so volatile, there is a somewhat greater than usual risk of changes to the forecast when we carry out the usual updating exercise next month for final decisions in the Budget and for the FSBR.

HPE

H P EVANS

SECRET

RSP

£7 bn

SECRET

w/ FA for 1987/8 (& 1988/9)

(cf 3.13)

TREASURY ECONOMIC FORECAST

JANUARY 1986 REPORT

Also growth in '86 (2½ or 3?)

Infl in '87 & '88

<u>**Contents**</u> <u>**Page**</u>

productivity

demand

Infl

Earnings

growth

& unemployment

(8¾ % in 1986)

SECRET

TREASURY ECONOMIC FORECAST: JANUARY 1986

Report by EA

Introduction

This is the report on the internal January exercise. Detailed reports are being circulated as follows:

Public finances, Miss Peirson (PSF).

Oil production and revenues, Mr Hacche (EA2).

Financial forecast, Mr Mowl (EA2).

World economic prospects, Mr Matthews (EF2).

2. In general, we follow the policy framework of the last MTFS. The forecast covers the next two years, in summary pages 2-15, and in detail pages 21-59. Pages 16 to 20 outline the consequences of yet lower oil prices.

3. The **world economy** is now in a period of moderate growth and low inflation. The steep fall in oil prices in recent weeks will bring benefits to consumers in the form of lower inflation and higher growth of real incomes.

SUMMARY

4. The forecast makes broadly the same assumptions as the MTFS: that monetary and fiscal policy together will be set so as to bring about a decline in the growth of nominal GDP.

5. From 1986-87 onwards, the PSBR is as in the MTFS, although the composition (especially higher asset sales and lower oil revenues) has changed. This suggests that fiscal policy is a little easier than in the MTFS. To compensate for this and for the tendency of money GDP growth to be a little faster, monetary policy has to be somewhat higher than was implied by the projections underlying the MTFS. tighter

6. Indeed monetary policy is already tighter. The exchange rate is higher, and interest rates are very high, in real terms, in relation to other countries and relative to the MTFS.

Oil prices

7. The main uncertainty in this forecast is the level of oil prices and the consequences of the recent fall in prices for the world economy and the UK. Ever since 1982, successive forecasts allowed for falls in real oil prices as a consequence of the growing imbalance between supply and demand - but these falls did not begin until 1985.

8. We have assumed that North Sea prices average $20 for the rest of this year and in 1987, 25 per cent below last year. A bigger fall is likely if OPEC does not reduce its output. Even if the price does average $20 for 1986, there are liable to be sharp fluctuations: one possibility is that prices will fall further before recovering later in the year.

Exchange rates and interest rates

9. This forecast was completed against the market background of a falling pound and upward pressures on interest rates. Thus far the exchange rate has fallen no more than would be expected given the fall in oil prices. Fears of further oil price falls, and some uncertainty over policy, may explain the current market pressures. The situation is, however, different from a year ago, when there was only a modest fall in oil prices in relation to the fall in the exchange rate, and a larger rise in UK interest rates. Last year these factors led to a sharp recovery in the exchange rate, though with some delay.

10. We assume that the exchange rate fall attributable to oil prices (using a ratio of about 1:4) is accommodated with only a moderate rise in interest rates - because the net effect on inflation is probably small. We also assume that, whatever the immediate fluctuations, the lure of high UK rates will serve to steady the exchange rate once the uncertainties over oil prices and over policies are reduced.

	Exchange rates		North Sea		Short-term Interest rates, per cent		
	Effective index	\$/£	Oil price \$	Oil price £	UK	UK-world differential	UK "real"
1984 Q4	75	1.22	28½	23½	10	1	5½
1985 Q4	80	1.44	29	20	11½	3½	7
1986 January 29	74	1.39	18½	13½	13	5	9½
1986 Q4	75	1.44	20	14	11½	4½	7½
1987 Q4	73	1.48	21½	14½	10¾	4½	6½

The financial forecast

11. MO growth has slowed down this financial year, probably in response to higher interest rates. The growth of MO remains around 4 per cent in 1986-87 and 1987-88 as the growth of personal incomes stays high and interest rates decline slowly. We judge that rapid growth in £M3 is consistent with low inflation: there is every reason to expect further falls in velocity. A chart on page 59 shows that in successive versions of the MTFS (the same is true in internal forecasts) there has been a pronounced tendency to over-forecast £M3

velocity. (Forecasts of money GDP have been much more accurate than forecasts of £M3.) The scale of financial liberalisation, and probably somefall in the price of financial services, is continuing to encourage both companies and persons to hold more financial assets and liabilities. The forecast is summarised and compared with the MTFS in the following table:

Monetary Policy Targets and Indicators

(per cent changes on a year earlier for MO and £M3)

	Sterling Index		**MO**		**£M3**		**UK short Interest Rates**	
	Forecast	**MTFS**	**Forecast**	**MTFS range**	**Forecast**	**MTFS range**	**Forecast**	**MTFS**
1984-85	76	76	5½	4-8	9½	6-10	11	11
1985-86	79	74	4½	3-7	13	5-9	12¼	12
1986-87	75	74	3½	2-6	13	4-8	11¾	10
1987-88	73	72	3½	1-5	12	3-7	10¾	9

11-15

Inflation

12. Inflation, as measured by the RPI, is now set to fall quickly. Even with a rise in mortgage rates, the RPI should be a little below 4 per cent in the second quarter, on the assumption that indirect taxes are indexed in the budget. By the fourth quarter the RPI rate may be about 4 per cent: the slight deterioration compared with the Autumn Statement reflecting adverse movements in the mortgage rate and local rates. The broader measure of inflation, the GDP deflator, is expected to rise by 5½ per cent in 1985-86, and 4 per cent in 1986-87: both figures would be 1-1½ per cent higher without the steep decline in sterling oil prices. Most measures of inflation are not expected to change much in 1987: lower increases in wages and profits should offset the faster growth of import prices.

Income and spending

13 Rising output and falling commodity prices should provide companies (except those in the North Sea) and households with substantial rises in real incomes; we expect real incomes of industrial and commercial companies to rise a further 7 per cent in 1986, while persons' real incomes, after tax, may rise by about 5½ per cent. This includes ½ per cent from the assumed fiscal adjustment.

14. Judgments about private sector spending also take into account the high level of interest rates and the availability of finance. The forecast gives greater weight to the high level of interest rates than to the availability of finance. Even so, private sector spending is likely to rise strongly this year, and, though perhaps more slowly, in 1987.

Constant prices, per cent changes on a year earlier

	level in 1984 £ bn	1985	1986	1987
Company sector spending	27	4	4	3½
Personal sector spending	152	2½	4	4
Government spending on goods and services	62	1	½	0
Total domestic demand	241	2	3½	3

Activity

15. Both 1984 and 1985 saw strong rises in **exports**: for manufactures export growth was probably 1-2 percentage points above the growth in world trade. We have assumed that this good performance will not be repeated: even so, export growth in 1986-87 may not be much short of that in world markets. In the home market too 1985 was a good year for domestic manufacturers, with only a slow rise in import penetration.

16. The fastest period of (underlying) growth in the economy was probably in the second half of 1984 and first half of 1985: some 4 per cent at an annual rate. There was some slowing down in the course of 1985: our forecast, which seems consistent with the January CBI Trends survey, suggests that underlying growth will be around 2½ per cent in 1986 and 1987.

Per cent changes on a year earlier

	1985	1986	1987
Domestic demand	2	3½	3
Exports (non-oil)	6	3	3
Imports (non-oil)	4	5½	4
GDP: non-oil output	3½(3)	3 (2½)	2½
GDP: total output	3½(3)	3 (2½)	2

Figures in brackets are after adjustment for the effects of the coal strike

Unemployment

17. The continuing rise in activity is probably still creating new jobs, though the statistics are not adequate to measure the scale of increase with any accuracy. Unemployment has risen only a little in the past nine months. The increasing effect of special employment measures (this forecast assumes extra spending out of the reserve of £150 million net in 1986-87), the re-structuring of National Insurance Contributions, and the slow down in the growth of the labour force may well make for a slow fall in unemployment. But at the aggregate level,there is no sign of any downward adjustment of real wage growth in the UK.

Current account of the balance of payments

18. The current account has been in sizeable surplus for some years now, and we expect another substantial surplus to be earned in 1986, despite the decline in oil prices. The deficit on manufactures may increase, with the surplus on invisibles growing. 1987 may see a smaller surplus, partly because of a smaller contribution from oil.

Nominal income: the policy framework and the impact of falling oil prices

19. The forecast is for the growth of money GDP to slow down, though by rather less, mainly in 1987-88, than in the MTFS:

? not strike adjusted	per cent 1984-85	1985-86	1986-87	1987-88
MTFS	6¾	8½ —?	6½	5¾ — what was the internal forecast?)
January forecast	7(8½)	9(7½)	6½(6½)	7 (6½)/7

See below

Figures in brackets are adjusted for the estimated effects of the coal strike. Growth in nominal GDP this year is turning out very close to that in the MTFS.

The composition of money GDP growth in the forecast is as follows:

<u>**January forecast**</u>	per cent 1984-85	1985-86	1986-87	1987-88
GDP Deflators total	4½	5½(5)	4 (4½)	4½(3½)
non-oil	3½	7	5½	4½
oil	+ 15	- 18	- 28	+ 1
output (strike adjusted)	3½	2½(2½)	2½(2)	2 (2)
Nominal GDP (strike adjusted)		?8½		
: total	8½	7½(7)	6½(6½)	6½(5¾)
non-oil	7½	9	8½	7½

Figures in brackets are from the 1985 MTFS ?

get the lines thread, or have we an inconsistency between this table & the one at the top of the page

20. Even though oil output represents only 5-6 per cent of total GDP, the big price falls mean that its contributions to changes in nominal GDP are significant. The bottom line shows that there is a declining trend in non-oil nominal incomes in both of the forecast years. This mainly reflects the trend in prices: the fall in oil and other commodity prices working their way through to wages and profits. The fall in nominal GDP brought about by lower oil prices is at least partly offset by a faster rise in output in the non-oil sector.

Risks and uncertainties

21. Errors from past forecasts are reminders of the scope for error:

	Forecast	Average error from past forecasts
GDP growth 1985 to 1986	3	1
Balance of payments on current account, £billion, 1986	4	2½
RPI: per cent increase to fourth quarter, 1986	4	1*
Fiscal adjustment 1986-87, £ billion	2	2½**

* Average error calculated from budget forecasts since 1979

** Average error calculated from PSBR errors in budget forecasts (since 1981)

The fiscal prospect

22. On **Public expenditure**, (full details are set out in Miss Peirson's note) we start with the plans in the 1986 PEWP, though for years after 1986-87 the plans look increasingly unrealistic in some key areas. We attempt to forecast whether the Reserves will be over or under spent, and by how much. For 1986-87, we make the following crucial assumptions:

(i) There will be no major policy changes increasing expenditure. But the pressures on programmes are nearly always upwards.

(ii) There will be no major unexpected calls on the Reserve - such as a coal strike.

(iii) Economic developments will be as in our main forecasts.

23. The new style Reserve covers all spending over and above programmes. By calculating the difference between outturn and programme plans for the year immediately ahead we see the size of reserve that was actually needed in recent years:

				£ billion		
	1981-82	**1982-83**	**1983-84**	**1984-85**	**1985-86 Forecast**	**1986-87 Forecast**
Reserve needed	1.5	1.4	2.2	6.1 (3.5)	4.7 (3.6)	4½
Allowance in Budget forecast	1.6	2.4	- 0.1	2.8	5.0 (4.5)	4½*

Figures in brackets exclude the costs of the coal strike.

* 1986 PEWP

24. The increasing difficulties of public expenditure control are reflected in the top line. For 1986-87, it is sensible to make a comparison with the strike adjusted figures for earlier years. Except for 1983-84, the allowance made in the FSBR for the year ahead was about right, if the coal strike effects are excluded.

! 25. Our central estimate of the **Reserve** required is £4½ billion in 1986-87. It is a coincidence that this is the same figure as in the PEWP.

26. For later years the Reserves have usually been seriously inadequate: the same is likely to be true of current plans, by perhaps £2½ billion in 1987-88 and perhaps double that in 1988-89. The increase in the Reserve (from £4½ billion in 1986-87 to £6¼ billion in 1987-88 to £8 billion in 1988-89) is barely enough to cover the likely increases needed for local authorities alone, and there will be other claims (such as social security) increasing over the period.

What basis is used for forecasting the FA?

27. **Revenues** are buoyant, except for oil revenues which are forecast to fall from £11½ billion this financial year to £8 billion in 1986-87 and £6½ billion in 1987-88. This is based on a North Sea price of $20 a barrel.

The table below analyses the forecasts of central government revenues from taxes and National Insurance contributions.

CG revenues (excluding oil taxes) from taxes and NICs, as proportion of nominal income (less oil), per cent

	1983-84	1984-85	1985-86	1986-87**	1987-88**
(1) Actual/forecast	33.4	33.3*	32.8	33.2	34.0
(2) Line (1) adjusted to remove effects of changes in tax rates and allowances in 1984 and 1985 Budgets	33.4	33.3*	33.4	33.7	34.4

* adjusted for effects of coal strike (because the net effect on revenues was small)

** before fiscal adjustment

28. The rise of more than one percentage point between 1984-85 and 1987-88 in the adjusted proportion mainly reflects the effect of real fiscal drag on personal income tax (worth about £¾ billion). Receipts from corporation tax rise rapidly because of the lagged reaction of onshore company taxes to the rapid rises in profits in earlier years. A further factor is the forecast shift in the distribution of income from 1985-86 in favour of employment incomes and away from onshore company profits (reversing the shift seen up till then). This will tend to raise taxes for given total nominal incomes because the average tax rate on employment income is higher than on company income.

29. Since the 1985 MTFS, the forecasts have changed as follows:

£ billion	1985-86		1986-87		
	MTFS	Jan 86	MTFS	Jan 86	
Oil revenues	13½	11½	11½	8	-3½
Non-oil revenues	136½	138	147½	150	
Total	150	149½	159	158	

30. The increase in non-oil revenues in both years reflects mainly a 2 per cent increase in the level of non-oil nominal income, as well as some increase in the yield for given incomes and expenditure. With no change in the planning total for 1986-87 (higher asset sales offsetting higher programme expenditure), the scope for fiscal adjustment has been reduced by the fall in oil revenues -but by much less in absolute terms because of the extra revenues elsewhere, some of which are already evident in 1985-86.

31. The 1985-86 PSBR which we revised up to £8 billion in the Autumn Statement we have now revised down to £7 billion: that estimate is likely to change further in the run-up to the Budget.

32. Our best estimate of the annual fiscal adjustments, with a PSBR at £7½ billion, are £2 billion for 1986-87 and £4 billion in 1987-88. There have been major changes to asset sales and to oil revenues in particular:

Does this allow for Para 26? (PSBR 90)

Tut! Tut!

Asset sales, £ billion

	1985-86	1986-87	1987-88
MTFS	2½	2¼	2¼
PEWP/January forecast	2½	4¾	4¾

Oil revenues, £ billion

	1985-86	1986-87	1987-88
MTFS	13½	11½	9½
January forecast	11½	8	6½

33. The PSBR is one measure of the fiscal position. The **public sector financial deficit** - the net acquisitions of financial assets by the public sector - excludes from the PSBR financial transactions such as asset sales and net lending. In contrast to the PSBR, the financial deficit has increased in recent years.

as % of GDP??

		£ billion
	PSBR	**Financial deficit**
Average: 1980-81 to 1982-83	10	9
Average: 1983-84 to 1985-86	9	12
1986-87	7½	11½
1987-88	7	11½

SUMMARY TABLE AND COMPARISON WITH THE FSBR AND AUTUMN STATEMENT

	FSBR/MTFS MARCH 1985	AUTUMN STATEMENT NOVEMBER 1985	JANUARY 1986
1. World GNP (major 6)			
(% change on year earlier)			
1984	4½	4½	4½
1985	3½	3	2½
1986	3	3	3
1987	3½	-	3
2. Effective Exchange Rate			
(1975=100)			
1984 Q4	75	75	75
1985 Q4	74	81	80
1986 Q4	74	81	75
1987 Q4	72	-	73
3. Oil prices, $ North Sea spot			
1984	29½	29½	29½
1985	27	27½	27½
1986	26	25	20½
1987	26½	-	20½
4. Nominal GDP (mp)			
(% change on year earlier)			
1984-85	6¾	7	7
1985-86	8½	9	9
1986-87	6½	7	6½
1987-88	5¾	-	6½

	FSBR/MTFS MARCH 1985	AUTUMN STATEMENT NOVEMBER 1985	JANUARY 1986
5. GDP Volume (% change on year earlier)			
1984	2½	2½	2½
1985	3½	3½	3½
1986	2	3	3 2½?
1987	2	-	2
6. RPI (% change on year earlier)			
1985 Q4	5	5½	5½
1986 Q4	3¾	3¾	4
1987 Q4	3	-	4¼
7. Unemployment (UK s a excluding school leavers, millions)			
1985 Q4	3.1	3.18	3.17
1986 Q4	3.0	3.2	3.10
1987 Q4	3.0	-	3.10
8. Current Balance (£ billion)			
1984	0	1	1
1985	3	3	3½
1986	2½	4	4
1987	1½	-	1½
9. PSBR, £ billion (% of GDP in brackets)			
1984-85	10½(3¼)	10 (3)	10 (3)
1985-86	7 (2)	8 (2¼)	7 (2)
1986-87	7½(2)	7½(2)	7½(2)
1987-88	7 (1¾)	-	7 (1¾)

	FSBR/MTFS MARCH 1985	AUTUMN STATEMENT NOVEMBER 1985	JANUARY 1986
10. Fiscal Adjustment (annual not cumulative)			
1986-87	3½	[3]	2
1987-88	3	-	4
11. Interest Rates Short-term (per cent)			
1985 Q4	11½	11½	11¾
1986 Q4	10	10¼	11½
1987 Q4	9¼	-	10¾
12. Money Supply £M3 (% change)			
1984-85	9½	9½	9½
1985-86	8½	13½	13
1986-87	7½	12	13
1987-88	6½	-	12
13. Money Supply MO (% change)			
1984-85	4¾	5½	5½
1985-86	4½	4½	4½
1986-87	4½	4	3½
1987-88	5½	-	3½

This may not be shown (perhaps 2½?)

14. Money GDP (%)

OIL PRICE VARIANT

34. The main forecast assumes that world oil prices in 1986 and 1987 remain at about $20 per barrel, close to the current spot level. There is great uncertainty over this, and as a variant we have investigated the effect on the world and UK economies of assuming that there is further fall in the price of oil of $5 (25 per cent) at the beginning of the second quarter of 1986. Oil prices are then assumed to remain about $5 per barrel lower than in the base throughout the forecast period.

Effects on World Economy

35. The fall in oil prices will tend to reduce inflation, boost consumer spending and reduce government expenditure in the oil importing countries. The ultimate effect on world economy will depend crucially on the policy reactions of governments in both the industrialised and oil-exporting countries. In the former it is assumed that governments in the major seven countries keep monetary growth rates unchanged by lowering interest rates; and that countries with historically high budget deficits (US, France, Italy and Canada) allow the operation of automatic stabilisers to reduce their deficits in relation to nominal GDP, while deficits in Japan, Germany and the UK remain broadly unaffected by the lower oil price. The net effect is to reduce nominal GDP in the major 7 countries by up to 0.8 per cent, policy not being sufficiently expansionary to offset the effects of the fall in oil prices on the price level. The oil exporting countries, some of whom face severe balance of payments difficulties even in the base case, are assumed to cut imports and invisible payments (eg. payments to expatriate workers) by as much as possible to avoid exhausting their reserves of useable overseas assets too quickly.

36. Largely because we have no clear idea of the precise consequences, the variant makes no allowance for major changes in economic behaviour. Such a sharp fall in oil prices could pose problems for the banking system, eg. from the increased likelihood of default on debt repayments by an oil-dependent countries such as Nigeria or Mexico, or from failures of banks in the US which are heavily exposed in the energy sector. We have not attempted to make specific allowances for these risks.

37. Within this policy framework and under these assumptions, real GDP in the major seven countries could be 1¼ per cent higher after two years, and world import volumes perhaps 1¾ per cent higher in part due to greater world oil trade. The price level in the major 7 is forecast to fall by about 1 per cent after about a year. This effect increases to about 2 per cent after 2 years, but then stabilises because of higher world activity.

Effects on UK Economy

38. In the face of lower oil prices we have assumed that the PSBR ratio is unchanged, and that lower oil revenues lead to a smaller fiscal adjustment. This contrasts with the assumption in the Powell/Horton Working Paper where the PSBR was allowed to rise. We have assumed no change in interest rates. This is consistent with little effect on monetary growth.

39. The forecast variant is shown in levels terms in the table on page 19 and as differences in the table on page 20.

40. Unlike other OECD countries, whose balance of payments benefit, lower oil prices lead to a deterioration in the UK current account. Furthermore, if the lower oil price is expected to persist, the value of North Sea oil reserves, and future export earnings, are reduced. In the forecast variant the sterling effective rate falls by nearly 4 per cent in 1986, slightly less in 1987. This is less than our previous relationship - a 10 per cent fall in oil prices leading by itself to a 3 per cent fall in the effective rate - might suggest. This is because the effect on the exchange rate depends on the absolute (not the percentage) fall in oil prices: and a 25 per cent fall starting from $20 per barrel would have about two thirds the effect of a 25 per cent fall starting from $30 per barrel.

