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5/9/95

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

PO -CH /NL/0143
PART D

DM/69

SECRETARY OF STATE FOR EMPLOYMENT

Caxton House Tothill Street London SW1H 9NF

Telephone Direct Line 01-213 6460

Switchboard 01-213 3000

CH/EXCHEQUER
REC. - 4 JUN 1986
ACTION MR H. EVANS
COPIES TO CST FST EST MST
SIR P. MIDDLETON
SIR T. BURNS
MR BYATT, MR CASSELL
MR KEMP MR ODLING-SMEE
MR PERETZ MR SCHOLAR
MR CULPIN MS O'MARA
MR THRIE MR ROSS-GOOBEY

4/6

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
London SW1

June 1986

Ch/ Reflects discussion with HF, who have taken legal advice. See Peretz minute below.

4/6

Dear Nigel,

OK

RETAIL PRICE INDEX ADVISORY COMMITTEE

As I think you know, this Committee - which was reconvened by my predecessor towards the end of 1984 and on which the Treasury is represented - is expected to report shortly. I understand that its report is likely to be submitted to me within a week or so of its next meeting on 12 June. The report has to be published and I shall need to announce my decisions on its recommendations.

See Peretz minute below

Our officials have discussed the way in which the report might best be handled given the possible implications for indexed gilts and National Savings Certificates if any major change in the constitution of the RPI appeared to be in prospect. I would welcome your confirmation that what I propose is acceptable.

On the day the report is submitted to me, I propose written answers to PQs in both Houses announcing that I have received it and am arranging to have it published just as soon as possible together with my decisions on its recommendations. I will ensure, by press notice, that this statement is also directed to a wider audience.

Immediately thereafter I shall be writing to you and other colleagues most closely concerned with my preliminary views on the report's recommendations inviting any comments. My aim will be to reach conclusions just as quickly as possible. Ideally, I would hope to publish the report as a White Paper and at the same time announce my final decisions within about two weeks of receiving the report. The announcement would be in the form of further written answers to PQs, backed by a press notice.

Are you content with these arrangements?

Yours,

David

DR 1/042

FROM: MRS R LOMAX
DATE: 5 June 1986

PS/ECONOMIC SECRETARY

cc Chief Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Evans
Mr Peretz
Mr Sedgwick
Mr Culpin

RPI ADVISORY COMMITTEE: IMPLICATIONS FOR INDEX LINKED GILTS AND SAVINGS CERTIFICATES

The Chancellor has seen Lord Young's letter (undated) and Mr Peretz's submission of yesterday (also undated).

Subject to the Economic Secretary's views, he is content with the timetable proposed by Lord Young.

RL

RACHEL LOMAX

90a:4

FROM: S D KING
DATE: 6 JUNE 1986

Mon 6/6

1. MISS O'MARA
2. PRINCIPAL PRIVATE SECRETARY

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
PS/Minister of State
Sir P Middleton
Sir T Burns
Sir G Littler
Mr H P Evans
Mr Odling-Smee
Mr Scholar
Mr Culpin
Mr S J Davies
Mr S Matthews
Mr Cropper
Mr Ross Goobey
Mr Tyrie
JB/03

Thanks. Do we really think that our inflation is going to be higher than Italy's?

'ECONOMIST': 'THE BAD OLD DAYS RETURN'

You asked us to take a look at this article, to see what kind of quick response (attached) could be given to the points the 'Economist' makes. I understand the forecasters are producing a more considered piece.

S D KING

'The Economist': 'The bad old days return'

'The Economist' notes that the OECD forecasts for 1987 give:

(a) slowest rate of growth of major 7 economies

(b) highest rate of inflation of major 7 economies

(c) highest unemployment rate of major 7 economies

(d) current account deficit

On growth:

'Economist' attributes deteriorating performance in UK largely to the effects of high interest rates and a high exchange rate (the one claimed as necessary to preserve the other in order to suppress inflation) on exports and investment.

But exports expected to grow faster than in Japan (though forecast UK investment is admittedly lowest of the 7 - the FSBR gave a forecast of zero growth for first half of 1987). In any case, we have always said that UK, as a net oil producer, will not benefit so much from lower oil prices as major competitors. Nevertheless, can still expect steady sustained growth - and May CBI enquiry suggests pick up in growth in second half of 1986. To extent that growth in first half of 1986 lower than expected, growth in 1987 could well be higher.

On inflation:

'The decline in the rate of inflation is solely the result of the fall in petrol prices and the mortgage rate'.

Certainly, petrol price and mortgage rate have helped. But article ignores major contribution of firm financial policies and regards high pay settlements as a source of inflation. Pay settlements have consistently lagged behind falling RPI, yet it has continued its downward trend. However, high pay settlements will not help prospects for a reduction in unemployment.

On unemployment:

Article claims, helpfully, that "prospects for the jobless look brighter", drawing attention to the slower growth of the labour force and the expansion of the Government's employment measures.