41. The fall in the exchange rate and some rise in UK exports in line with higher world activity is not sufficient to prevent a deterioration in the current account of about £1 bn in 1987. This compares with the fall in the value of oil exports of £2¾ bn in the same year. By 1987 it seems likely that North Sea production would be adversely affected, and a small allowance for this has been made of 4½m tonnes (4%).

42. The variant suggests that there would be virtually no change in GDP. However UK real incomes (measured by Real National Disposable Income) fall by nearly one half of 1 per cent compared with the forecast. Within unchanged GDP there is:

- higher non-oil net exports because of higher world trade, and an improvement in competitiveness,

- a small rise in fixed non-North Sea investment and stockbuilding caused by higher private non-oil output,

- lower consumers' expenditure, mainly because the smaller fiscal adjustment reduces real personal disposable income.

43. Unlike other industrialized countries which clearly benefit, UK inflation, as measured by the RPI, is virtually unchanged as a result of lower world oil prices in 1986 and 1987. This is because higher import prices and wage costs offset the effect of lower sterling oil prices. The GDP deflator, which excludes the effect of higher import prices and in which oil prices have about a 5 per cent weight, is lower than in the main forecast, by about ½ per cent, and consequently Money GDP is also lower in the first year, by about the same.

44. The assumed fall in the dollar price of oil of about 25 per cent leads to a reduction in sterling oil prices of about 23 per cent. This, coupled with lower production, reduces North Sea Revenues by £1¼ bn and £2¼ bn in 1986-87 and 1987-88 respectively, and gives levels of North Sea revenues of £6¼ bn and £4 bn in the two years. The fall in revenue is proportionately larger than the fall in prices because, in broad terms, taxes are levied on the surplus over operating costs.

45. The variant suggests that the fiscal adjustment would be £1½ bn and £2 bn lower than in the forecast in 1986-87 and 1987-88. The main changes in the public sector accounts are set out below:

£bn	Fiscal Adjustment	Income Taxes ex FA	North Sea Taxes	Total Receipts	Total Expenditure
1986-87	-1.4	0.2	-1.6	0	0
1987-88	-2.0	0.4	-2.3	-0.2	-0.2

SUMMARY TABLE JANUARY 1986 FORECAST

		MAIN FORECAST	LOWER OIL PRICES
		$20 pb	$15 pb
1.	World GNP (major 7 excluding UK) % change on year earlier)		
	1986	3	3½
	1987	3	3½
2.	Effective Exchange Rate (1975 = 100)		
	1986 Q4	75	72
	1987 Q4	73	70
3.	Oil prices, $ Brent spot		
	1986 Q4	20	15
	1987 Q4	21½	16½
4.	Nominal GDP (mp) (% change on year earlier)		
	1986-87	6.7	6.2
	1987-88	6.8	6.7
5.	GDP Volume (% change on year earlier)		
	1986	2.7 ? (see para 16)	2.8
	1987	1.7	1.8
6.	RPI (% change on year earlier)		
	1986 Q4	4.1	4.0
	1987 Q4	4.3	4.2
7.	Current Balance (£ billion)		
	1986	4¼	3¾
	1987	1½	½
8.	Fiscal Adjustment (annual not cumulative)£bn		
	1986-87	2¼	¾
	1987-88	4¼	2¼

LOWER OIL PRICE VARIANT

% change from base

Year	Major 7 excl. UK GDP	Major 7 excl. UK Consumer Price Index	Real GDP	RPI	Nominal GDP	Real National Disposable Income	£ Effective exchange rate
1986-87	+0.6	-1.1	+0.1	-0.1	-0.5	-0.3	-3.8
1987-88	+1.1	-2.2	+0.1	-0.1	-0.6	-0.4	-3.7
1988-89	+1.3	-2.3	0	+0.1	-0.2	-0.2	-3.2
1989-90	+1.2	-2.0	0	+0.1	0	-0.2	-2.8

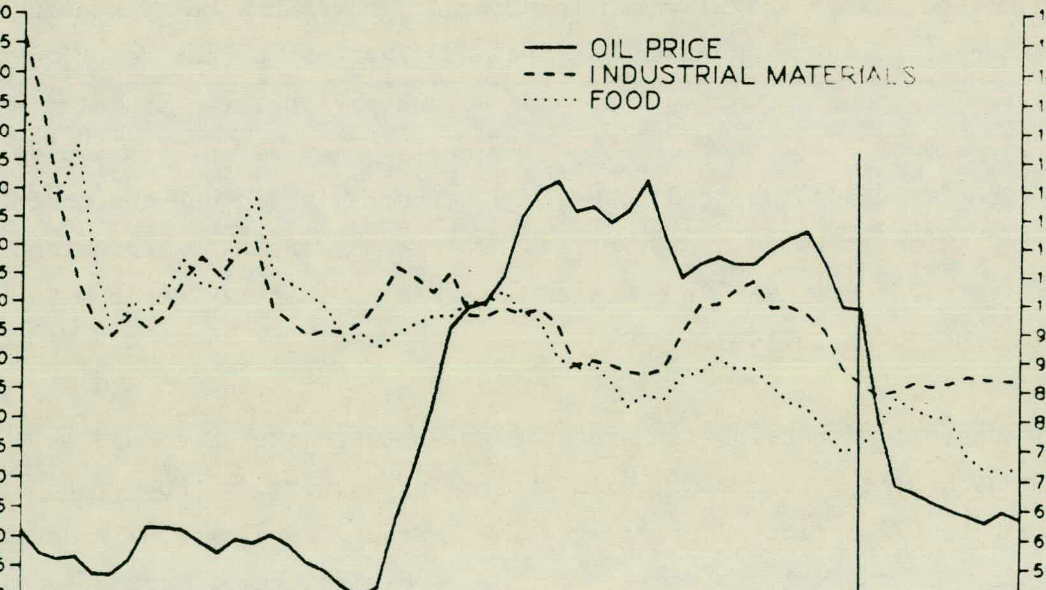
Year	Labour cost competitiveness	Earnings	Employees in employment (000s)	North Sea Revenues (£bn)	Fiscal Adjustment (£bn)	World Trade in manufactures (UK weighted)
1986-87	-3.8	+0.2	+10	-1.6	-1.4	+0.7
1987-88	-2.9	+0.3	+70	-2.2	-2.0	+1.5
1988-89	-2.9	+0.6	+70	-2.1	-1.6	+1.5
1989-90	-3.2	+1.0	+10	-1.9	-1.2	+1.4

THE WORLD ECONOMY

46 For some time we have been forecasting falls in **world oil prices**, but not big or fast enough. For this forecast we have assumed that world prices are $20 a barrel in 1986. This is not very different from the current (January 28) spot and forward price for West Texas Intermediate. The implications of a bigger fall were examined earlier in this report. For 1987 we have assumed no change in the dollar oil price, but a continuing fall in the dollar, and hence in the real oil price. Real oil prices are now close to their pre 1979 levels. With a few exceptions like coffee, other **world commodity markets** provide evidence of plentiful supplies relative to demand. Prices are likely to remain weak.

REAL COMMODITY PRICES *

1980=100



* IN RELATION TO PRICES OF MANUFACTURES

47. These big falls will stimulate oil demand and reduce supply from non-OPEC countries. But these effects build up only slowly (we have not yet seen the full effect of the 1979-80 price rises); and the present level of output in OPEC is likely to remain a long way below potential for some years. Hence any major strengthening of prices seems unlikely before the early 1990s.

48. Falling commodity prices provide a favourable background for industrial countries, enabling inflation to fall without squeezing profit margins or reducing real wages.

Per cent changes on a year earlier

	1983	1984	1985	1986	1987
World GNP (major 7)	2½	4½	2½	3	3
Consumer prices (major 7)	4½	4½	4	3	3
World imports: total	3	9	3	5	4

49. In the **United States** the slowdown in economic growth has been accompanied by lower interest rates. Short rates are now around 8 per cent, tax-deductible for business and consumers, and no longer look high in relation to an inflation rate of 3 per cent or so. The dollar has fallen (in effective terms) by over 20 per cent since its peak in February 1985, but the potential effect on inflation is being partly offset by lower importers' margins and the fall in oil prices. For 1986 as a whole, US import prices may be no more than 4 per cent higher than in 1985.

50. If confidence in financial markets does not break, the US should be able to continue with some growth and low inflation for a time. But the speed of adjustment to the deficits looks very slow indeed. The external deficit, in particular, is unlikely to decline much - even with some further dollar depreciation - until domestic demand growth in the US is appreciably slower than in other OECD countries. This could come about either through a speeding up of domestic demand growth elsewhere, and there is an element of this in our forecast for Japan and Europe, or by a further slowing down in the US. A US recession could be induced by tighter policies if a faster adjustment to the deficits is required. Domestic demand growth in the US and other countries is summarized in the following table:

Domestic demand at constant prices

per cent changes on a year earlier, at annual rates

	US	Japan	Europe	UK
1982-84	7	2½	1½	3½
1984-87	3	4	2½	3

51. With some further appreciation of the yen and DM, and with falls in commodity prices, we expect falling interest rates and broadly stable prices in **Japan** and **Germany** for the two or three years. In terms of both deutschmarks and yen, world oil prices are currently roughly half their level of eighteen months ago. But with some further tightening of fiscal policy in Japan, the expansion of domestic demand may not fully compensate for a slower growth of Japanese exports, leaving GDP growth in the 3-4 per cent range, compared with the 4-5 per cent of recent years. The potential for faster growth is greater in Europe and we expect the 2 per cent growth rates of the last two years to be succeeded by growth nearer to 3 per cent in 1986 and 1987.

52. Most **developing countries** will benefit from continued expansion in OECD, and from the big fall in oil prices, even though their own export prices may be weak. Oil exporters face the prospect of further large cuts in imports, as well as running down their reserves. Heavily indebted oil producers such as Mexico and Nigeria are likely to face particular difficulties and to seek greater debt relief from their creditors.

EXCHANGE RATES AND COMPETITIVENESS

53. Forecasts made a year ago underestimated the level of sterling in 1985. One factor was an initial underestimate of the interest differential in favour of sterling (see table), which averaged 4 points, compared with less than 1 in the two previous years; another was a larger than expected fall in the dollar. But for most of the explanation we have to resort to the tendency of financial markets to overshoot in the short run. In the present forecast we have made some allowance for this, but have taken the assumed improvement in sentiment partly in the form of a fall in interest rates from their current level and partly a small rise in sterling.

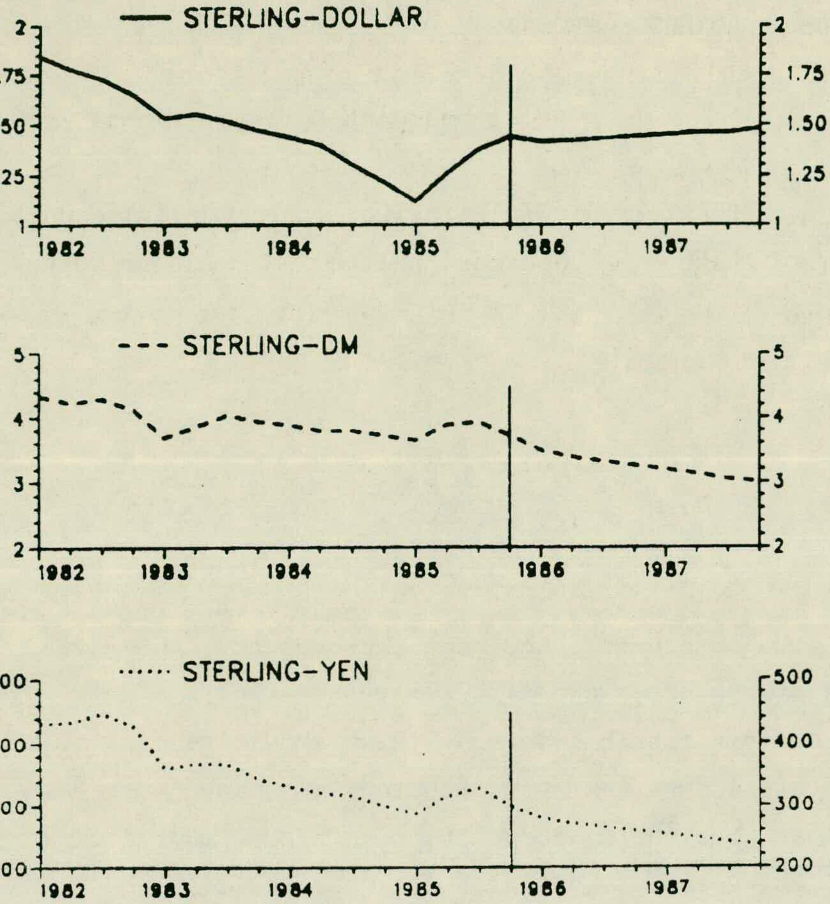
Forecasts for 1985 made in:

	January 1985	Budget 1985	Autumn Statement 1985	1985 Outturn	Current Forecast for 1986
Sterling Index	72	73	78½	78¼	75½
Short term Interest rates	11½	12½	12¼	12¼	12¼
Interest differential	2¾	3½	4	4	5
Oil prices:					
$	26½	27	27	27	20½
Real*	101	109	103	105	71
Dollar effective	142	148	141	141	122

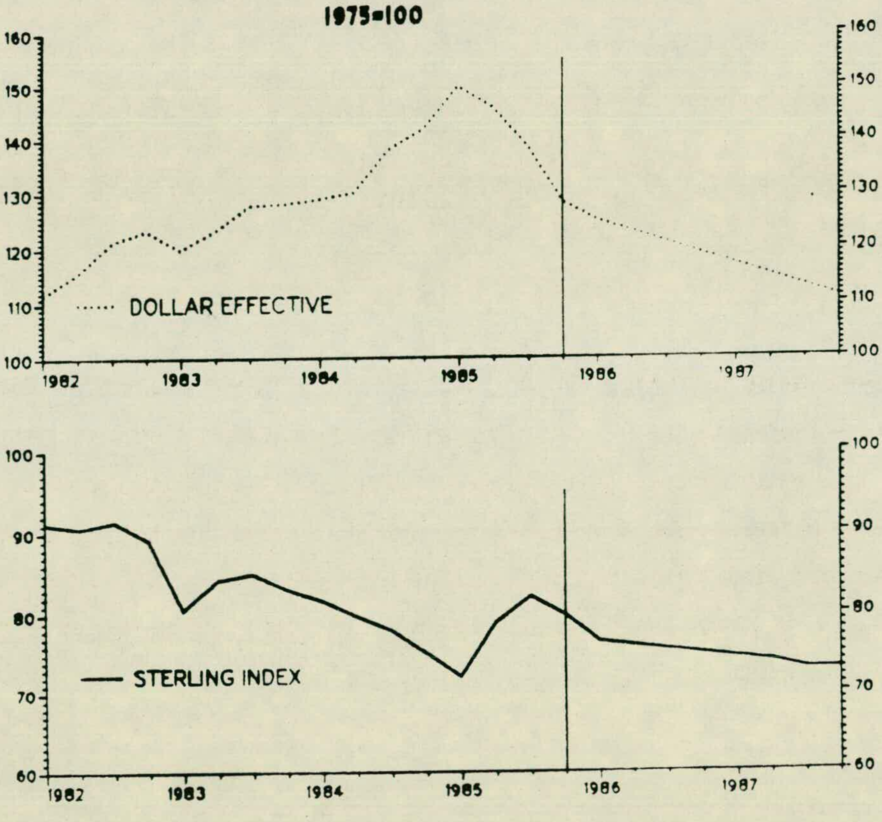
* 1980=100

54. Recent market expectations, as implied by the interest differential reflected in the forward rate, have been for sterling to depreciate about 5 per cent over the next year. The forecast has a slower fall because we assume a revised market assessment if oil prices stabilise as forecast, the dollar continues to weaken and the economic indicators (inflation, current account) are favourable. UK short rates in 1986 are forecast to be 5 per cent above the average of the major 6.

BILATERAL RATES FOR STERLING



STERLING AND DOLLAR EXCHANGE RATES
1975=100



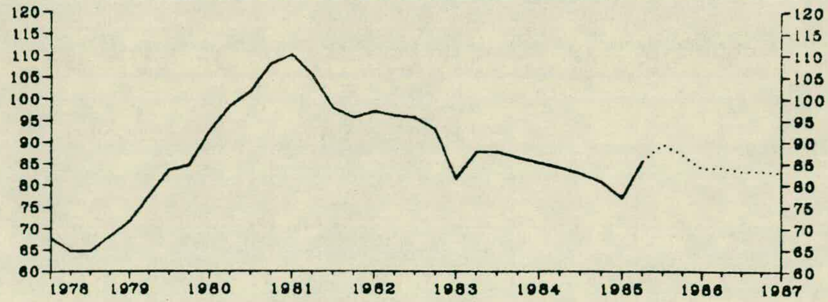
55. With the effective exchange rate at the bottom end of, or slightly below, the 75-85 range of the last four years, there should be a slight improvement in UK manufacturing competitiveness.

Price and Cost Competitiveness 1980=100

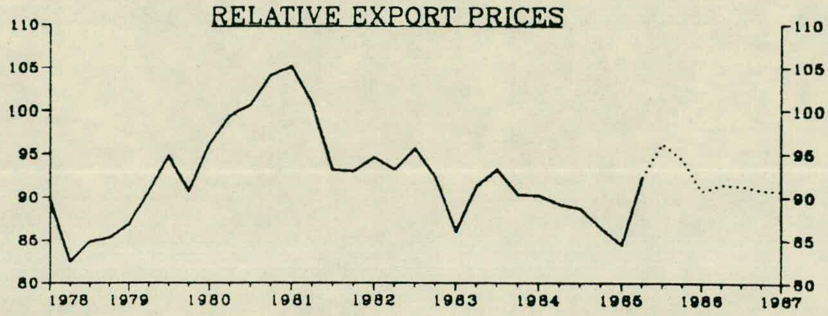
	Effective Rate	Relative export prices	Relative Unit Labour Costs
1983	83½	90	85½
1984	78½	88½	83
1985	78	92	85
1986	75½	91	83½
1987	73½	90½	82

56. While all the measures show an improvement in cost and price competitiveness since 1980, the last few years - and the next two years on our forecast - exhibit little change. This is despite a falling trend in the exchange rate, and reflects the tendency of labour costs in the UK to rise more than in our main competitors. The fluctuations in measured competitiveness in recent years (which are mirrored in the CBI balances - see next chart) are not likely to be contributing much to the UK's trade performance.

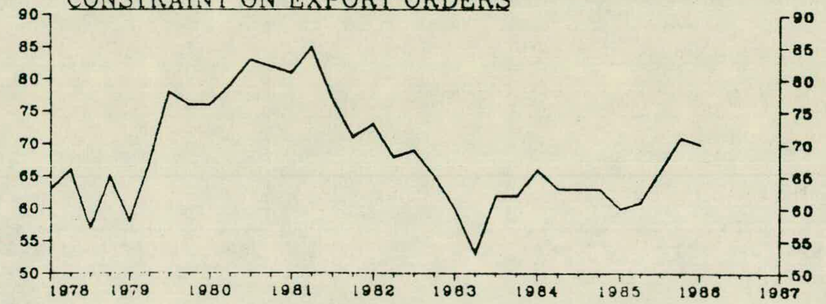
RELATIVE ACTUAL UNIT LABOUR COSTS



RELATIVE EXPORT PRICES



PROPORTION OF RESPONDENTS IN C.B.I. SURVEY CITING PRICES (COMPARED WITH OVERSEAS COMPETITORS) TO BE A CONSTRAINT ON EXPORT ORDERS



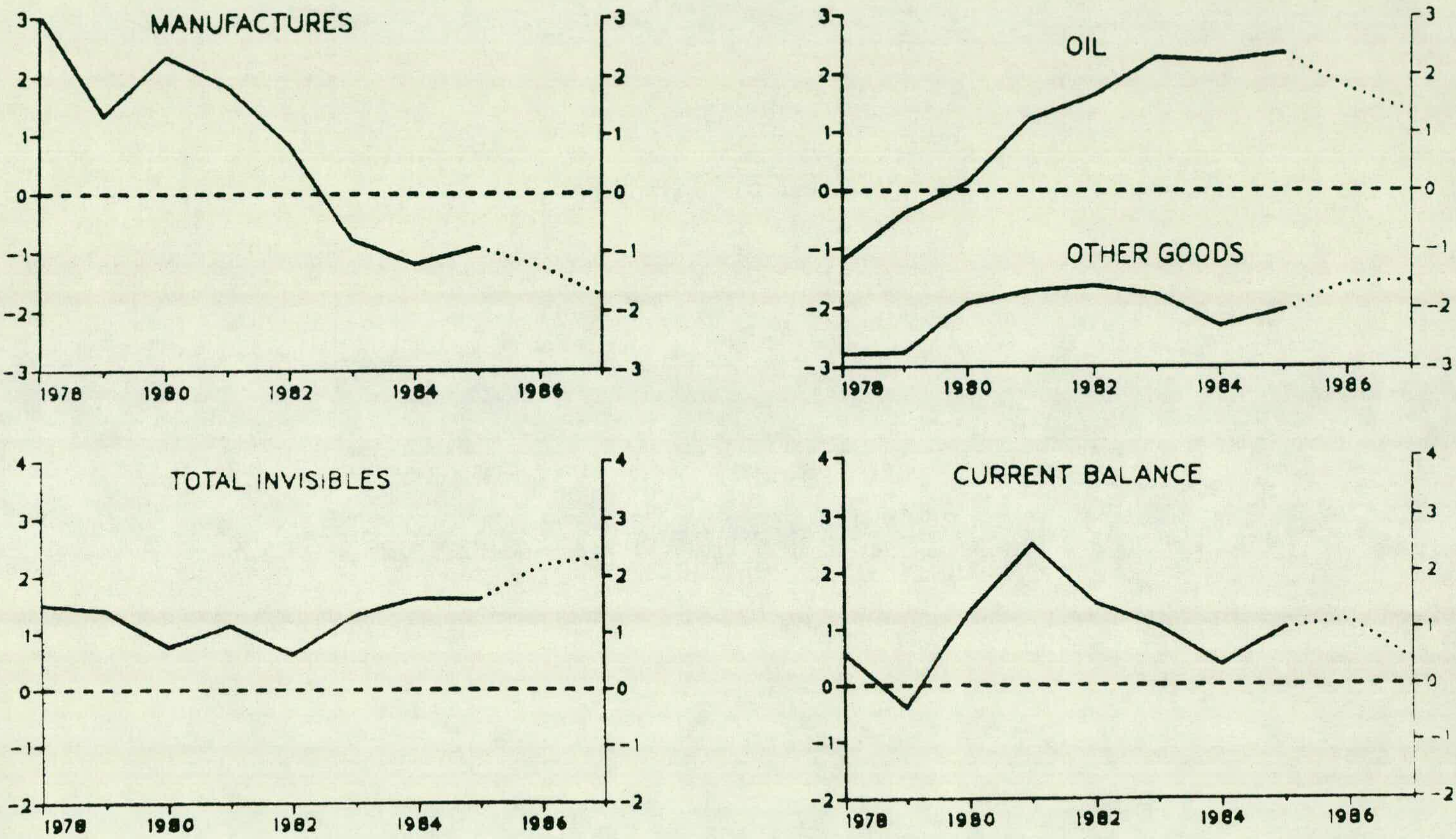
Trade and the balance of payments

57. The UK is expected to continue to run a substantial balance of payments surplus in 1986, as it has done since 1980. The contribution of manufacturing has tended to fall since 1979, more than offset by rising surpluses elsewhere. The chart below sets out recent trends and prospects.

58. Over the forecast period the oil surpluses fall with oil prices. The deficit in manufacturing was steady in 1984 and 1985, reflecting a combination of good growth in world trade, a strong trade performance - in terms of market share - by the UK, and in 1985 improving terms of trade.

59. We assume that trade performance will continue to be strong by the standards of the past 10-15 years, but not to the same extent as in 1984-85.

TRADE BALANCES AS SHARE OF GDP

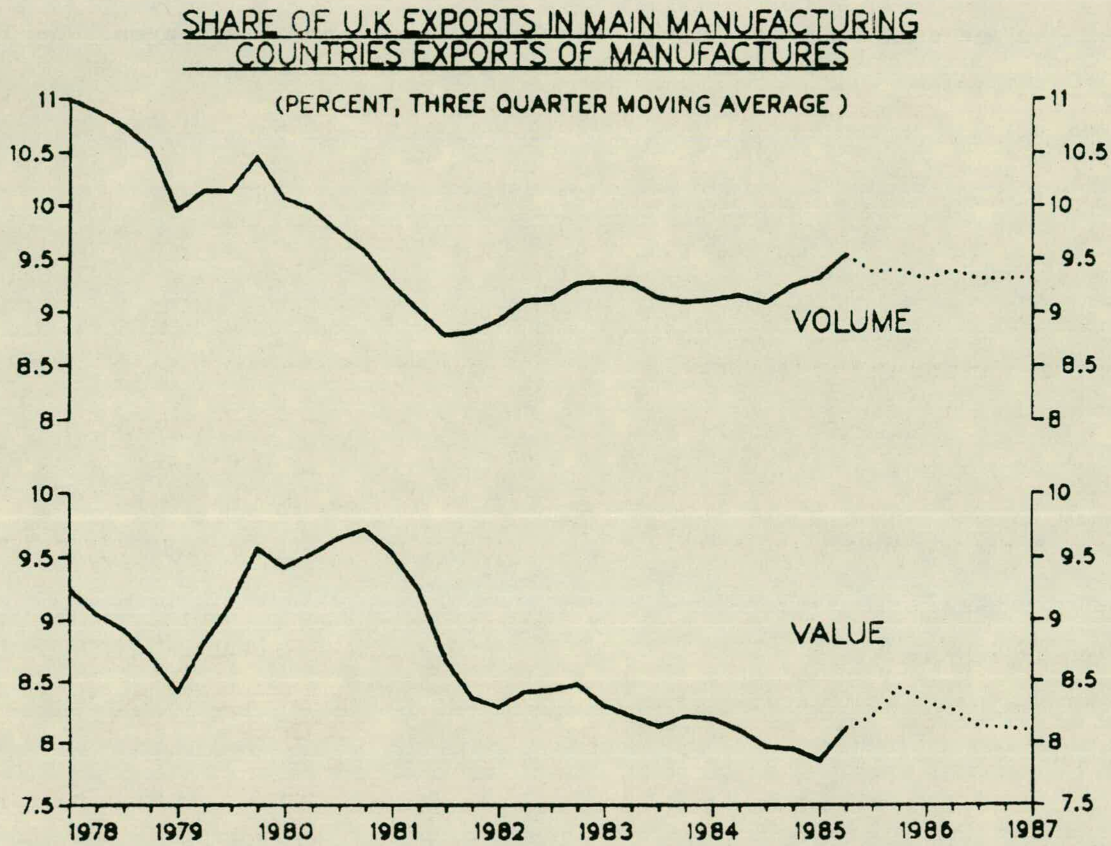


60. The improvement in the balance on other goods (food, drink and tobacco and basic materials) is largely the result of the 9 per cent improvement in the terms of trade that has recently taken place.

Trade in Manufactures

61. Short term movements in manufactured goods trade, which account for 70 per cent of total trade, are dominated by world trade and domestic demand.

62. Exports were higher than forecast in both 1984 and 1985 and exporters improved their share of world trade in volume terms - this is unusual in a period of substantial growth in world trade. The chart below shows the UK share of world trade in both volume and value terms.



63. Recent information on exports suggest that we have once again experienced an increase in the last quarter of the year - although DTI statisticians claim that the seasonal adjustment is not at fault.

64. The forecast of exports is for slower growth of 3-3½ per cent in 1986 and 1987, partly because of some slowdown in world trade in 1987, but also because we have allowed for only part of the recent good performance to be repeated. Even so, any fall in the UK share of world trade is likely to be very modest.

65. In the last three years, the growth in demand has been shared by importers and domestic producers, with importers continuing to increase their share. We expect domestic demand for manufactures to grow a little more slowly in 1986 and 1987, partly because growth in the economy is less investment and more consumption orientated. Nevertheless with consumer durables spending rising strongly, especially in 1986, import growth is likely to be substantial: we put it at 8 per cent in 1986, 6 per cent in 1987.

Trade in Manufactures

per cent changes (except for last line), annual averages

	1974-1982	1982-1985	1985-1987
Volumes			
World trade	3	4½	4
UK exports	1	5	3½
Domestic demand	- 2	5½	3
UK imports	6	10	7
Terms of trade	+ 2	0	1
Balance of trade in manufactures level, as per cent of GDP	2½	- 1	- 1½

Invisibles

66. The balance of trade in **services** has more than doubled since 1982, and recent revisions by the CSO confirm that 1985 was an exceptionally good year for services - partly because the strengthening of the pound in the spring led to an improvement in the terms of trade without much effect on volumes. Any further improvement in the services balance in 1986 and 1987 is liable to be small. The balance on transfers was low in 1985 because most of the EC rebate for 1984 was deferred into 1986. Net payments to the EEC are expected to remain low in 1987.

67. Earnings from **Interest, Profits and Dividends** have been rising strongly in recent years as the stock of overseas assets has risen. There was a setback in 1985 because UK interest rates and other rates of return rose relative to those overseas, and because of BP's 0.6 billion write-off on Sohio. In 1986 and beyond, oil debits will fall, reflecting lower profits in the North Sea, and the non-oil balance, though still held down by high UK rates, should resume their rise as the stock of overseas assets rises. The invisible balance and its main components are set out in the following table.

Invisibles balances £ billion

	1984	1985	1986	1987
Services	4	6½	6½	6½
IPD	3½	3	4½	5½
Transfers	- 2½	- 3½	- 2½	- 3
Total	5	5½	8	9

ie much bigger than oil surplus (4½)

The sterling value of the total stock of overseas assets has benefitted from rising stock markets but has been reduced by the rise in the sterling/dollar rate (a high proportion of our overseas assets are denominated in dollars). The table below gives past and forecast levels of our stocks of overseas assets. Of the rise estimated at £77 billion between 1979 and 1985, the cumulative current balance accounts for £20 billion, the remainder is accounted for by revaluations, including currency and stock market changes.

Net overseas assets

End year	£ billion	per cent of GDP
1979	12	6
1984	76	24
1985	90	26
1986	99	26
1987	105	26

68. The current account surplus is set out in the following table, with some of the special factors which distort the trends:

	1981	1982	1983	1984	1985	1986	1987
							£ billion
	Current account						
Actual/forecast	6	4	3	1	3½	4	1½
i)coal strike effects	-	-	-	2½	1½	-	-
ii) Shift of EC rebate	-	-	-	-	½	- ½	-
iii) Sohio write-off	-	-	-		½	-	-
Current balance allowing for i) and ii) and iii)	6	4	3	3½	6	3½	1½
Memo Net oil exports less NS IPD debits (this item is adjusted for the coal strike)	1	2	4	6½	6½	4½	3½

69. Once again, despite some allowance for upward revisions of early estimates, the current account for 1985 is turning out a little better than in the forecasts. Except for oil, there now appears to be little tendency for the UK current account to deteriorate, when the UK and the world economy are growing at similar rates. The sharp deterioration between 1981 and 1983 reflected mainly the faster growth of domestic demand in the UK: 7 per cent, as against 2½ per cent in the major 6.

INFLATION

Producer Prices

70. As recent data and responses to the CBI survey show, manufacturers' ability to raise their prices remain very limited, mainly as a result of falling prices of competing manufacture imports. Even with little change in the growth of wage costs, the increase in total costs including imported materials and fuels may be no more than 3 per cent from now on. The main influences on producer prices are set out in the table below:

Manufactures

per cent changes on a year earlier

(annual averages)

	Unit Labour costs	Import costs	Total costs	Prices of imported manufactures	Domestic output prices
1984	1½	10	4½	7½	5½
1985	4	4	4	6½	6½
1986	4½	- 7½	1	4	4
1987	4½	2	3½	6½	4

71. The table shows costs again rising faster than more slowly than domestic output price so that margins rise in 1986.

RETAIL PRICES

72. **Nationalised Industry** prices in 1986 are being set early in the year, and provide for increases close to (a backward looking estimate of) the inflation rate. In consequence the growth of nationalised industry prices for the rest of 1986 looks high in relation to prices in general. By 1987, however, nationalised industry prices should rise at a slower rate than prices in general. We have allowed for the effects of lower oil prices on coal, gas and electricity, though more on industrial than domestic prices. **Petrol prices** are forecast to fall to 175p a gallon by the end of 1986.

Retail Prices Index, per cent changes on a year earlier

	Food	Housing	Nationalised industries	Petrol	Other	Total
Weights	19	15	8	5	53	100
1984 Q4	3.3	10.6	4.2	3.2	4.1	4.8
1985 Q4	3.2	9.3	5.4	1.6	5.5	5.5
1986 Q2	2½	8	5	- 10	4	3¾
1986 Q4*	3	9	5	- 10	4	4
1987 Q2*	3½	3	2½	- 7	5	4
1987 Q4	3½	5	3	- 2	5	4½

* Forecasts for these periods are normally published in the FSBR, but without the split between petrol and other.

73. **Housing** prices will be affected by a sharp increase forecast for local authority rates in April; and by movements in the mortgage rate: we have assumed a rise of 1 per cent in March, which is reversed in August. Details of the housing index are set out in the next table:

Housing prices in the RPI, percentage change on a year earlier

	Mortgage Interest payments	LA rates	Other (rents, insurance, repairs etc)	Total
Weights	32	25	43	100
1985Q4	12	9	7	9
1986Q2	9	12	5	8
1986Q4	12	13	4	9
1987Q2	- 3	9	4	3

74. RPI inflation slows to under 4 per cent over the next few months as the big increases in early 1985 drop out of the annual comparisons. The monthly figures may look as follows:

RPI

per cent changes on a year earlier

December 1985	(published)	5.7
January 1986		5.6
February		5.0
March		4.6
April *		3.9
May		3.8
Q3		4
Q4		4

This assumes specific indirect tax rates are raised by 5.7 per cent in the budget, in line with December outturn. The consequence for the level of the total index is ½ per cent, which is allowed for in these figures. If there were no rise in the mortgage rate, then the figures for March to May would be lower by 0.4 per cent.

75. By Q4 1986 the inflation rate is put at 4 per cent, ¼ per cent higher than the forecast in the Autumn Statement; the effects of lower oil prices have been more than offset by a lower exchange rate, a higher mortgage rate, and a higher forecast of local authority rates.

76. In 1987, there may not be much change in the inflation rate, as the growth of unit wage costs slows, but there is less gain on commodity and oil prices.

GDP Deflator

77. This measures the price of UK "value added". It is not affected directly by import prices nor by mortgage rates, and so tends to be more stable than the RPI (though subject to revision, usually upwards). Its main components are wages and profits per unit of output.

78. The MTFS profile showed only a very muted rise in 1985-86 and a slow fall thereafter. Our latest assessment is very similar.

no it isn't!

GDP deflator, per cent change on a year earlier

	1984-85	1985-86	1986-87	1987-88
MTFS	4½	5	4½	3½
January forecast: total	4½	5½	4	4½
: total less oil	3½	7	5½	4½

79. The GDP deflator measures domestically generated inflation. It is affected by world prices only when world prices affect domestic profits, earnings, or other domestic incomes. Neither the rise in non-oil import prices during 1984-85 nor their subsequent fall has had the impact on the GDP deflator that it has had on other price indices. In 1985-86 and 1986-87 the fall in world oil prices pushes down North Sea prices and profits: the deflator for non-oil GDP rises by about 1½ points a year more than the whole economy GDP deflator.

Pay

80. Earnings growth in the private sector has been broadly constant at an annual rate of 7½-9 per cent since late 1982. Price inflation has fluctuated around an average of 5 per cent. Each of the last three pay rounds has led to a substantial increase, some 3 per cent a year on average, in real earnings before tax. This was a little higher than anticipated by wage bargainers, because of the tendency for price forecasts to be pessimistic except in 1985. There has been little or no tendency for the high level of unemployment to restrict the growth of wages. The ability of employers to pay, as substantial productivity gains have been made, has increased over this period.

Factors influencing private sector earnings, pay rounds

	1982-83	1983-84	1984-85	1985-86	1986-87
Inflation, per cent					
(i) At start of round, Q3	8	4½	4½	6½	(4)
(ii) Outcome on inflation, Q3	4½	4½	6½	(4)	(4)
Unemployment level at start of round, per cent	11	12	12½	12¾	(12½)
Profit share, per cent (non-North Sea ICCs)	8¾	10	12	(12¾)	(12½)
Earnings growth per cent change on a year earlier	8¼	7¾	8½	(8)	(6¾)

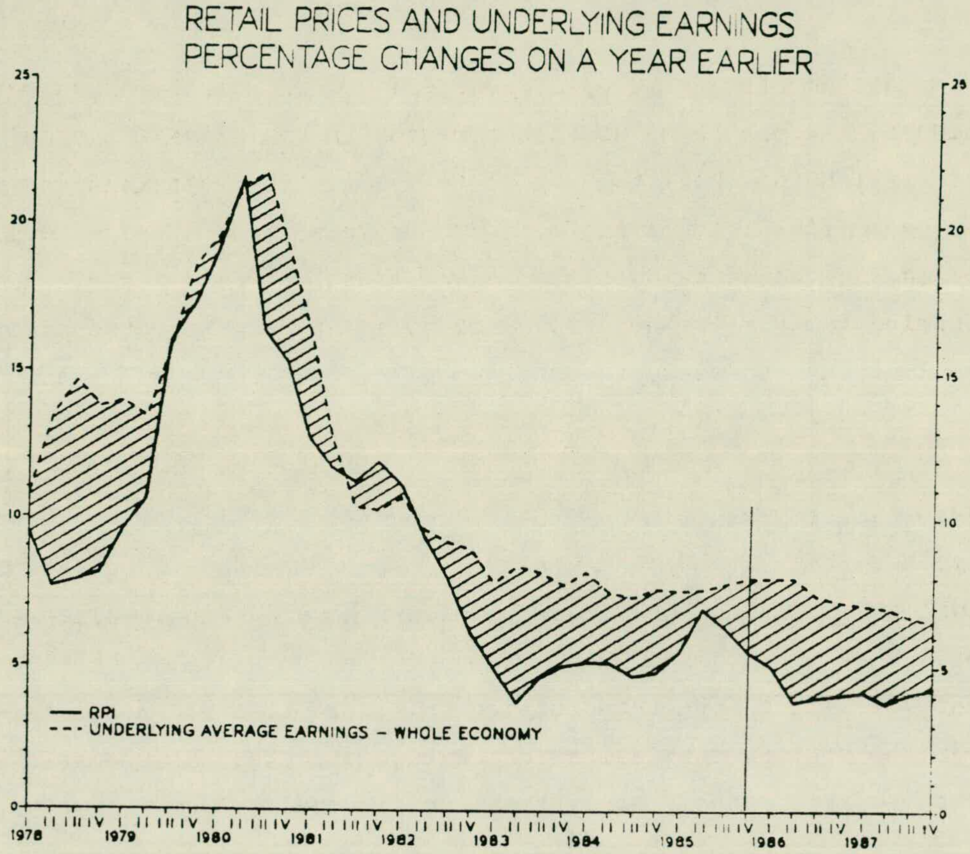
Figures in brackets are forecast; pay rounds run approximately from September to August

81. With both employers' and employees' real incomes rising strongly, wage bargains have been concluded with little difficulty. Short-term fluctuations in price inflation - often not fully anticipated - have had little impact on wage settlements and earnings growth. But a clear and sustained shift in the rate of inflation is likely to be reflected in wage settlements, though not immediately.

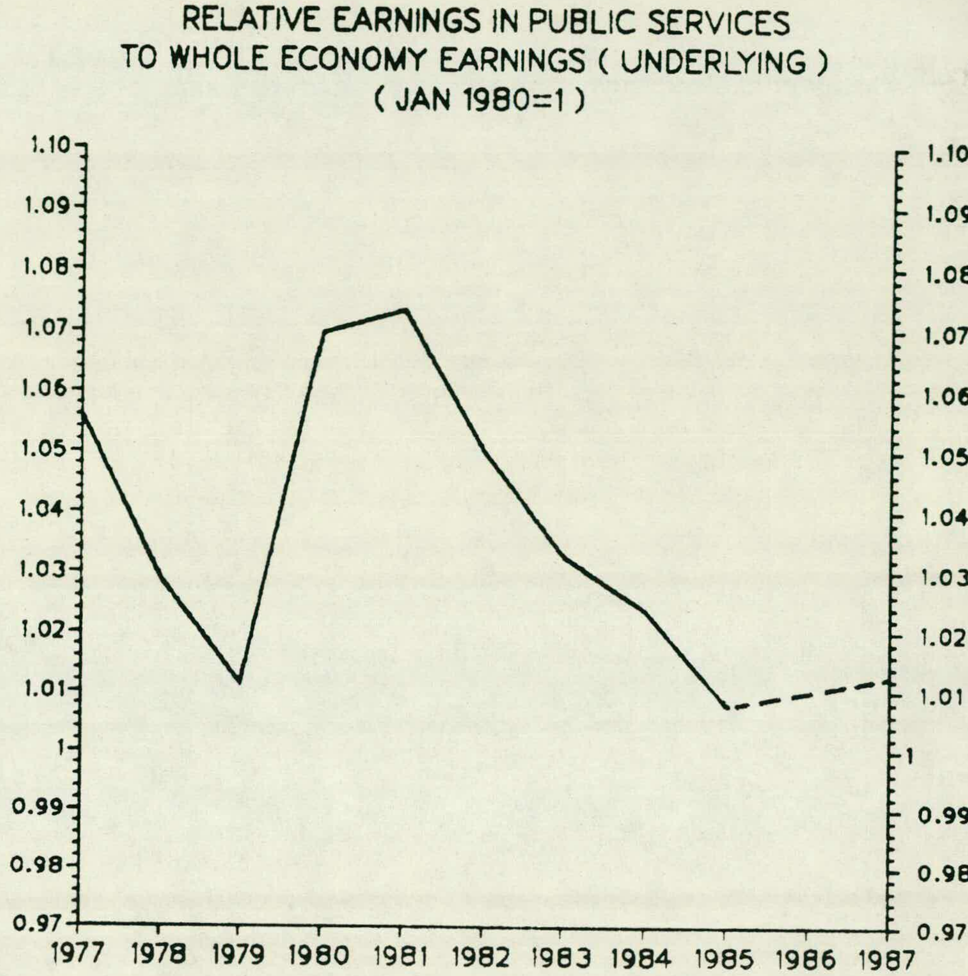
82. Current pay settlements are much as forecast: we expect earnings growth in the pay round as a whole to be about 8 per cent in the private sector. By the spring, inflation is likely to be down to below 4 per cent, and any pick-up later in the year likely to be small. By mid year, the average employee may have seen his take home pay up by some 6 per cent in real terms. (This includes a contribution of 1 per cent from the fiscal adjustment of £2 billion in the 1986 budget, assumed to be wholly in the form of income tax cuts).