But it fails to focus attention on responsibility of employers and employees to show greater moderation in pay settlements. It also fails to point out that OECD forecast employment growth in UK in 1987 to be faster than EC average.

On trade:

Current account deficit forecast based on very tentative assumptions over exchange rate and response of non-oil exports [although we too are concerned about increasing import penetration].

But we recognise importance for competitiveness of controlling growth of UK unit labour costs.

Article also fails to point out broad support which OECD has given to UK macro - and micro - policies:

(a) "The recovery has now lasted five years and looks set to continue through the next eighteen months [even though the pace of the recovery seems to have slowed]"

(b) "An important feature of the current recovery has been the resilience of the economy during the year long miners' strike and then through the recent period of falling oil prices."

(c) "The overall net effect of the fall in oil prices is judged to be positive."

(d) "It does seem as if public spending is being better controlled than in the past."

(e) "The unfavourable effects of any fall in the exchange rate... are likely to be more than offset... by the lower oil price."

BRITAIN

The bad old days return


Coping with the cycle

Britain's economy has done well for the past four years. As Conservative ministers often boast, it has had the fastest growth rate in Europe and lower-than-average inflation. That period now seems to be ending. Next year, Britain faces the unenviable combination of the slowest rate of growth of the big seven industrial economies, the highest rate of inflation—higher even than Italy's—the highest unemployment rate and a return to current-account deficit. This is the view not just of the perpetually gloomy forecasters at Britain's National Institute of Economic and Social Research, but also of their counterparts at the OECD, normally a more cheerful bunch.

The chancellor of the exchequer, Mr Nigel Lawson, agrees that growth has faltered. He hopes it is just a temporary dip. Last week, he promised a "vigorous resumption of growth" later in the year as the benefits of falling interest rates, lower inflation and tax cuts start to feed through to higher spending. His quarrel with the OECD's economists is easy to exaggerate: the difference between "good" growth next year (say 3%) and "bad" (say 2-2½%) is well within a forecasting margin of error.

But the chancellor is in a tight corner. He would like to reduce inflation by gradually cutting the growth of Britain's nominal GDP; if prices, and particularly pay settlements, responded to that pressure, the real economy could continue to grow. They haven't. So the government is trying to keep the lid on prices—and thus on earnings—by using high interest rates to preserve a strong exchange rate. The cost of this pay policy is weaker investment and exports, and booming imports.

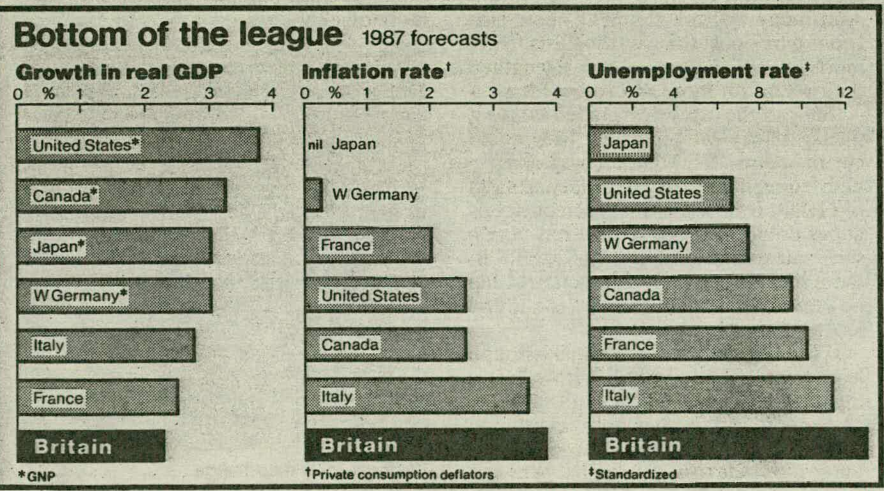
● **Inflation.** During 1986, retail price inflation is expected to reach a low of around 2%, but the forecasters doubt it will stay there. The decline in the rate of inflation is solely the result of the fall in petrol prices and the mortgage rate, which reduce the level of prices once-for-all. They do not affect the underlying rate at which prices are rising. Unless pay settlements moderate, the rate of inflation could bounce back to 4-5% by the end of 1987.

● **Growth.** In the four years to 1985, real GDP grew by an average of almost 3% a year, but since the middle of last year the recovery seems to have run out of steam. In the past three quarters, GDP growth has slowed to an annual rate of barely 1½%, largely because of a fall in the output of manufacturing industry. The May survey of manufacturers by the Confederation of British Industry suggests that activity has remained weak in the second quarter: a balance of 16% of firms reported that their order books were below normal.

During 1986 and 1987, consumer spending will replace investment and exports as the main engine of growth. Firms will not automatically turn their higher profits into higher investment, as money is still expensive. Banks are charging firms a real rate of interest of at least 8%—the highest of any of the big seven economies. And the abolition of capital allowances in April may mean a pause in business investment over the next year, which will only partly be offset by the recent pick-up in housing investment.