83. At mid 1986, employers will continue to see their ability to raise prices as limited: without lower wage settlements, profit shares and rates of return would be liable to decline. Taking into account both employers' and employees' position - and tending to give rather more weight to the former, though it is not crucial to the outcome - we think that earnings growth in the private sector may slow to 7 per cent or below in the course of 1987. Even this - with the help of another large fiscal adjustment in the 1987 budget -could deliver another 4-5 per cent growth in real take-home pay.

84. The overall picture for earnings growth and price inflation is shown in the next chart:



85. Public service pay presents more difficulties to both pay bargainers and forecasters. We interpret the offers made to local authority manuals, teachers and civil servants as evidence that pay will no longer rise more slowly in the public services than in the rest of the economy. We have assumed that from now on, earnings in the public services will in general rise at the same rate as earnings elsewhere: this will often mean higher settlements in the public services because of lower drift. The teachers we treat as an exception: as well as getting a late settlement of their 1985 pay claim (too late to be paid in financial year 1985-86) they get the extra £1¼ billion spread over 4 years. The resulting ratio of public service to whole economy earnings is shown in the chart below:



Labour costs

86. The table below shows the composition of unit labour costs (recent fluctuations in the monthly statistics for unit wage costs, around an average of some 5 per cent, are probably of little significance):

Private sector, per cent changes on a year earlier

	Earnings (underlying)	Taxes on labour and employers' contributions	Total labour costs	Productivity	Unit Labour costs
1983	8½	4	8	5	3
1984	8	- 2½	6½	3	3½
1985	8	0	7	2½	4½
1986	8	3	7½	2½	5
1987	7	4	6½	2	4½

NIS reductions, and reductions in employers' contribution to pension funds, account for low figures in the second column.

COMPANY INCOME AND SPENDING

87. 1985 saw a further recovery in the profitability of industrial and commercial companies taken as a whole. However, the fall in sterling oil prices - and the flattening out of North Sea output - meant that North Sea companies' profits went into reverse after the first quarter of the year; while non-North Sea profits benefited from the lower price of oil and other inputs. North Sea profits may fall by about a third in 1986; but non-North Sea profits should again rise as the economy continues to expand and costs grow slowly.

Industrial and Commercial Companies' Profits (per cent)

	As a Share of Total Income		Rate of return on assets, non-North Sea
	Oil	**Non-oil***	
1973-1983 average	2.5	10.3	5.3
1984	6.9	11.2	6½
1985	6.2	12.2	8
1986	3.9	12.7	8½
1987	3.3	12.1	8

* Net of stock appreciation; adjusted for privatisation.

88. Data revisions are reducing the size of the discrepancy in the company sector accounts for 1984 and the first half of 1985. The financial accounts now give a rather healthier picture for the position of ICCs than previously - one that is much more consistent with the buoyancy of ICCs profits. The financial accounts are also now more consistent with the results of surveys which suggest quite a comfortable liquidity postion. Our forecast suggests that ICCs liquidity should remain at around present levels in relation to sales over the next two years.

Business Investment

89. Business investment now appears to have fallen back rather more sharply after the first quarter of 1985 than we had thought at the time of the Autumn Statement. For 1985 as a whole we now expect that manufacturing investment will rise by about 6 per cent (including assets leased from finance lessors), and non-manufacturing investment by a similar amount.

90. These rates of investment imply that the ratios of capital to output have continued to fall in both manufacturing and non-manufacturing over the last year. Although manufacturing output is only about 4 per cent below its 1979 average, manufacturing investment is still almost 20 per cent below its 1979 level. As measured by the CSO, the gross capital stock in manufacturing is rising at around ½ per cent a year; although the true growth rate may be a little higher than this (perhaps up to 1½ per cent) if there has, in the past, been substantial - but unrecorded - premature scrapping of the capital stock.

91. Despite the 3 per cent rise in manufacturing output over the past year, the number of firms quoting capacity as a potential constraint on output is the same as a year ago. While some industries such as textiles have been reporting capacity constraints approaching 1973 levels, overall the proportion is well below levels experienced in 1973 and at cyclical peaks during the 1960s.

92. The level of capacity utilisation and the much improved rate of profit now being earned on the existing capital stock both point to a further rise in investment during 1986. But the latest DTI Intentions Survey again suggests weak business investment this year. Part of the explanation for this weakness may be that investment has been brought forward into 1985 to forestall the reduction in capital allowances due in April 1986; but it is likely that most of the investment brought forward will occur in the first quarter of 1986, so that the total for investment in the calendar year is unlikely to be greatly affected by forestalling. Possibly high interest rates are part of the explanation, though with the stock market strong throughout 1985, the cost of equity finance has not risen as much as real interest rates.

93. In the forecast we have written up the DTI Intentions Survey figures for both 1986 and 1987: the forecast for 1986 is not much changed from the Autumn Statement.

	Percentage Increase by Volume in 1985	1986	1987
Manufacturing* (£6.4 billion in 1984)			
DTI Survey	6	- 2	0
HMT Forecast	6	0	3
Non-manufacturing** (£14.4 billion in 1984)			
DTI Survey	6	2	3
HMT Forecast	6	4	4
Total	6	2¼ 3	3½

* Including leased assets

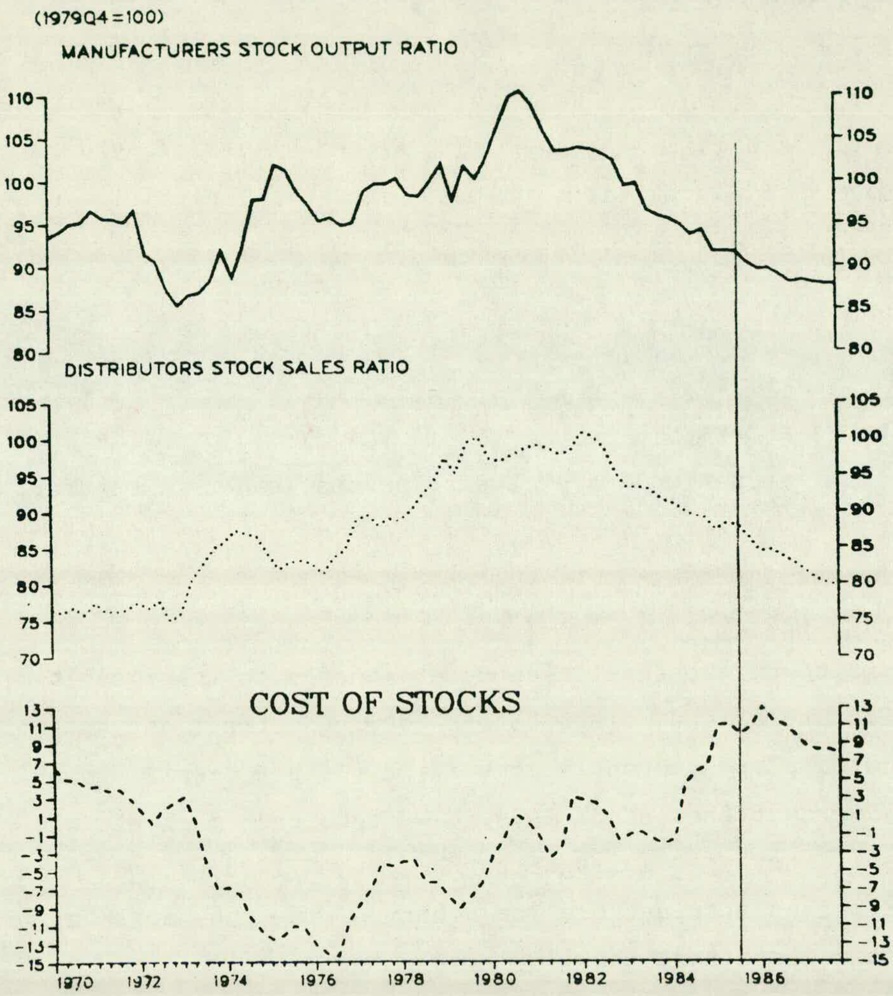
** Adjusted for privatisation and excluding assets leased to manufacturers.

Stockbuilding

94. There seems to have been little overall change to the level of stocks held by manufacturers and distributors during the course of 1985: manufacturers' stocks are currently some £5 bn (14 per cent) lower in real terms than they were at the end of 1979. We interpret much of the rise in stock output ratios during the latter part of the 1970's and much of the subsequent reversal as attributable to changes in the cost of financing holdings of stocks - see next chart.

95. High real interest rates, and the abolition of stock relief in the 1984 Budget mean that the cost of holding stocks is now much higher than at any time in the last ten years. The implication is that stock output ratios are likely to continue to fall; and this receives further support from recent Surveys. A positive balance of both distributors and manufacturers still say that their stock levels are too high; and replies to the CBI's January Trends Survey indicate that manufacturers are expecting to reduce stocks from current levels.

AGGREGATE STOCK RATIOS



PERSONAL INCOME AND SPENDING

96. For some time now we have been forecasting an exceptionally large rise in personal disposable income in 1986, and with it the re-emergence of consumer spending as the main area of growth in demand. This pick up in consumption has already started and is now evident in the figures for 1985; the CSO's preliminary estimates of consumers' expenditure for the fourth quarter (which we expect will be revised up a little) show 3 per cent growth in total consumers' expenditure between the second halves of 1984 and 1985, compared with 1½ per cent in 1984; and a 9 per cent rise in spending on durable goods over the same period.

97. The rise in spending so far has been rather larger than might have been expected given the recorded change in personal disposable income: the personal savings ratio may have fallen by about a point between the second half of 1984 and the second half of 1985. There seems to have been an improvement in consumer confidence over this period: perhaps the outcome of the coal strike has had something to do with this.

98. We now expect real personal disposable incomes of persons to rise by about 5½ per cent in 1986, and by about 3½ per cent in 1987: this compares with rises of just under 2½ per cent a year in the three years to 1985. The main contributions to the much higher growth rates in real incomes come from:

(i) a fall in consumer price inflation, which may average a little under 4 per cent in 1986, compared with 5 per cent in the previous three years;

(ii) the slight pick up in wage settlement rates during the 1984-85 pay round, higher public sector settlements during the present pay round, and a large chunk of back pay for teachers, which together mean that growth in average earnings is about ¾ per cent higher in 1986 than in 1985;

(iii) the forecast fiscal adjustment of £2 bn in 1986 and £4 bn in 1987 which adds about ½ per cent to disposable income growth in 1986, and 1½ per cent in 1987;

(iv) employment growth of about 1 per cent a year over the next two years, helped by the 1985 Budget measures, and by an assumed further employment package in the 1986 Budget.

These are partly offset by:

(v) a reduction in employers' pension fund contributions in response to the present large (£10-12 bn according to GAD estimates) actuarial surpluses of pension funds.

99. We do not expect consumers' expenditure quite to keep pace with the growth of personal income in 1986. The saving ratio normally rises during periods of fast personal income growth; and as durables spending seems during 1985 to have anticipated the pick up in incomes growth due for 1986, it may grow correspondingly less this year. Our forecast also allows for some impact of the current high level of interest rates on consumer spending. On the other hand the fall in inflation in 1986, and the reduction in employers' pension fund payments - which will depress measured income but probably not expenditure - will tend to reduce the personal saving ratio.

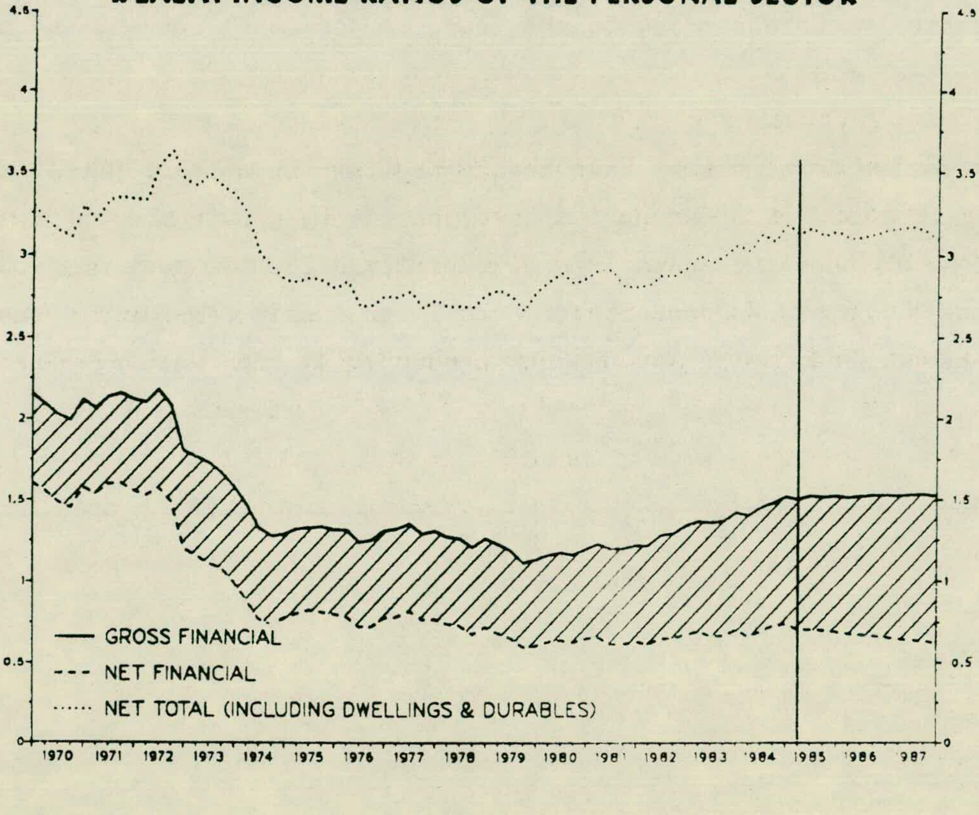
100. On balance we now expect consumers' expenditure to rise by about 4 per cent in 1986; and by a similar amount in 1987. The personal saving ratio is forecast to rise by a bit over one point in 1986, and to fall back a little in 1987.

101. We also expect persons' investment in housing to pick up in 1986. Private housing starts have been on an upward trend throughout 1985, although housing completions and investment in new dwellings have fallen. This rise in housing starts was not expected at the beginning of 1985; and the two increases in mortgage interest rates in the first four months might have been expected to lead to a still less favourable outturn. But the housing market managed to cope with these interest rates increases - the freer availability of mortgages clearly helped - and in the more prosperous parts of the country house prices have been rising fast enough to stimulate housebuilders to increased activity.

102. We expect therefore to see both completions and investment in new dwellings picking up again by the middle of 1986. Investment in improvements, now recognised as about half of total housing investment, was low between mid-1984 and early 1985 following the extension of VAT and the reduced availability of improvement grants. It recovered in the third quarter of 1985 and we expect it to continue rising roughly in line with growth in personal incomes.

103. The slowdown in inflation, the strength of the stock market, and (more recently) of house prices has meant that although the personal saving ratio has fallen from about 15 per cent in 1980 to around 12 per cent on average in the last three years, net personal wealth has been rising in relation to income. At first sight it may seem surprising, in view of the high level of interest rates, that the increase in the value of physical assets (included in the top line of the Chart) has been greater than the rise in net financial assets. But this is a consequence of asset revaluations and the programme of council house sales which have reduced persons' net financial wealth but not their total wealth (including dwellings). Persons' net financial wealth (which includes the net worth of life assurance and pension funds) is forecast to fall a little in relation to income in 1986 and 1987, as pension funds reduce their current actuarial surpluses. The forecast high level of durables purchases and housing investment is reflected in a gradual rise in the ratio of total net personal wealth to incomes.

WEALTH INCOME RATIOS OF THE PERSONAL SECTOR



Income and spending: the private sector in total

104.We expect a combination of rapid growth in real incomes and very high interest rates to keep saving high in 1986 (except of course for companies with North Sea interests). By 1987, companies will be finding it more difficult to raise profits. We assume that the rate of return falls a little in 1987: wage increases come down only moderately and productivity growth slows a little; while price increases continue to be restrained by very low inflation in the world. Calls on company incomes are likely to increase, with another large rise in the tax bill, reflecting profit growth in 1985 and 1986, and spending on capital assets rising further. In consequence the financial surplus of companies is forecast to fall in 1987, from the high levels of 1985 and 1986:

Financial surpluses £ billion

	1984	1985	1986	1987
Personal sector	12	12	15	15
Companies: i) North Sea	3	1	- 3	- 1
ii) Other	5	10	10	5
Total private sector	20	22	22	19

(Financial deficits are being run by the public sector, and by the overseas sector - corresponding to the surplus on the current account of the balance of payments.)

105.In successive forecasts we have been expecting the rate of profit to level off, but companies, by securing faster productivity growth and in other ways, have achieved further increases in profitability. The two most obvious routes to lower costs are higher productivity and lower (real) wage settlements: our forecasts have tended to be low on both productivity and real wage increases.

DEMAND AND ACTIVITY (SUMMARY)

106.The prospects for domestic demand (at constant prices) are summarised in the table below:

	per cent changes on a year earlier				
	1983	**1984**	**1985**	**1986**	**1987**
Personal Consumption	4	1½	2½	4	4
Public Consumption	2	1½	0	½	0
Total Investment	4½	8	2	4	1½
Change in stockbuilding (as per cent of level of GDP)	1	- ½	0	0	0
Total Domestic Demand	4½	2½	2	3½	3

107.The balance of trade made a substantial contribution to growth in 1985, because of the strong performance by UK manufacturers in both overseas and domestic markets. Domestic demand growth takes up the running this year and next.

108.The table below tries to split the growth of output into the contributions of domestic demand, external demand and trade performance. The numbers are only very approximate:

Contributions to growth of (non-oil) output, per cent

	1984	**1985**	**1986**	**1987**
Domestic demand <u>less</u> normal import content	1¾	¾	2	2
External demand	1½	1	¾	¾
Trade performance	- ¼	1¼	- ¼	0
Other	- ¼	- ¼	0	- ¼
GDP less oil and adjusted for coal strike	3¼	2¾	2½	2½

109.A positive figure for "Trade performance" measures the extent to which (a) exports gained share of the overseas market and (b) importers' share of the domestic market rose more slowly than usual. The 1¼ per cent figure for 1985 combines a strong export performance with a slower than expected rise in import penetration.

110. The estimated effects of the coal strike and of North Sea oil and gas production on total GDP can be seen in the following table:

	1983	1984	1985	1986	1987
	1980 = 100, and per cent changes on a year earlier				
GDP Average Measure	103.7	106.1	109.9	112.9	115.2
	(3.3)	(2.3)	(3.6)	(2.8)	(2.0)
Contribution of North Sea production to GDP changes	+ 0.4	0.2	0	- 0.1	- 0.5
Effects of coal strike	0	- 1.2	0.8	0.4	0
GDP <u>less</u> contribuiton of both oil and coal strike	2.9	3.2	2.8	2.4	2.5

111. The growth of oil production has accounted on average for half a per cent a year of the growth of GDP between 1980 and 1984. Oil production is now forecast to peak in 1986 and fall 5 per cent in 1987.

PRODUCTIVITY, EMPLOYMENT AND UNEMPLOYMENT

112. Recent CSO revisions to the figures for manufacturing output in 1985 (including the introduction of a bias adjustment to figures for the most recent six months) mean that we now see less of a slowdown in productivity growth over the last year. Output per head in manufacturing in 1985 probably rose by about 3½ per cent (on the published definition which includes an allowance for growth in self-employment in manufacturing): this is very close to the average growth rate in manufacturing productivity since 1979.

113. Although continuing high growth in real wages and low materials prices will encourage substitution away from labour over the next few years, we expect somewhat lower manufacturing productivity growth in 1986 and 1987, reflecting the gradual slowdown in output growth.

114. Outside manufacturing, productivity growth is affected by a number of special factors. The continuing shift towards part-time work is reducing growth in output per head by about ¾ per cent a year. The effect of the 1985 Budget measures (SEMS and NIC restructuring) and a further SEMS package assumed for the 1986 Budget reduce productivity growth by around ½ per cent a year on average in 1986 and 1987. On the other hand, the collapse of the coal strike and the outcome of the British Rail guards dispute mean that the way is open for substantial long overdue productivity gains in some nationalised industries. Exceptional productivity improvements in the two industries named (and also in the post office) are assumed to add almost ½ per cent a year to non-manufacturing productivity growth on average in 1986 and 1987.

Productivity Growth

	Manufacturing			Non-manufacturing*			
	Trend	Actual		Trend per full-time worker	Trend per head	Actual output per head	
1973-79	1.6	0.7		1.6	1.0	0.5	
1979-84	3.3	4.0	3.7	1.9	0.9	1.0**	1.1
1984-87	3.5	3.3		2.3	1.5	1.3**	

* Private sector and nationalised industries (excluding steel). (These productivity estimates differ from published figures in attributing all self employment growth to non-manufacturing. They thus tend to overstate productivity growth in manufacturing a little, and understate productivity growth in non-manufacturing.)

** Adjusted for coal strike.

115. The implications for employment are set out in the table below. The last reasonably firm estimate for employment is for the second quarter of 1984.

Employment, 000s, changes

	1981 Q2 - 1985 Q2 (Annual average)	1985 Q2 - 1986 Q2	1986 Q2 - 1987 Q2
Employees	- 165	+ 75	+ 145
Self-employed	+ 125	+ 125	+ 125
Total employment	- 40	+ 200	+ 270
of which: full-time	- 245	+ 10	+ 15
part-time	+ 205	+ 190	+ 260
Full-time equivalent	- 145	+ 105	+ 145

116. Our projections for labour supply growth start off from the projections published in the July 1985 Employment Gazette. As compared with the Department of Employment's figures, we have allowed for rather higher female activity rates; and a continuing fall in activity rates for men near to retirement age.

Labour Supply, 000s, changes

	1983 Q2 - 1985 Q2 (Annual average)	1985 Q2 - 1986 Q2	1986 Q2 - 1987 Q2
Males	90	45	35
Females	340	115	140
Total	430	160	175
(of which population effect)	160	120	110

117. The trend in unemployment changed markedly for the better between the second and fourth quarters of 1985. We had been expecting some improvement during the course of the year, but the extent of the improvement (and the deterioration in the most recent months) was not expected and is at present not easy to explain. Maybe when the 1985 LFS arrives it will help to clarify the reasons for the improvement.

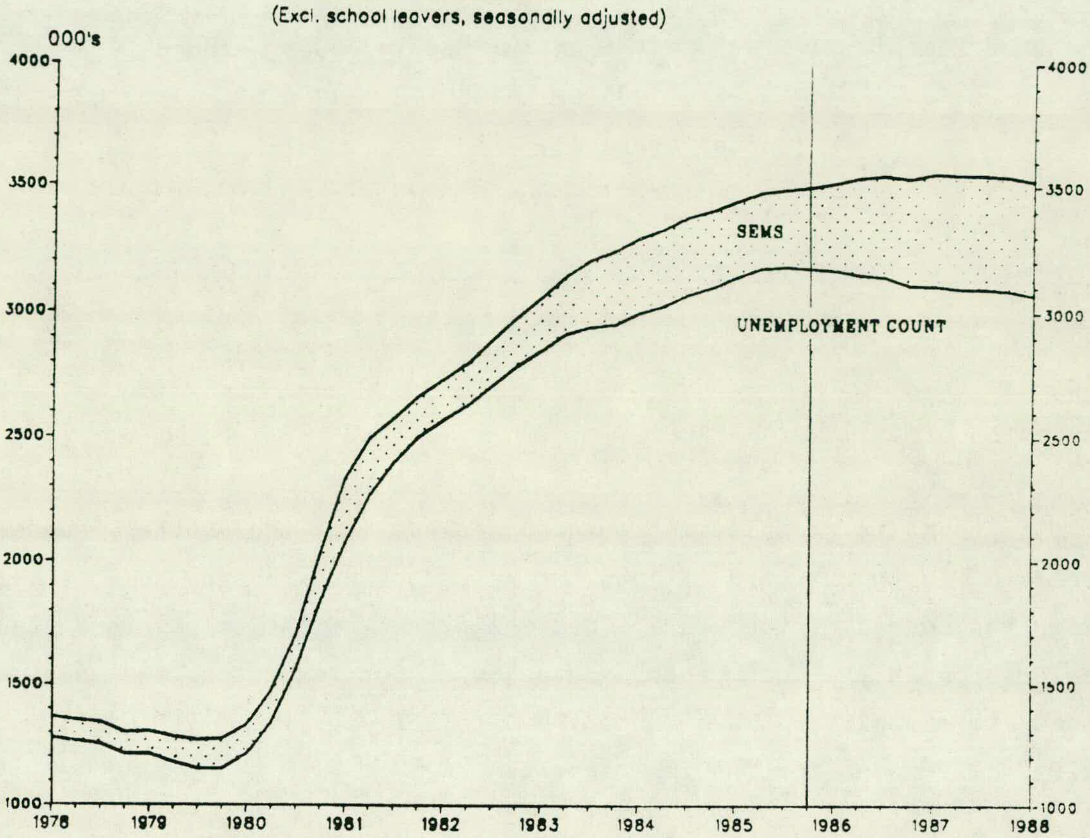
118. The latest employment statistics show a 120,000 smaller increase in the employed labour force in the first three quarters of 1985 than in the corresponding period of 1984. There was a 14,000 bigger fall over the more recent period in the number of employees in the production industries, (manufacturing, energy and water supply): industries where the employees are mainly full-time male workers with a high propensity to register as unemployed. The unemployment figures do show a rise in inflows onto the register in 1985; but this has been more than offset since the spring by a larger rise in outflows off the register. It is possible that this evidence of increased inflows and outflows means that the downward bias in the employment statistics - which reflects a failure of the statistics to keep pace with changes in the labour market - will have increased recently.

N.B.

119. Our forecast does not make much allowance for a continuation of the unexplained part of the improvement in unemployment trend. Nevertheless we do expect unemployment to fall over the next two years as a result of lower growth in labour supply and the effects of the 1985 Budget measures. We have also allowed for a further package of employment measures in the 1986 Budget, which reduce (adult) unemployment by 60,000 by the first quarter of 1987. The chart shows the actual path of unemployment in the forecast, and also the growing impact of SEMS on the count.

UK UNEMPLOYMENT

(Excl. school leavers, seasonally adjusted)



120. As in previous forecasts we assume in constructing our unemployment forecast that:

(i) changes in the number of manufacturing employees feed one for one into claimant unemployment;

(ii) changes in part-time female employment have little effect on the number of claimant unemployed. Thus, taking account of the relative importance of this type of employment outside manufacturing, claimant unemployment might fall by only about 40 for every 100 extra jobs in the private sector outside manufacturing and by 60 for every 100 extra jobs in the public sector;

(iii) additions to labour supply from higher female activity rates do not have much impact on claimant unemployment, because most women joining the labour force will not have the insurance records that enable them to claim benefit.

The forecast for unemployment is set out below.

	Changes		
	1981Q2-1985Q2 (Annual average)	1985Q2-1986Q2	1986Q2-1987Q2
Unemployment:			
Total including school leavers.	+ 230	- 35	- 95
Narrow definition excluding school leavers.	+ 230	- 25	- 55
Memo: SEMS effect on unemployment			
- Total	- 30	- 85(-15)	- 90(-45)*
- Adult	- 15	- 85(-15)	- 60(-45)*
SEMS effect on employment statistics.	0	85(15)	0 (50)*

* Figures in parentheses show contribution of assumed 1986 SEMS package.

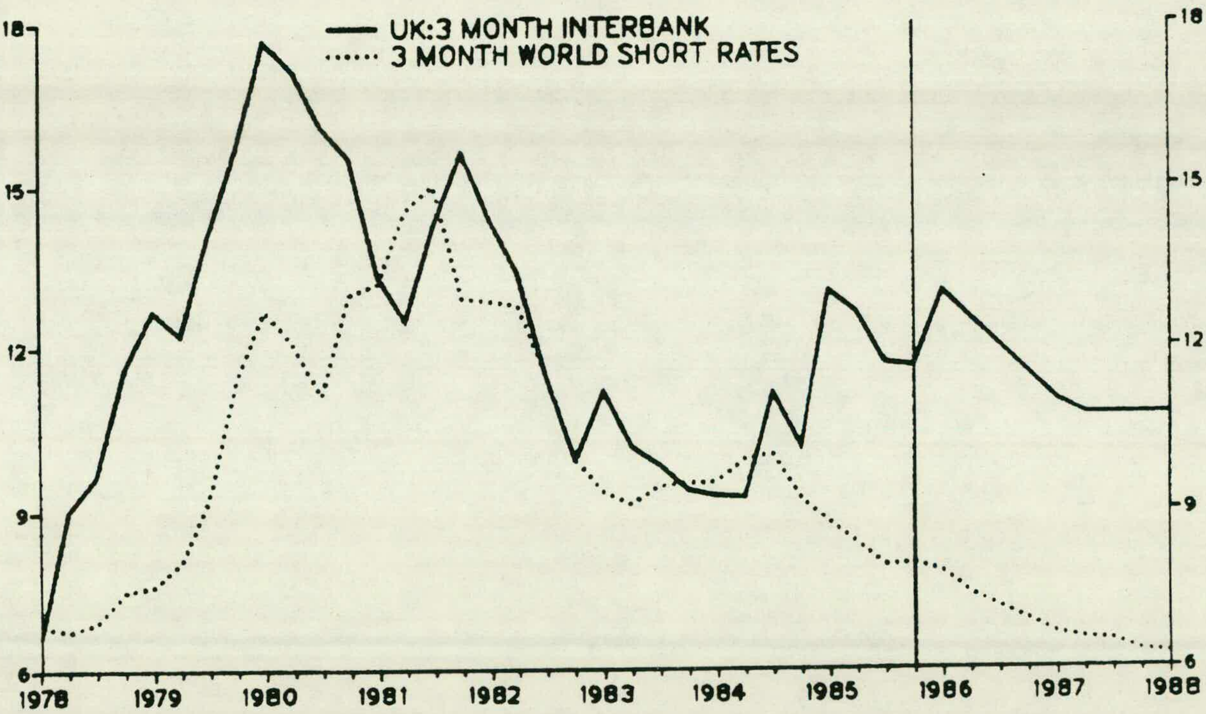
Financial forecast

121. As a result of the steep fall in oil prices and market pressures we have once again revised up our forecast of short-term interest rates. With overseas rates likely to fall at least outside the US (the recent fall in oil prices should help that process), we think that UK rates should be able to drift slowly downward once the immediate crisis is past. Even so sterling interest rates stay 4-5 per cent above the average of overseas rates through 1986 and 1987. Long rates, which have changed little in response to changes in money market rates, may not change much from current levels.

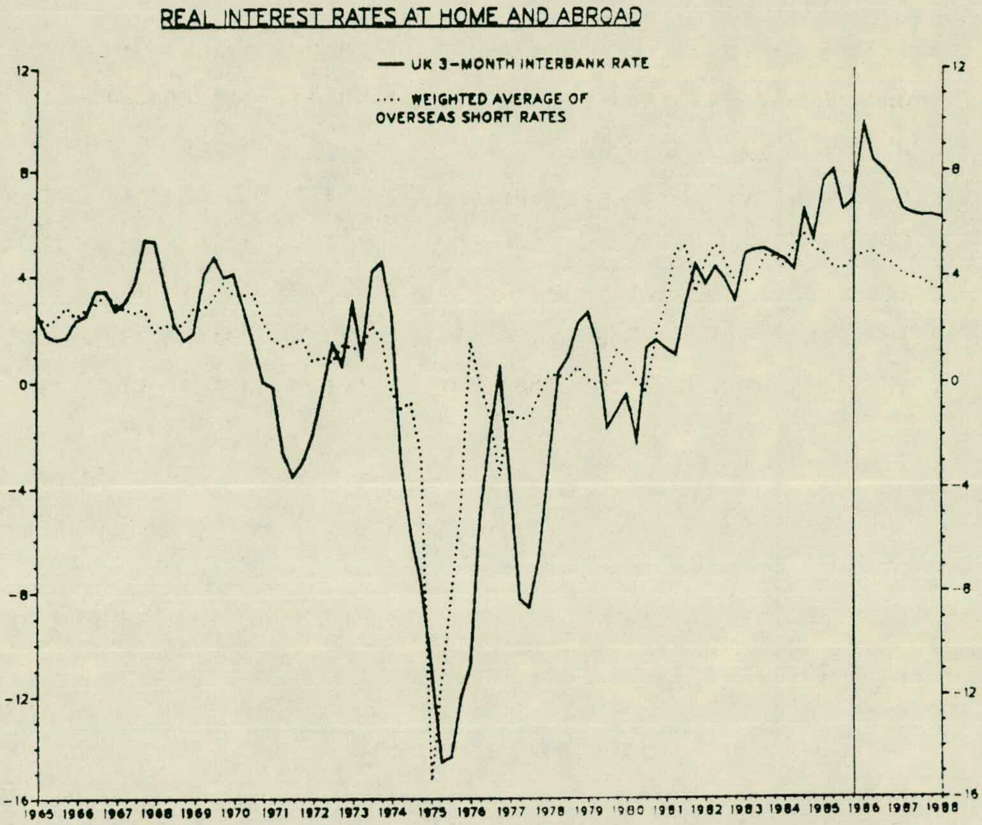
	World basket	UK rates	
	short rate	3 month	mortgage rate*
1985 Q4	8	11½	12¾
1986 Q4	7	11½	12¾
1987 Q4	6½	11	12

* with a rise to 13¾ per cent assumed by March and a fall in Q3.

INTEREST RATES, PERCENT



122. **Real rates** in the UK are higher than in most other countries:

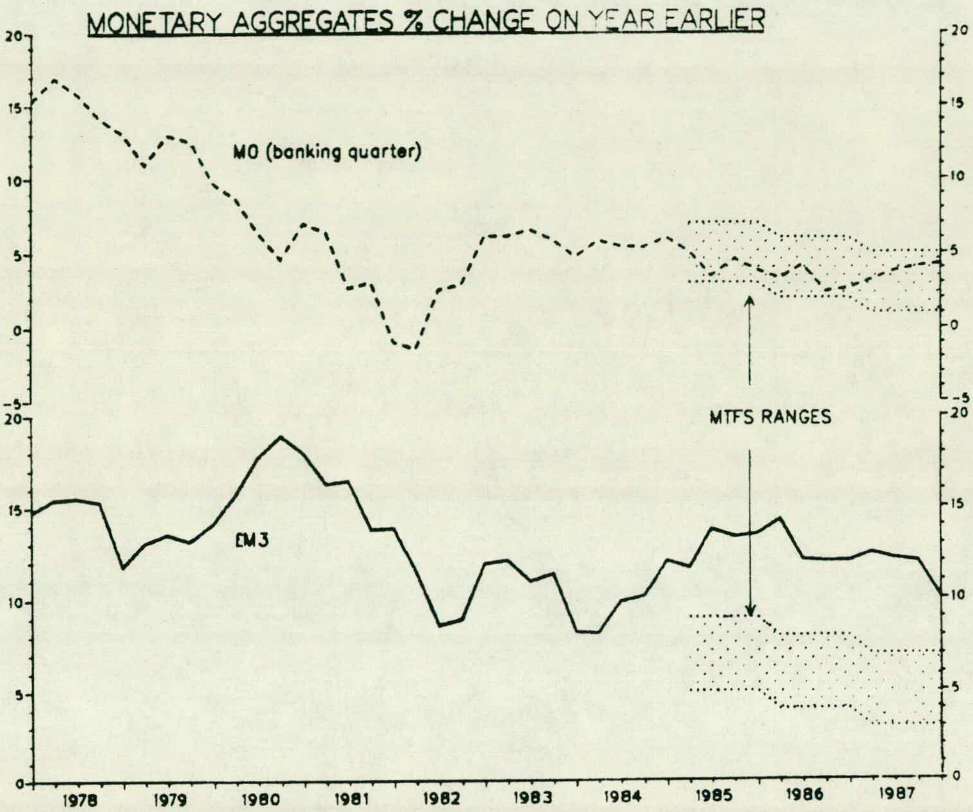


Monetary aggregates

123. The forecast is summarised and compared with the MTFS ranges in the following table and in the chart:

Average Percentage growth rates in financial years

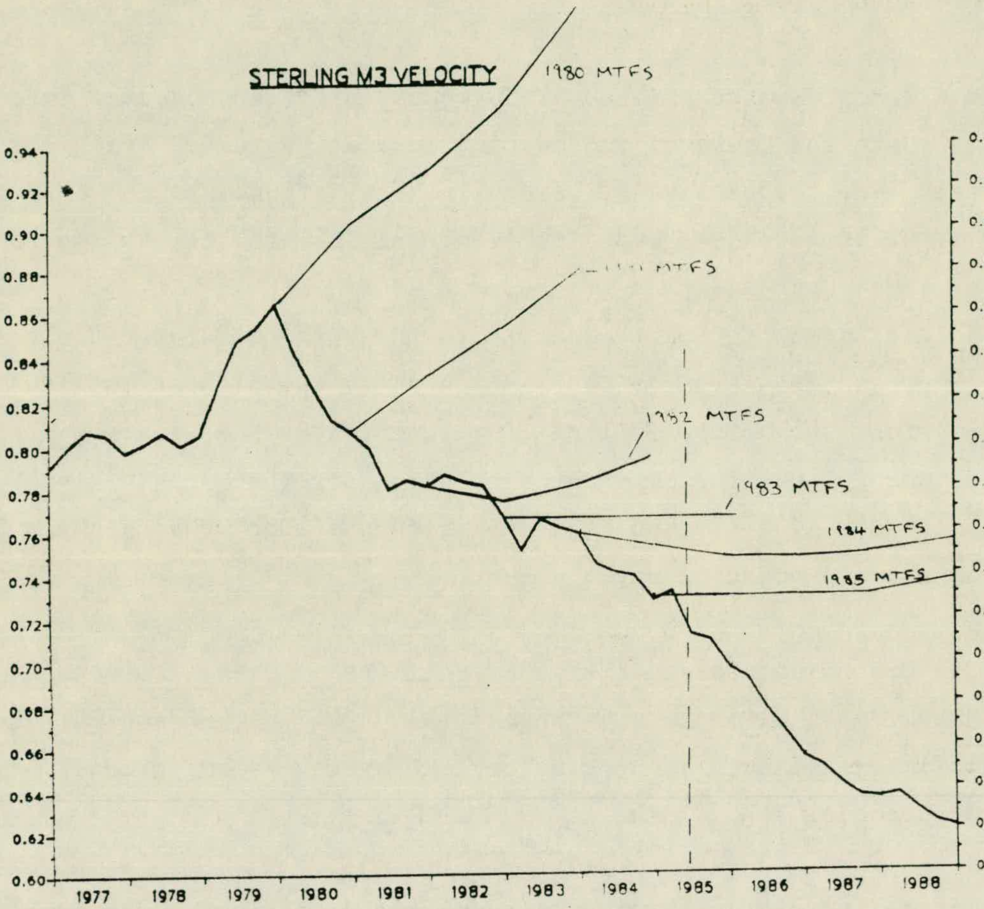
	MO		£M3		PSL2A
	MTFS range	**Outturn/Forecast**	**MTFS range**	**Outturn/Forecast**	**Outturn/ Forecast**
1984-85	(4-8)	5½	(6-10)	9½	13
1985-86	3-7	4½	5-9	13	12½
1986-87	2-6	3½	4-8	13	11½
1987-88	1-5	3½	3-7	12	11½



124.**MO growth** has fallen by over one point over the past year, mainly in response to the rise in interest rates last winter, and is currently in the bottom half of its target range. The recent rise in interest rates will impart another downward impulse to MO, which will only be partly offset by buoyant personal incomes and expenditure. MO growth could therefore stay in the 3-4 per cent range for most of the forecast period.

125.The forecast for **£M3 growth** - based on the assumption of no overfunding - assumes that the trends in velocity observed in recent years will continue: high real interest rates, financial liberalisation and the associated reduction in the margins between borrowing and lending for many customers all point to further rapid expansion in financial assets and liabilities. A range for £M3 in 1986-87, were it to be chosen purely on the basis of this central forecast, would be 11-15 per cent, 7 per cent above the range in the 1985 MTFS.

126.Early versions of the MTFS assumed a continuation of the rising velocity of the 1970s. More recent versions assumed that the growth of £M3 would be broadly in line with income - in fact, velocity has fallen almost continuously: see next chart.


STERLING M3 VELOCITY
1980 MTFS
MTFS
1982 MTFS
1983 MTFS
1984 MTFS
1985 MTFS
0.94
0.92
0.90
0.88
0.86
0.84
0.82
0.80
0.78
0.76
0.74
0.72
0.70
0.68
0.66
0.64
0.62
0.60
1977
1978
1979
1980
1981
1982
1983
1984
1985
1986
1987
1988

ANNEX: COMPARISON OF FORECASTS

Outside Forecasts

1. Table A compares the Treasury forecast with an average of outside forecasts. Both the Treasury and outside forecasters have revised up their GDP forecasts over the past year. The Treasury forecast is currently in the top half of the outside range for 1986, and is near the average for 1987.

2. The RPI inflation forecast is close to the outside average for both 1986 and 1987, whereas the earnings forecast is above the highest outside forecast (by the CBI) for 1986 before falling in line with the average for 1987. The implied higher real income growth in 1986, together with a higher fiscal adjustment to both 1986-87 and 1987-88 accounts for the higher Treasury forecast of private consumption.

3. The forecasts used are NIESR, LBS, Phillips & Drew, Simon & Coates, Henley, Cambridge, Oxford, Liverpool, CBI, OECD, CUBS and EC. Note that not all forecasts are used in working out the average - only those which are directly comparable.

4. Comparisons of oil prices and revenues are given in the separate report on oil, circulated by Mr Hacche.

Treasury Forecasts

5. Table B compares the internal January forecast with the last three Budget forecasts.

6. The outlook for GDP growth in 1986 is over half a per cent higher than in the last Budget forecast. This reflects higher oil production, and stronger growth of domestic demand, including fixed investment and government spending.

7. In contract to the FSBR forecast, which assumed a broadly constant exchange rate we now have a fall of around 6 per cent between 1985 and 1987, with lower real oil prices more than offsetting the effects of the projected fall in the dollar and higher domestic real interest rates.

SECRET

TABLE A - COMPARISON WITH OUTSIDE FORECASTS

	January Forecast	Outside Average	Outside range	
£M3 % change on year earlier				
1985-86	12.9	12.9	11.0(LBS)	15.5(Henley)
1986-87	12.8	11.6	9.7(LBS)	13.8(Henley)
1987-88	11.9	10.5	6.2(LBS)	13.3(Henley)
MO % change on year earlier*				
1985-86	4.5	4.6	2.9(Henley)	5.75(NIESR)
1986-87	3.3	6.2	5.6(Henley)	7.1(LBS)
1987-88	3.6	2.7	1.3(LBS)	4.0(P&D)
PSBR £ bn				
1985-86	6.8	8.3	7.8(S&C)	9.3(Henley)
1986-87	7.6	8.6	7.5(LBS)	9.4(Henley)
1987-88	7.1	9.2	7.4(LBS)	11.1(Oxford)
Fiscal Adjustment (Annual)				
1986-87	2.2	1.6	0 (NIESR)	3.5(CBI)
1987-88	4.2	1.8	0 (NIESR)	3.8(S&C)
Exchange rate (1975 = 100)				
1986 Q4	75.0	76.5	73.1(Oxford)	80.3(NIESR)
1987 Q4	73.0	73.6	70.7(Oxford)	75.0(P&D, LBS)
Current account £ bn				
1985	3.6	3.2	1.3(L'pool)	4.25(OECD)
1986	4.3	2.6	1.1(CBI)	4.6(L'pool)
1987	1.6	-0.1	-4.2(Oxford)	4.5(L'pool)

SECRET

	January Forecast	Outside Average	Outside range	
Consumption % change on year earlier				
1986	4.0	3.5	2.8(C'bridge)	4.2(S&C)
1987	3.9	2.7	1.8(NIESR, Henley)	3.7(LBS)
Import volume: goods and services % change				
1986	5.4	4.6	3.3(C'bridge)	6.6(CBI)
1987	4.1	4.6	2.7(NIESR)	8.1(Oxford)
Export volume: goods and services % change				
1986	3.6	2.6	0.5(Oxford)	4.3(CBI)
1987	1.7	2.3	1.4(C'bridge)	3.2(CBI)
GDP (output) volume % change				
1986	2.9	2.4	1.5(C'bridge)	3.7(CUBS)
1987	2.1	2.2	1.1(NIESR)	4.7(CUBS)
UK adult unemployment (millions)				
1986 Q4	3.1	3.10	3.03(S&C)	3.18(Henley)
1987 Q4	3.1	3.07	3.0(NIESR)	3.15(CBI)
RPI % change on year earlier				
1986 Q4	4.1	4.3	3.0(NIESR)	4.7(P&D)
1987 Q4	4.3	4.2	3.3(LBS)	5.0(P&D)
Average earnings % change on year earlier				
1986	8.7	7.7	6.6(L'pool)	8.3(CBI)
1987	6.8	6.8	4.6(L'pool)	7.5(S&C, P&D)

SECRET

TABLE B

COMPARISON OF TREASURY FORECASTS

	1983 MTFS/FSBR	1984 MTFS/FSBR	1985 MTFS/FSBR	January 1986 Forecast
<u>Money Supply £M3</u>				
(% change on year earlier)				
1984 Q1	9.0	9.5	8.1	9.8
1985 Q1	8.8	9.2	9.5	11.1
1986 Q1	7.5	8.2	8.0	13.4
1987 Q1	6.1	7.9	7.2	12.0
1988 Q1	-	6.0	6.2	11.0
<u>PSBR</u>				
£ billion (% of money GDP)				
1983-84	8.2(2.8)	10.0(3.3)	9.7(3.2)	9.7(3.2)
1984-85	8.9(2.5)	7.2(2.2)	10.5(3.2)	10.1(3.1)
1985-86	7.0(2.0)	7.0(2.0)	7.1(2.0)	6.8(1.9)
1986-87	6.4(1.8)	7.0(1.9)	7.5(2.0)	7.6(2.0)
1987-88	-	6.8(1.7)	7.0(1.8)	7.1(1.75)
<u>Fiscal Adjustments</u> (£ billion)*				
1983-84	-	-	-	-
1984-85	-0.4	-	-	-
1985-86	-3.8	-1.9	-	
1986-87	-8.8	-6.8	-3.7	-2.2
1987-88	-	-10.0	-6.8	-6.4
<u>Nominal GDP</u> (mp)				
(% change on year earlier)				
1983	7.5	8.6	8.4	8.5
1984	8.6	8.1	6.6	6.8
1985	7.9	6.9	8.5	8.8
1986	6.9	6.1	6.9	7.4
1987	-	5.7	6.1	6.5
<u>RPI</u>				
(% change on year earlier)				
1983 Q4	5.8	5.0	5.0	5.0
1984 Q4	5.4	4.3	4.8	4.8
1985 Q4	5.2	3.5	5.2	5.5
1986 Q4	5.1	4.5	3.8	4.1
1987 Q4	-	4.0	3.0	4.3

SECRET

	1983 MTFS/FSBR	1984 MTFS/FSBR	1985 MTFS/FSBR	January 1986 Forecast
Current Balance (£ billion)				
1983	1.5	2.0	2.5	3.1
1984	1.5	2.2	0.1	1.1
1985	-0.6	0.7	2.9	3.6
1986	4.2	1.0	2.6	4.3
1987	-	-0.5	1.4	1.6
Manufacturing Output (% change on year earlier)				
1983	1.8	1.5	2.5	2.8
1984	2.4	3.6	3.4	3.8
1985	1.9	2.1	2.6	3.2
1986	0.9	1.4	2.0	2.4
1987	-	1.4	1.3	1.5
GDP Volume (% change on year earlier)				
1983	2.0	2.8	3.1	3.3
1984	2.7	3.1	2.5	2.3
1985	2.4	2.5	3.3	3.6
1986	1.9	2.0	2.2	2.8
1987	-	2.0	2.2	2.0
Interest Rates % (Short term)				
1983-84	9.6	9.7	9.7	9.7
1984-85	7.8	8.7	10.9	10.9
1985-86	7.4	7.8	11.9	12.2
1986-87	7.4	6.8	10.1	11.8
1987-88	-	6.1	9.3	10.8
World Trade in Manufactures, UK Weighted				
1983	1.0	1.3	1.4	0.8
1984	6.6	5.1	10.2	8.5
1985	5.7	4.5	5.5	4.2
1986	2.9	4.5	4.4	4.6
1987	-	3.8	4.5	3.5
UK Exports of Goods, Services (% change on year earlier)				
1983	0.9	0.6	1.4	2.6
1984	5.0	5.0	6.6	7.0
1985	4.9	3.9	6.4	6.6
1986	2.3	2.8	2.3	3.6
1987	-	2.8	2.7	1.7

136:2

Thanks. I had forgotten X: apologies.

FROM: K VERNON
DATE: 30 JANUARY 1986

1. ~~MISS~~ O'MARA
2. MR KUCZYS

The article has attracted no press attention so far, though today's unemployment figures may stir it up. We expect the Opposition to make good use of the information here & will provide detailed briefing for First Order.

MOM
30/1

cc PS/CST
PS/FST
PS/EST
PS/MST
Mr Monck
Mr Evans
Mr Scholar
Mr Culpin
Mr Davies
Mr Hunt
Mr Cropper
Mr Davies
Mr Lord
HB/07

Ch/ I have established that a draft of the article was sent over here before Xmas; EB warned you on 7 Jan. X A lot of this information is already published, & has been picked up. The damage lies in bringing it together and [illegible] the "discouraged workers" [illegible] has been deliberately trying to [illegible] head on for some time ([illegible] a speech). I'm [illegible] [illegible] wise.

Re
30/1

CLASSIFICATION OF ECONOMIC ACTIVITY

The Chancellor expressed interest in this article and asked who are the 2,555,000 classified as marginally active but not as unemployed.

2. The breakdown, given in the article,is:-

TABLE 1

		'000's	% Marginally Active (not classified as unemployed in official statistics)
(i)	TOPS course or student	318	12
(ii)	Long term sick or disabled	379	15
(iii)	Looking after family/home	1,063	42
(iv)	Retired	267	10
The discouraged ones. (v)	Believe no jobs available	364	14
(vi)	Not yet started looking	59	2
(vii)	Other reasons not looking	100	4
		2,555	100

3. All these groups expressed interest in finding work at some undefined time when questioned during the Labour Force Survey. However, many of them are clearly not actively looking for a job or wanting work in the near future. The Labour Force Survey therefore tried to identify through further questioning how many of the 2½ million "marginally active" could reasonably be said to be looking for work at the time the Survey was undertaken. Table 2 below gives the breakdown:

TABLE 2

		'000's	% of same category in Table 1
(i)	TOPS course or student	159	50
(ii)	Long term sick or disabled	17	4
(iii)	Looking after family/home	138	13
(iv)	Retired	16	6
(v)	Believe no jobs available	123	33
(vi)	Temporarily not seeking work)	118	74
(vii)	Other reasons for not looking)		
		617*	

*Individual items sum to less due to rounding.

4. Thus only 13 per cent of those looking after their families or homes actually wanted a job around the time of the Survey, only 6 per cent of the retired and only 4 per cent of the long term sick and disabled. Even when this sift has been made, it seems that some of those who appear in Table 2 could not reasonably be termed "unemployed" eg those still in education or training but looking for work.

5. It is more difficult to assess "hidden unemployment" among the 364,000 emotively termed "discouraged workers" here and in the October Gazette. Only ⅓ of this number actually looked for work in the four weeks preceding the Survey. In some areas of the country where unemployment among certain groups is particularly high and long-term, it is possible that some individuals may genuinely want to work but nevertheless not take steps to look for a job for more than a month. However, it seems clear that the total of 364,000 well overstates the problem.

6. DEm have used the figures in Table 2 as their best proxy for the calculation of

unemployment on its widest possible definition to give a total of 3,522,000 for Spring 1984, compared with an official headline count of 3,030,000.

7. If the unemployment total is to be adjusted in this way, it is equally legitimate to say that certain categories should be removed from the count. However, DEm's calculation of the "widest" unemployment definition, based on the Labour Force Survey results, already excludes some categories included in the official count eg some long term sick and disabled and some of those looking after the home who are claimants but are not seeking work. Nevertheless, the "widest" definition is wide and we can plausibly argue for a narrower one. For instance, the article shows that if we confine the definition of unemployed to those seeking a job in the reference week and available to start work within 2 weeks, the total is 2,627,000 (and this still includes the self employed looking for work).

8. Additional defensive lines might be:-

(a) Employment Gazette shows 2½ million more unemployed than regular count. Nonsense. As Gazette makes clear, bulk of "marginally active" are looking after family, students, retired or long term sick. Ridiculous to call them unemployed. Only 4 per cent of long term sick or disabled genuinely seeking work in near future; only 6 per cent of retired.

(b) Other definitions: Equally legitimate to class only as "unemployed" those who looked for work in reference week and available to start work in next 2 weeks. On this basis, unemployed total in Spring 1984 falls to 2,627,000 or 10.1 per cent, compared with 3,030,000 or 13 per cent on official count. Various permutations possible.

(c) 364,000 discouraged workers? Definition arbitrary. Of this total, only 123,000 sufficiently concerned to find job that actively sought one out at some point in four weeks preceding Survey.

KVen

K VERNON

~~b/f~~ 25/2 pl

R. To be aware – we expect FSBR Part III tonight. Ro 25/2

CHANCELLOR OF THE EXCHEQUER

C.

You asked for new forecast runs.

Huw Evans says we will receive next Tuesday, 25 Feb, the full draft of the FSBR Part III plus an updated forecast on the $15 per barrel basis. Variants will follow thereafter, but they thought it important to first get the $15 case thoroughly worked up.

In the meantime, he suggested that for "differences" the table on page 20 of his 30 January submission should still be broadly OK. (If he has any further thoughts on that he'll include them in his note next Tuesday).

Ro. 20/2

N.L. ✓

SECRET

COPY NO 1

FROM: H P EVANS
DATE: 31 January 1986

CHANCELLOR

[illegible]

Ch/
Do you want to commission some more work on this (see para 3)?
RL
31/1

[illegible]

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
PCC Members
Mr Fitchew
Mr Monger
Mr Peretz
Mr Odling-Smee
Mr Turnbull
Mr S Davies
Mr Mowl
Miss Peirson
Mr Riley
Mr Cropper
Mr Lord
Mr H Davies
Sir L Airey (IR)
Sir A Fraser (C&E)

TREASURY ECONOMIC FORECAST: OIL PRICE VARIANTS

The forecast report circulated yesterday included, pages 16-20, a description of the possible consequences of a $15 oil price. As requested, this note describes a variant in which oil prices move quickly to $18: summary tables are attached.

2. In constructing this case, we have simply interpolated between the $20 main case and the $15 variant. We know this is not correct for some of the effects: in particular for the tax system. For instance, the cuts in both production and exploration that have been built into the $15 case would not be pro rata for a smaller price fall. But these effects were broadly offsetting in their effect on revenues in the $15 case, and may be again in the $18 case.

SECRET

If you wanted to take the $18 case seriously as a central assumption, then we should need to do more work on it (consulting Inland Revenue and Department of Energy in particular).

4. Like the Powell/Horton working paper, the $18 case represents a 10 per cent fall in oil prices. But there are important differences from the working paper :

(i) the $18 case starts from a lower level of oil prices, so that the effect on the exchange rate is smaller; and

(ii) the $18 case assumes a fixed (instead of a higher) PSBR; partly in consequence, it assumes no change (instead of a rise) in interest rates.

HPE

H P EVANS

SUMMARY TABLE JANUARY 1986 FORECAST

		MAIN FORECAST	LOWER OIL PRICES	
		$20	$18	$15
1.	World GNP (major 7 excluding UK) % change on year earlier			
	1986	3	3.2	3½
	1987	3	3.2	3½
2.	Effective Exchange Rate (1975 = 100)			
	1986 Q4	75	74	72
	1987 Q4	73	72	70
3.	Oil prices, $ Brent spot			
	1986 Q4	20	18	15
	1987 Q4	21½	19½	16½
4.	Nominal GDP (mp) (% change on year earlier)			
	1986-87	6.7	6.5	6.2
	1987-88	6.8	6.8	6.7
5.	GDP Volume (% change on year earlier)			
	1986	2.7	2.7	2.8
	1987	1.7	1.7	1.8
6.	RPI (% change on year earlier)			
	1986 Q4	4.1	4.1	4.0
	1987 Q4	4.3	4.3	4.2
7.	Current Balance (£ billion)			
	1986	4¼	4	3¾
	1987	1½	1	½
8.	Fiscal Adjustment (annual not cumulative) £bn			
	1986-87	2¼	1¾	¾
	1987-88	4¼	3½	2¼

LOWER OIL PRICE VARIANT

$15 case ($18 case in brackets)

% change from base

Year	Major 7 (excl. UK) GDP	Major 7 (excl. UK) Consumer Price Index	Real GDP	RPI	Nominal GDP	Real National Disposable Income	£ Effective exchange rate
1986-87	+0.6 (+0.2)	-1.1 (-0.4)	+0.1 (0.04)	-0.1 (-0.02)	-0.5 (-0.2)	-0.3 (-0.1)	-3.8 (-1.5)
1987-88	+1.1 (+0.4)	-2.2 (-0.9)	+0.1 (0.04)	-0.1 (-0.04)	-0.6 (-0.2)	-0.4 (-0.2)	-3.1 (-1.4)
1988-89	+1.3 (+0.5)	-2.3 (-0.9)	0 (0)	+0.1 (+0.04)	-0.2(-0.1)	-0.2 (-0.1)	-3.2 (-1.3)
1989-90	+1.2 (+0.5)	-2.0 (-0.8)	0 (0)	-0.1 (+0.04)	0 (0)	-0.2 (-0.1)	-2.8 (-1.1)

	Labour cost competitiveness	Earnings	Employees in employment (000s)	North Sea Revenues (£bn)	Fiscal Adjustment (£bn)	World Trade in manufactures (UK weighted)
1986-87	-3.8 (-1.5)	+0.2 (+0.1)	+10 (+ 4)	-1.6 (-0.6)	-1.4 (-0.6)	+0.7 (+0.3)
1987-88	-2.9 (-1.2)	+0.3 (+0.1)	+70 (+30)	-2.2 (-0.9)	-2.0 (-0.8)	+1.5 (+0.6)
1988-89	-2.9 (-1.2)	+0.6 (+0.2)	+70 (+30)	-2.1 (-0.8)	-1.6 (-0.6)	+1.5 (+0.6)
1989-90	-3.2 (-1.3)	+1.0 (+0.4)	+10 (+ 4)	-1.9 (-0.7)	-1.2 (-0.5)	+1.4 (+0.6)

LR2.24

FROM: MRS R LOMAX
DATE: 31 January 1986

MR VERNON

cc Miss O'Mara

p.s.f.

CLASSIFICATION OF ECONOMIC ACTIVITY

The Chancellor was grateful for your minute of 30 January. He recalls that you did alert him to the forthcoming publication of this article - most recently in your minute of 7 January.

RL.

RACHEL LOMAX

62:4

CONFIDENTIAL
until 11.30am 10 February
then UNCLASSIFIED

FROM: S D KING
DATE: 6 February 1986

Continuing good news on this front.
MOM 6/2

1. MISS O'MARA
2. CHANCELLOR OF THE EXCHEQUER

Thanks

Nigel

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Mr Monck
Mr Evans
Mr Culpin
Mr S Davies
Mr Brooks
Mr Pickering
Mr Pickford
Mr Vernon
Mr Cropper
Mr H Davies
Mr Lord
HE/01

PRODUCER PRICES FOR JANUARY

These will be published at 11.30 on Monday 10 February and, following the trend of recent months, show encouraging prospects for inflation.

2. **PRODUCER PRICES**
(percentage change over year earlier)

	1985 Q1	Q2	Q3	Q4	1986 January
Output prices	5.9	5.6	5.6	5.2	5.2
Output prices (less food, drink, & tobacco)	6.4	6.4	6.5	6.0	5.9
Input prices (not s.a.)	9.5	3.4	-0.7	-5.3	-7.1
Input prices (s.a.)	9.7	3.4	-0.7	-5.4	-7.6

CONFIDENTIAL
until 11.30am 10 February
then UNCLASSIFIED

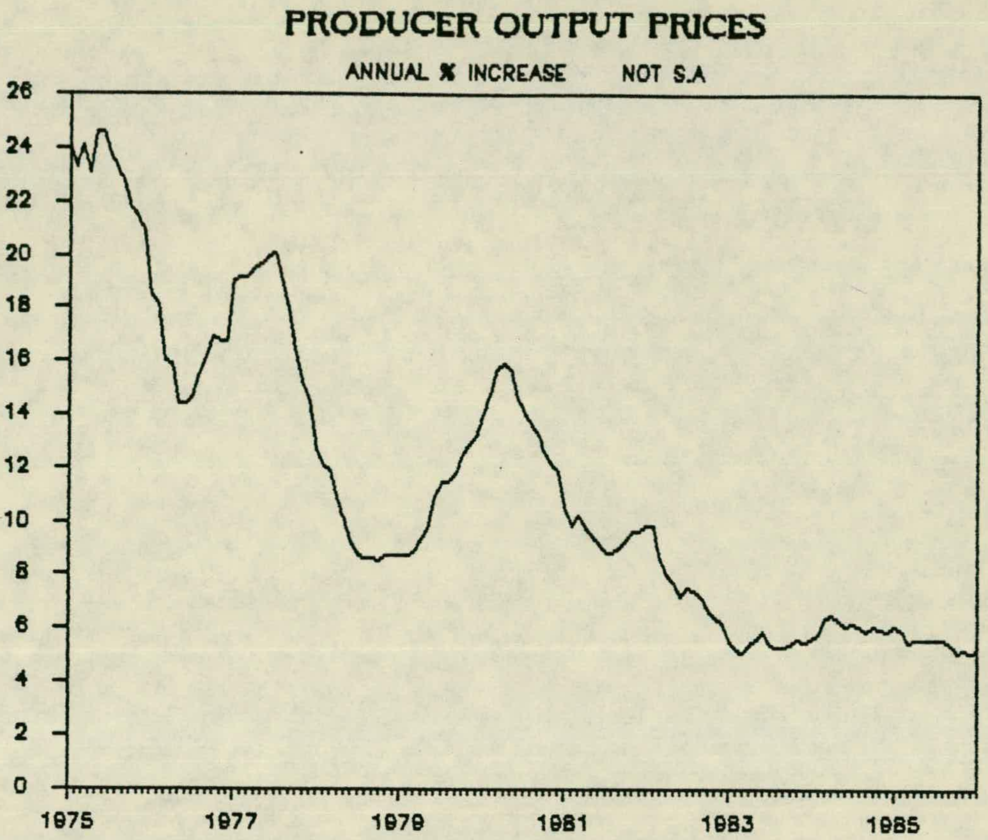
3. A new, seasonally adjusted series for input prices is contained within the above table. This has been introduced by DTI mainly to avoid the large seasonal fluctuations caused by variations in the costs of industrial electricity and in prices of materials purchased by the food manufacturing industries. However, a corresponding series for output prices has not been introduced; this index has a less marked seasonal pattern, which can be difficult to assess and interpret. This is mainly because of the variable effects on the index of changes in drink and tobacco duties usually made in Budgets.

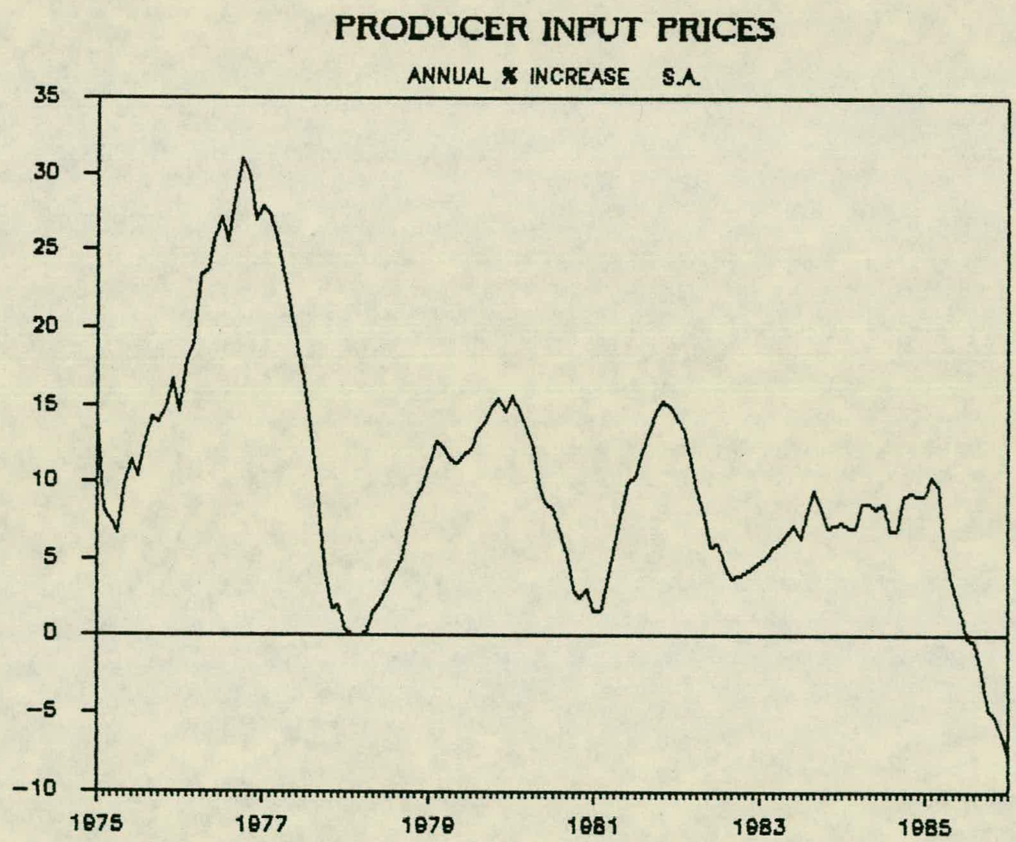
4. Prices of materials and fuel bought by manufacturing industry fell by 7.1 per cent (not s.a.) and by 7.6 per cent (s.a.) in the year to January, after respective falls of 6 per cent and 6.3 per cent in December - the best performance since the present series began in 1974. Between December and January the unadjusted index rose by 0.3 per cent but on an adjusted basis fell by 0.4 per cent. The increase in the unadjusted index can be attributed mainly to the higher costs of imported materials.

5. Only some of the improvement in input prices has so far fed through to producer output prices. Over the year to January they rose by 5.2 per cent - little changed from December (5.1). The rise was, however, among the lowest recorded in the present series. Between December and January the index rose by 0.3 per cent. Excluding food, drink and tobacco, the increase in the index for manufactured products fell to 5.6 per cent in the year to January from 5.9 per cent in December.

6. Movements in annual rates of producer input and output inflation from January 1975 are shown in the attached charts.

S D KING


PRODUCER OUTPUT PRICES
ANNUAL % INCREASE NOT S.A
26
24
22
20
18
16
14
12
10
8
6
4
2
0
1975
1977
1979
1981
1983
1985


PRODUCER INPUT PRICES
ANNUAL % INCREASE S.A.
35
30
25
20
15
10
5
0
-5
-10
1975
1977
1979
1981
1983
1985

8:2

PERSONAL AND CONFIDENTIAL
until 11.30am Friday 14 February
then UNCLASSIFIED

FROM: K VERNON
DATE: 13 FEBRUARY 1986

1. **MISS O'MARA**

2. **CHANCELLOR OF THE EXCHEQUER**

Despite the disappointing monthly fall in the index - wholly attributable to temporary factors - the underlying picture is encouraging & gives good grounds for believing the GDP figures for Q4 will show a resumption in growth. The index is now back to its 1979 all time high, though manufacturing output still has some way to go.

MOM 13/2

Thanks. N.

- Nigel

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir Peter Middleton
Sir Terence Burns
Mr Cassell
Mr Monck
Mr Burgner
Mr H P Evans
Mr Scholar
Mr Shaw
Mr Culpin
Mr S Davies
Mr Pickford
Mr Naisbitt
Mr Pickering
Mr Dyer (+1 for No 10)
Mr King
Mr Cropper
Mr H Davies
Mr Lord
Mr Mansell - CSO
Mr Kingaby - CSO
Mr Hilton - CSO
HB/02

INDEX OF OUTPUT OF THE PRODUCTION INDUSTRIES - DECEMBER 1985

This will be published at 11.30am on Friday, 14 February.

2. The index of production increased by ½ per cent in the fourth quarter of 1985 and was 5½ per cent higher than a year earlier. Within production, manufacturing output rose by 1 per cent in the fourth quarter.

3. Between November and December 1985 the index of production fell by 2½ per cent. Manufacturing output was unchanged but output of the energy and water supply industries fell by 7 per cent - this was mainly due to an exceptional fall of 9 per cent in oil and gas extraction because of bad weather and other temporary factors such as the closure of one field for repairs - nothing to do with oil price falls.

4. **Recent movements**

percentage changes	1985 on 1984	1985Q4 on 1985Q3	1985Q4 on 1984Q4	December on November
Index of Production	+5	+½	+ 5½	-2½
within which:				
Manufacturing	+3	+1	+ 3½	0
Energy and Water	+9	0	+11	-7

---

adjusted for coal strike:				
Index of Production	+3	+ ½	+2	-2½
Manufacturing output	+3	+1	+3	0

5. Manufacturing output growth was sluggish around the middle of the year but has since grown steadily. CSO's best estimate after correcting for strikes and other temporary movements is that manufacturing output is growing by around 2½ per cent in underlying terms. Manufacturing output is 13 per cent above 1981Q1 trough but is 6½ per cent below 1979Q2 peak.

6. In the fourth quarter the index of production was 2 per cent above its average 1979 level and equals the all time high for an individual quarter, reached in 1979Q2.

Other Industrial detail

7. Good increases in output in the fourth quarter of 1985 compared with a year earlier were recorded by Mechanical engineering [+9 per cent], Textiles [+7½ per cent], Motor vehicles [+7½ per cent.]

Assessment

8. Manufacturing output has risen strongly, over the past two years and continues to grow in underlying terms at around 2½ per cent a year. Industrial production is growing, in the same terms, at around 2 per cent a year since energy output is probably flat in underlying terms.

9. Press comment will probably be mixed. Headlines may stress the 2½ per cent fall in the index of production but more serious comment will note that this is mainly due to temporarily depressed oil and gas extraction and that both manufacturing output and industrial production continue to show growth on the quarterly comparison.

10. Manufacturing output grew by 3 per cent in 1985, the fourth year of uninterrupted growth - the longest such period since 1971.

Lines to take

11. Possible lines for IDT to take are:

12. Positive:-

(i) Industrial production increased by 5 per cent in 1985 - equivalent to 3 per cent growth after allowing for effects of coal strike.

(ii) Manufacturing output grew by 3 per cent in 1985 and best assessment is that it continues to grow at annual rate of around 2½ per cent.

(iii) Manufacturing output has now grown for four successive years - longest period of uninterrupted growth since 1971.

(iv) Manufacturing output up by 13 per cent on 1981Q1 trough and 11 per cent since June 1983 election.

Defensive:-

(v) Production down by over 2 per cent in December. Bulk of fall due to temporary reduction in oil and gas extraction. Both production as a whole and manufacturing continue to grow in underlying terms.

(vi) Oil price falls responsible for oil production decline in December. No. Production down because of bad weather and closure of a field for repairs.

JKVern

K VERNON
EB

PERSONAL AND CONFIDENTIAL
until 11.30am, Friday 14 February

TABLE 1

OUTPUT OF PRODUCTION AND CONSTRUCTION INDUSTRIES

1980 = 100, seasonally adjusted

	Production * (Divisions 1-4) *	Energy and Water Supply (Division 1)	Manufacturing (Divisions 2-4)	Construction (Division 5)
1979	107.1	100.5	109.5	105.8
1980	100.0	100.0	100.0	100.0
1981	96.6	103.9	94.0	89.9
1982	98.4	110.0	94.2	91.6
1983	101.9	115.8	96.9	95.3
1984	103.2	110.1	100.7	98.6
1985	108.2	120.0	103.9	
1983 Q4	104.1	118.3	98.9	97.8
1984 Q1	104.3	117.7	99.5	97.0
Q2	102.2	107.9	100.1	98.1
Q3	102.6	105.4	101.7 R	100.5
Q4	103.6 R	109.5	101.5 R	98.7
1985 Q1	106.5 R	115.8	103.1 R	99.3
Q2	108.4 R	121.0 R	103.9 R	100.2
Q3	108.6 R	121.6 R	104.0 R	100.1
Q4	109.2	121.6	104.8	
1984 October	103.4 R	110.2	100.9 R	
November	103.4 R	109.0	101.4 R	
December	104.0	109.4	102.1 R	
1985 January	106.1 R	115.8	102.6 R	
February	105.7 R	113.9	102.8 R	
March	107.6 R	117.7	104.0 R	
April	108.7 R	122.3	103.8 R	
May	108.8 R	123.0	103.7 R	
June	107.8 R	117.7 R	104.2 R	
July	107.9 R	120.3 R	103.4 R	
August	108.4 R	119.4 R	104.4 R	
September	109.6 R	125.1 R	104.1 R	
October	109.2 R	123.0 R	104.2 R	
November	110.5 R	125.4 R	105.1 R	
December	108.0	116.5	105.0	
% changes				
Latest 3 months on previous 3 months	0.6	.0	0.8	-0.1
Latest 3 months on year earlier	5.4	11.0	3.3	-0.4
Latest 3 months on 1981 Q1 (trough)	14.9	19.2	13.0	8.3
Latest 3 months on 1979 Q2 (peak) +	.0	16.7	-6.7	-6.6

Notes

* Within the total 'production' index energy and water supply industries accounts for 26 per cent, and manufacturing for the remaining 74 per cent

'R' signifies revised figure

+ Energy & Water Supply peak is 1979 Q3

PERSONAL AND CONFIDENTIAL
until 11.30am, Friday 14 February

TABLE 2

OUTPUT OF PRODUCTION INDUSTRIES CHANGES IN DETAIL

Percentage change, latest 3 months* on:

	Previous 3 months	Same 3 months last year	1981 Q1 (trough of output of production industries)
Total Production Industries	0.6	5.4	14.8
Energy & Water Supply	0.0	11.0	19.3
o.w. extraction of oil & gas	0.3	-2.6	37.1
coal and coke	2.1	196.5	-16.0
Total Manufacturing	0.8	3.3	13.0
o.w. Metals	-3.8	4.0	11.4
Other minerals +	1.3	0.1	6.6
Chemicals (and man-made fibres)	-2.4	-0.6	19.5
Engineering	2.0	5.2	17.7
Food, drink, tobacco	1.3	1.7	4.2
Textiles etc.	-0.1	3.9	13.3
Other ++	0.2	2.5	7.6

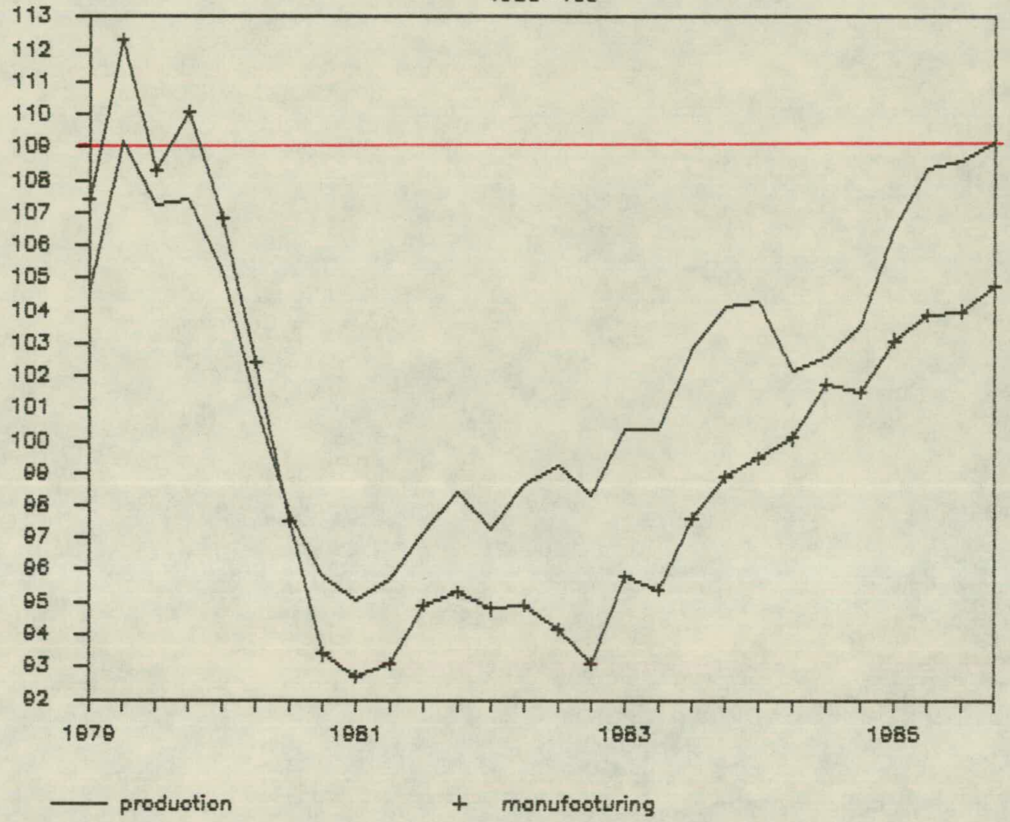
* October, November and December 1985

\+ Mainly building materials

++ Paper, printing, publishing, timber, furniture, rubber, plastics

QUARTERLY INDEX NUMBERS OF OUTPUT

1980=100



PERSONAL AND CONFIDENTIAL UNTIL 1130 AM ON FRIDAY 14 FEBRUARY AND THEREAFTER RESTRICTED

(2)

J0727

MR D NORGROVE

Prime Minister's Office

INDEX OF OUTPUT OF THE PRODUCTION INDUSTRIES - DECEMBER 1985

The provisional index of output of the production industries for December 1985 will be issued at 1130 am on Friday 14 February. A copy of the Press Notice is attached.

Latest figures

The December 1985 index of output of the production industries, that is energy (including coal) and manufacturing, is provisionally estimated at 108.0 (1980=100, seasonally adjusted). This is 2-2½ per cent below the November figure, largely the result of erratically low oil and gas extraction, but also due to a fall in gas and electricity supply from the high November level. For manufacturing the index was 105.0, little changed from November (see section on Bias Adjustments below).

In the fourth quarter of 1985 output of the production industries was ½ per cent higher than in the third quarter and manufacturing output was up 1 per cent. Industry detail is given in the attached Table.

Assessment

Manufacturing output has continued to grow steadily, with underlying growth now of the order of 2-3 per cent per year.

For production industries as a whole, underlying growth is probably under 2 per cent per year, reflecting a rather flat picture for the energy sector.

Output of the production industries in the fourth quarter was 15 per cent higher than at its trough in the first quarter of 1981.

1985 as a whole

Between 1984 and 1985 output of the production industries rose by 5 per cent (3 per cent if allowance is made for the coal dispute). Manufacturing output was up 3 per cent with better than average increases in engineering and allied industries, metals, chemicals and textiles and clothing.

Bias adjustment for manufacturing output

In line with the revised procedure introduced last month, figures of manufacturing output for the last six months include adjustments to try to allow for under-estimation in the provisional estimates (see Note 11 to Notes to Editors of Press Notice).

Impact of the dispute in the coal mining industry

The dispute had little or no effect on the production figures for the third and fourth quarters of 1985.

Figures for January

Figures for January are scheduled for publication on Tuesday 18 March 1986.

Skingales

pp K MANSELL

Central Statistical Office
13 February 1986

Table A

Copy No.

++ PERSONAL AND CONFIDENTIAL until release of Press Notice at 11.30 am on February 14 1986 and thereafter unclassified

Index of output of the production industries 1980=100

SUMMARY	Total production industries	Energy and water supply	Total manufacturing industries	Metals	Other minerals and mineral products	Chemicals and man-made fibres	Engineering and allied industries	Food, drink and tobacco	Textiles, footwear, clothing and leather	Other manufacturing
1984	103.2	110.1	100.7	108.4	95.1	113.9	99.2	102.1	97.9	97.7
1985	108.2	120.0	103.9	112.9	93.9	118.0	104.4	102.2	101.7	99.0
1984 3	102.6	105.4	101.7	109.4	96.0	116.2	100.7	102.2	98.4	97.6
4	103.6	109.5	101.5	106.4	95.0	116.0	100.4	101.7	99.3	98.1
1985 1	106.5	115.8	103.1	110.1	92.5	119.1	103.7	102.0	99.9	97.4
2	108.4	121.0	103.9	115.9	94.2	119.7	104.6	101.2	100.3	97.7
3	108.6	121.6	104.0	115.0	93.9	118.1	103.5	102.1	103.3	100.4
4	109.2	121.6	104.8	110.7	95.1	115.3	105.6	103.5	103.2	100.6
1985 O	109.2	123.0	104.2	111	95	115	105	103	102	100
N	110.5	125.4	105.1	112	96	116	106	103	104	101
D	108.0	116.5	105.0	110	95	114	106	104	104	100
Percentage change latest 3 months on:										
previous 3 months	+0.6	-	+0.8	-3.8	+1.3	-2.4	+2.0	+1.3	-0.1	+0.2
a year earlier	+5.4	+11.0	+3.3	+4.0	+0.1	-0.6	+5.2	+1.7	+3.9	+2.5
1st quarter 1981(a)	+14.8	+19.3	+13.0	+11.4	+6.6	+19.5	+17.7	+4.2	+13.3	+7.6
1st half 1979(b)	+2.2	+23.2	-4.6	-15.2	-11.8	+6.1	-3.7	+3.7	-13.9	-9.5

DETAILED ANALYSIS	Coal and coke	Extraction of mineral oil and natural gas	Mineral oil processing	Other energy and water supply		Metals	Other minerals and mineral products	Chemicals	Man-made fibres	Metal goods not elsewhere specified
1984	33.8	147.1	98.5	95.8		108.4	95.1	114.9	78.8	100.9
1985	67.2	149.8	98.6	106.3		112.9	93.9	119.3	74.3	99.5
1984 3	23.7	144.3	98.4	89.9		109.4	96.0	117.3	79.3	102.6
4	27.6	151.8	99.3	90.1		106.4	95.0	117.1	76.8	99.1
1985 1	35.9	155.6	99.2	100.0		110.1	92.5	120.4	73.0	97.8
2	70.9	148.7	99.6	109.0		115.9	94.2	121.0	75.4	97.9
3	80.2	147.3	98.7	108.5		115.0	93.9	119.3	75.9	101.6
4	81.8	147.8	96.7	107.4		110.7	95.1	116.5	73.1	100.6
1985 O	82	155	95	102		111	95	117	73	100
N	82	151	98	114		112	96	118	77	101
D	81	137	97	107		110	95	116	69	101
Percentage change latest 3 months on:										
previous 3 months	+2.1	+0.3	-2.0	-1.0		-3.8	+1.3	-2.3	-3.7	-1.0
a year earlier	+196.5	-2.6	-2.6	+19.3		+4.0	+0.1	-0.5	-4.8	+1.5
1st quarter 1981(a)	-16.0	+37.1	+0.6	+10.9		+11.4	+6.6	+20.5	-19.0	+13.6
1st half 1979(b)	-14.3	+57.5	-14.4	+2.5		-15.2	-11.8	+8.1	-47.1	-18.2

DETAILED ANALYSIS continued	Mechanical engineering	Electrical and instrument engineering	Motor vehicles and parts	Other transport equipment	Food	Drink and tobacco	Textiles	Clothing, footwear and leather	Paper, printing and publishing	All other manufacturing
1984	87.3	122.9	81.3	91.5	104.7	96.7	93.7	101.5	96.3	99.3
1985	92.7	131.2	86.6	95.3	105.0	96.4	98.4	104.5	98.7	99.4
1984 3	87.7	126.4	81.8	91.7	104.9	96.7	93.9	102.3	95.9	99.5
4	87.6	128.6	77.6	92.6	104.8	95.5	94.2	103.7	97.8	98.4
1985 1	90.9	131.0	86.6	96.7	105.0	95.8	97.0	102.4	97.4	97.5
2	94.0	130.5	87.4	96.8	103.8	95.8	96.0	104.0	97.5	98.0
3	90.5	129.6	89.2	92.9	105.2	95.7	99.4	106.7	99.4	101.5
4	95.5	133.7	83.0	95.0	106.0	98.2	101.3	104.8	100.5	100.7
1985 O	93	134	82	95	106	98	101	103	100	101
N	97	134	80	95	106	99	103	105	101	101
D	96	133	87	95	107	98	101	107	101	100
Percentage change latest 3 months on:										
previous 3 months	+5.5	+3.1	-7.0	+2.3	+0.7	+2.6	+1.9	-1.8	+1.1	-0.8
a year earlier	+8.9	+3.9	+7.0	+2.7	+1.1	+2.8	+7.5	+1.1	+2.7	+2.4
1st quarter 1981(a)	+9.3	+44.3	+8.3	-10.0	+7.7	-2.9	+11.9	+14.5	+5.9	+9.7
1st half 1979(b)	-13.3	+29.5	-32.5	+1.2	+6.5	-2.0	-18.8	-9.3	-6.0	-13.1

(a) Last trough for production industries (b) Last peak for production industries

Personal numbered copies of the minute and attachment to:

Treasury	(Principal Private Secretary (Sir Peter Middleton
Cabinet Office	(Mr Jack Hibbert
Department of Trade and Industry	(Private Secretary Secretary of State's Office
	(Private Secretary to Mr Geoffrey Pattie
	(Private Secretary to Mr Peter Morrison
	(Private Secretary to Mr John Butcher
	(Sir Brian Hayes (Mr H Liesner
	(Mr Whiting (Mr Harvey (Mr Wright
Bank of England	(Mr R Leigh-Pemberton

45:2

CONFIDENTIAL
until 11.30am Wednesday 19 February
then RESTRICTED

FROM: K VERNON
DATE: 18 February 1986

1. MISS ~~O'~~MARA

2. CHANCELLOR OF THE EXCHEQUER

Some encouraging signs of a resumption in growth, as we expected.
MOM 18/2

Thanks. Is the growth of GDP(A) in 1985 likely to be higher or lower than that of GDP(O)?

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Monck
Mr Scholar
Mr Burgner
Mr H P Evans
Mr Shaw
Mr Culpin
Mr S Davies
Mr Pickford
Mr Allum
Mr Pickering
Mr Dyer (+1 for No.10)
Mr H Davies
Mr Cropper
Mr Lord
Mr Mansell - CSO
Mr Clary - CSO
Mr Lang - CSO
HB/02

GDP (OUTPUT MEASURE) IN FOURTH QUARTER 1985

The CSO will publish the preliminary estimate for this on 19 February. An advance copy of the press notice is attached.

Fourth Quarter Figures

2. GDP(O) is estimated to have risen by ¾ per cent between the third and fourth quarters of 1985. This ¾ per cent increase followed an increase of ½ per cent in the second quarter and no change in the third quarter, on a coal strike adjusted basis.

3. The contributions of changes in the individual components of GDP(O) are tabled below.

Industry	Contributions to percentage change in GDP(O) 1985Q4 on 1985Q3
1. Agriculture, forestry and fishing	-
2. Construction	-0.2**
3. Services	+0.6
4. Industrial production ow:	+0.2
5. Oil and gas extraction	-
6. Other energy and water supply	-
7. Manufacturing	+0.2
GDP(O)*	+0.7*

* Sum of rows 1-4
**Not for use

4. Growth was fairly uniform across the service industries. The positive contribution of production growth to GDP growth was wholly due to growth in manufacturing. Oil and gas extraction and other energy output remained flat.

5. Revisions to manufacturing output, primarily as a result of CSO's bias adjustments, have been offset by revisions elsewhere to services output.

6. The GDP(O) figures for 1985Q4 give the first indication of GDP growth in 1985. They show growth of 3½ per cent - equivalent to 2¾ per cent after allowing for the coal strike - and are therefore consistent with the forecast of 3½ per cent growth in GDP(A) at the time of Autumn Statement.

Assessment

7. Growth seems to have resumed in the fourth quarter of 1985 after little change in strike adjusted terms, between 1985Q1 and 1985Q3. However medium comment may be that overall growth since 1985Q1 - equivalent to 1½ per cent a year in strike adjusted terms - is slowing down. Press comment on the whole however should be reasonably favourable and focus on the ¾ per cent growth in GDP(O) in the fourth quarter of last year and the 3½ per cent for the year as a whole.

8. [NOT FOR USE: Very preliminary information suggests that construction output fell by 2½ per cent in 1985Q4. However, this figure is very tenuous and subject to great alterations. Recent indicators such as private housing starts and completions have been reasonably buoyant.]

Lines to take

9. Positive

(a) GDP(O) up ¾ per cent between third and fourth quarters of 1985

(b) Preliminary estimate of GDP(O) suggests 3½ per cent growth in 1985.

Defensive

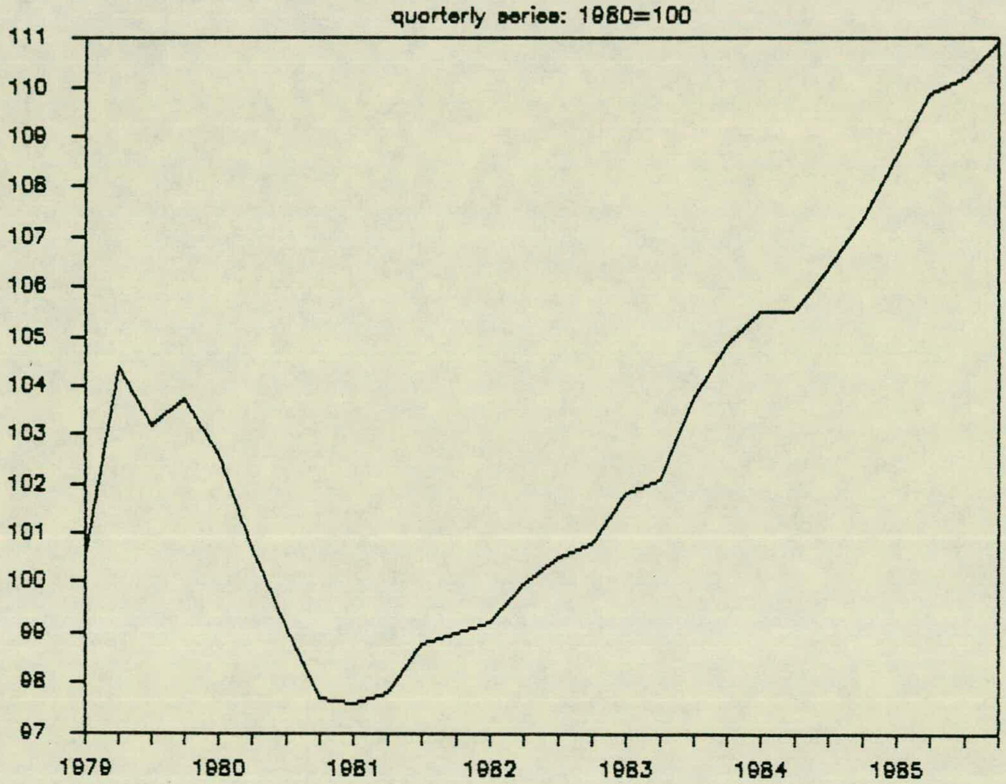
(c) Growth sluggish since beginning of last year. Growth affected by temporarily depressed oil and gas extraction in 1985. Preliminary estimates of GDP(O) suggest growth resumed in the fourth quarter when GDP(O) rose by ¾ per cent.

K Vernon

K VERNON

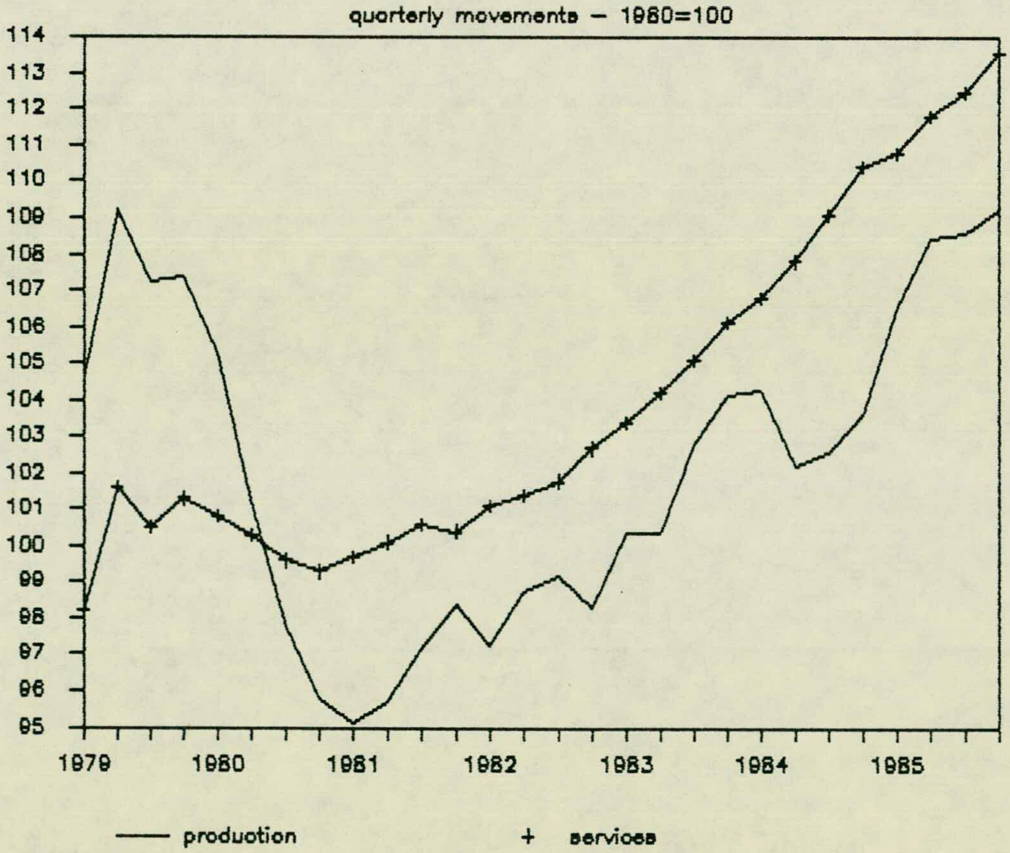
GDP (OUTPUT)

quarterly series: 1980=100



OUTPUT OF PRODUCTION & SERVICE SECTORS

quarterly movements – 1980=100



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CSO(86)20
19 February 1986

GROSS DOMESTIC PRODUCT (OUTPUT-BASED) - FOURTH QUARTER 1985

Preliminary estimates suggest that output of the whole economy rose by about ¾ per cent between the third and fourth quarters of 1985. Growth was fairly uniform across the service industries, averaging about 1 per cent, while output of the production industries increased by ½ per cent. The preliminary output-based estimate of gross domestic product (GDP) in the fourth quarter is 110.9 (seasonally adjusted at constant prices, with 1980=100), some 3¼ per cent above its level of a year earlier (2 per cent after adjusting for the effects of the coal strike).

The output measure of GDP rose by 3½ per cent between 1984 and 1985 (2¾ per cent after allowing for the miners' dispute). This compares with an increase of 3 per cent between 1983 and 1984 (4 per cent after adjustment). Manufacturing output rose by 3 per cent between 1984 and 1985, while service industries as a whole showed 3½ per cent growth. In particular, output of the transport and communications industry grew by over 5 per cent.

As can be seen from the Table, the expenditure, income and output measures of GDP (and by implication the average measure) can move irregularly for particular quarters, and differently to each other.

COPY No. 7

PERSONAL AND CONFIDENTIAL until release of Press Notice at 1130 p.m. on 19.2.86 and thereafter unclassified

GROSS DOMESTIC PRODUCT AT CONSTANT FACTOR COST

Seasonally adjusted

1980=100

		Average estimate	Based on: Expenditure data	Income data(1)	Output data
1980		100.0	100.0	100.0	100.0
1981		98.5	98.7	98.4	98.3
1982		100.4	100.1	101.0	100.1
1983		103.7	103.6	104.3	103.1
1984		106.1	105.0	107.1	106.2
1985		..	..	..	109.9 (2)
1982	1	99.7	100.0	100.1	99.2
	2	100.3	99.7	101.2	100.0
	3	100.3	99.2	101.3	100.5
	4	101.2	101.4	101.3	100.8
1983	1	102.8	103.5	103.2	101.8
	2	102.7	102.0	103.9	102.1
	3	104.1	104.0	104.5	103.8
	4	105.1	104.8	105.4	104.9
1984	1	105.5	105.2	106.0	105.5
	2	104.9	104.0	105.3	105.5
	3	106.1	104.2	107.9	106.4
	4	107.9	106.8	109.4	107.4
1985	1	108.8	108.2	109.5	108.6
	2	110.0	108.9	111.1	109.9
	3	109.7	108.1	110.8	110.2
	4	..	..	..	110.9 (2)

(1) Income data deflated by the implied index of total home costs derived from expenditure data.

(2) Preliminary estimate.

NOTES TO EDITORS

1. The preliminary estimate of the output based measure of gross domestic product is derived from the provisional estimate of the index of output of the production industries for the fourth quarter, published on 14 February, together with partial information for the rest of the economy. Any revisions to quarterly data, together with estimates of GDP based on expenditure and income data, will be released by Press Notice on 21 March. A series consistent with today's Press Notice is available on request for output of the whole economy other than extraction of mineral oil and natural gas.

2. As the table shows, the estimates of GDP based on expenditure, income and output data may move differently in the short term. The output based measure is usually considered to be the most reliable measure of short term movements.

3. The 1980-based GDP(O) series was introduced in September 1983. Since then, the revision in the month following publication to the preliminary estimate of change in GDP(O) between the two most recent quarters has tended to be upwards. The mean revision to the estimate of change is +0.2 but for any particular quarter the actual revision can fall within quite a wide range of this average; since rebasing, revisions have varied from -0.2 to +0.4. The average is based on only nine quarters and could itself change considerably as more quarters' data become available.

4. All GDP estimates are liable to revision over a much longer period, as firmer and more complete data become available. An article published in the July 1985 issue of Economic Trends reports the results of an investigation into the pattern of these long-term revisions. It should be noted that the article does not include revisions made in the month following the initial publication of GDP(O), which are discussed in the previous paragraph. While some assessment is made in the article of figures for the three separate measures of GDP, the focus of the analysis is in respect of the average estimate. GDP Press Notices containing new data for this measure now give ranges within which (based on past evidence) the finally revised figures are likely to lie, but related information is not published in respect of the individual measures.

5. Since 1980 some of the statistical sources used in compiling GDP(O) have been discontinued, or reduced in size. Estimates of GDP(O) may well as a result have been subject to a wider margin of error.

6. The series and weights used to compile the 1980-based GDP(O) series are described in an Occasional Paper. The effects of rebasing on all the measures of GDP were described in an article in December 1983 Economic Trends. Occasional papers (price £2.50 each) and off-prints of Economic Trends articles (price £1.20 each) are available from the Central Statistical Office.

BR/37

FROM: MRS R LOMAX

DATE: 20 FEBRUARY 1986

MR VERNON

cc Sir T Burns
Mr Evans
Miss O'Mara

GDP (OUTPUT MEASURE) IN 1985 Q4

The Chancellor was grateful for your minute of 18 February. He has asked whether the growth of GDP(A) in 1985 is likely to be higher or lower than that of GDP(O).

RL

RACHEL LOMAX

CONFIDENTIAL

FROM: S BROOKS

DATE: 20 February 1986

Discussed in draft

1. MR DAVIES

2. CHANCELLOR OF THE EXCHEQUER

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
PS/Minister of State
Sir Peter Middleton
Sir Terence Burns
Mr Butler
Mr Cassell
Mr Monck
Mr Kemp
Mr Evans
Mr Odling-Smee
Mr Scholar
Mr Culpin
Miss O'Mara
Mr Gilhooly
Mr Page
Mr Vernon
Mr Halligan
Mr P Davis
Mr Westwater
Mr H Davies
Mr Cropper

Nigel

THE JANUARY RPI (to be published at 11.30 am on Friday 21 February)

The RPI increased by 0.2 percent between December 1985 and January 1986. The twelve month rate of inflation fell from 5.7 percent in December to 5.5 percent in January. This is marginally better than we had expected.

2. As anticipated there was only a small fall recorded, of about 1p per gallon, in the price of petrol. The prices of durable household goods and of clothing and footwear declined by 1 percent and 1.2 percent respectively as a result of winter sales. There were large increases in the prices of rail travel (6.8 percent) and bus fares (2.1 percent) as price changes by BR and LRT became effective. Alcoholic drink increased 0.8 percent as pre-Christmas discounts were eliminated.

CONFIDENTIAL

3. The prospects are for a substantial fall in February, probably to around 5%. Petrol price reductions have already take place. Also the rise in the mortgage rate of February 1985 will cease to affect the twelve month comparison. However further rises in the prices of bread and coffee are likely to have been recorded, and there has been a rise in milk prices.

4. Between May 1985 and January 1986 (the period relevant to pensions uprating) the RPI increased by 1.1 percent, virtually the same as the assumption (1%) used in the 1986 PEWP.

5. Phillips and Drew and Wood Mackenzie are both correctly forecasting the one month percentage increase of 0.2; Simon and Coates had 0.3.

Simon Brooks

SIMON BROOKS

RR3.58

FROM: MRS R LOMAX
DATE: 20 February 1986

SIR PETER MIDDLETON

cc Sir T Burns

PANEL OF OUTSIDE ECONOMISTS

Prompted by Mr Murphy's record of your meeting with Chief Executives of the big four clearing banks the other day, the Chancellor has recalled that you and Sir Terence Burns are considering his suggestion that he might set up a panel of outside economists, with whom he might have regular - perhaps quarterly - discussions. He would like to discuss this again with you shortly, with a view to starting these meetings immediately after the Budget.

RL

RACHEL LOMAX

FROM: K VERNON

DATE: 21 February 1986

Keena

MRS LOMAX

Thanks

cc: Sir T Burns
Mr Evans
Miss O'Mara
Mr Allum
HE/03

GDP (OUTPUT MEASURE) IN 1985Q4

The Chancellor asked in your minute of 20 February whether growth of GDP(A) in 1985 is likely to be higher or lower than that of GDP(O).

2. The quarterly pattern of GDP(O) and GDP(A) thoughout 1984 and 1985 is tabulated below. The GDP(A) figure for 1985Q4 is the EA forecast as it currently stands and EA have also made some very small adjustments to the GDP(A) figures in 1984 and 1985 to reflect revisions in components of expenditure and income that will not yet be reflected in published estimates.

Index Nos (1980 = 100)

		GDP(O)	GDP(A)
1984	1	105.5	105.6
	2	105.5	105.0*
	3	106.4	106.2
	4	107.4	107.9*
1985	1	108.6	108.7*
	2	109.9	110.0
	3	110.2	109.7
	4	110.9	110.8*
1984		106.2	106.2
1985		109.9	109.8
% Change 84/85		3.5	3.4

* EA estimate, (not for use)

3. Thus the best assessment at the moment is that GDP(O) and GDP(A) both grew by 3½ per cent in 1985.

K Vernon

K VERNON

FROM: SIR T BURNS

DATE: 21 February 1986

CHANCELLOR

OK

cc Sir P Middleton

ESRC CONFERENCE 18-21 MAY TO DISCUSS BRITAIN'S ECONOMIC PERFORMANCE IN THE 1970s AND 1980s

Both Mr Odling-Smee and I are inclined to accept this invitation.

The programme of papers is not as balanced as it might be but the discussion should be interesting.

The only real blight is the possible participation of Chris Huhne!

Are you content?

T BURNS

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Telephone: 01-405 7686

PRGL/jp/86/95

12th February, 1986.

Dear Terry,

We are having a conference on Britain's Economic Performance in the 1970s and 1980s, to be held at the White House Conference Centre, Chelwood Gate (near Haywards Heath) from 18th to 21st May 1986. The idea is to produce a volume somewhat similar to the two earlier Brookings volumes on the British Economy. We enclose a copy of the programme with the proposed discussants. We do hope that you are willing to come and discuss the paper suggested. We think it should be a good event.

Yours sincerely

Rudi Dornbusch
Richard Layard

Sir T. Burns
H.M. Treasury
Parliament Street
London
SW1.

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CONFERENCE ON THE BRITISH ECONOMY

White House Conference Centre, Chelwood Gate, Sussex
18th to 21st May, 1986

PROPOSED PROGRAMME

Author	Paper	Proposed Discussants
David Begg	'Fiscal Policy'	Charles Goodhart Samuel Brittan
Stanley Fischer	'Monetary Policy'	Rudi Dornbusch Sir Terry Burns
Charles Bean	'Impact of North Sea Oil'	Marcus Miller John Odling-Smee
Mervyn King	'Capital Markets, Savings and Investment'	Stephen Schaefer John Flemming
Richard Layard & Stephen Nickell	'Labour Markets'	Patrick Minford Graham Reid
Tony Atkinson & Julian le Grand	'The Welfare State'	James Mirrlees Nick Morris
John Kay & David Thompson	'Industrial Policy, Privatisation and the Nationalised Industries'	Sir Douglas Hague Stephen Littlechild
Francesco Giavazzi	'The Impact of EEC Membership'	Peter Neary Christopher Huhne

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