Consumers have lots of cash, and they are eager to spend it. Earnings have risen by 7½% during the past 12 months, while the tax-and-price index—which measures the rise in wages needed to maintain real post-tax income—has risen by only 1.2%. However, consumers will spend much of their extra cash on foreign goods. The OECD reckons that real domestic demand in Britain will grow at an annual rate of 3¼% over the next 18 months—exactly the same as the OECD average. But a third of this will drain away into net imports. So domestic output will rise by only 2¼%—well below the 3¼% in the rest of the OECD.

● **Unemployment.** Prospects for the jobless look brighter. The labour force is expected to grow by only ½-¾% a year in 1986 and 1987, less than half the increase in the past two years, and the planned growth in the number of places on government job-creation schemes will mop up some of the unemployed. The National Institute reckons that adult unemployment will fall by more than 200,000 by the



Source: OECD

end of 1987. However, this would still leave the unemployment rate above 12%: only a whisker lower than today.

● **Trade.** The combination of lower oil prices, buoyant domestic demand and sterling's strength in late 1985 are taking their toll. In the three months to April, the volume of non-oil exports was 3% lower than in the same period of 1985, while non-oil imports were up by 2½%. The recent fall in the pound against other European currencies and the yen should help to boost exports later this year, but not by enough to offset the drop in oil revenues.

A firm of stockbrokers, Phillips & Drew, reckons that if non-oil exports are to expand to fill the gap left by lower oil revenues, then sterling's competitiveness needs to improve by 2% for every $2½-3 drop in the price of a barrel of oil. If Britain's labour costs continue to outpace those abroad, this implies an even bigger fall in the pound. However, despite a $15-a-barrel drop in the price of oil the pound's trade-weighted value is now only 3% below its average 1985 level. Britain's current-account surplus of £3 billion in 1985 could be transformed into a deficit by 1987.

These forecasts suggest that Britain, by the time of the general election, will be suffering from many of the economic woes familiar from the 1960s and the 1970s. Mrs Thatcher will be able to say that she has cut inflation dramatically. But with the labour market working as badly as ever, that cut is a remission, not a cure, of the British disease. Other countries have achieved as much, at lower cost in lost jobs and output.

Tory Central Office

Bad housekeeping

"It's the easiest thing in the world", Mrs Thatcher told a conference of Tory women, "to say 'Go on, spend more, borrow more'. But the question any good housekeeper has to ask is 'If the unexpected happens, have I left myself enough in reserve to cope?'". As a prime minister intent on teaching the British nation the virtues of good housekeeping, Mrs Thatcher sets a poor example in her own party. The Tories currently have a bank overdraft of some £1.5m. It would be £2.5m if it were not that some constituencies have been persuaded to "lend" £1m of their own money to reduce it.

Mrs Thatcher and her party big-wigs, particularly the chairman, Mr Norman Tebbit, and the treasurer, Lord McAlpine, have to decide whether this is a good moment to launch a rescue appeal. The problem is too big to be dealt with by better management of party assets.

The last big appeal was in 1968-69, when Lord Carrington asked for and got £2m. At the time, many said this should be used to set up a capital-growth fund. Instead, it went to plug a cash gap and to win Mr Heath the 1970 election.

It was only in 1984-85 that the party once again published accounts. In that year its income was £4.3m and expenditure £5.6m—a shortfall of £1.3m. In the year to March 1986 the results are expected to have been "somewhat better" but still nowhere near breakeven.

The main source of money is still direct donations by companies and we viduals to Central Office. A sophisticated collectors under ance of 73-year-old General Wyldbore-Smith, who has fo been director of the Conserva of Finance, appeals to the nobler instincts of company Honours are not sold but the times follow outstanding mun the Tory party. It is easiest to appeals when the Tories are tion, or at least when a Tory g is popular. To some extent th collectors are being helped by tory noises being made by t shadow chancellor of the excl Roy Hattersley, with his threa taxation, renationalisation an of institutional investment.

Part of the problem is that cies do not pay their share Office funds. Each constituen quota which varies with how ' In 1984-85 the total quota £1.8m but only about half £892,000—was actually colle constituencies paid two or their quota and some paic among them that of Mrs Tha decessor, Mr Edward Heath. cies can get credits towards when Central Office collector businessman or when constit money to the Board of Financ

One Central Office initiativ persuade constituencies to use of their extensive prope to be surveyed by a prop committee, just set up by t Finance. All constituency ch

Is queueing healthy?

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Health economists and officials argue that the length of a waiting list is not a good guide to anything much—the list could lengthen, yet more people be treated, and treated better. They are not even a perfect guide to the number of people waiting for operations. A waiting list may include: people who are dead, people who have already had their operations elsewhere, people who no longer need them. Doctors compile their waiting lists in different ways. Some will not put any patients on their list when they think it is too long already; others will. Some put patients on a list long before the operation is needed; others wait. And many doctors claim to know surgeons who boost their waiting lists to get more private patients, or to strengthen their claims for more NHS resources.

Many of the recently installed NHS unit managers say privately that they could cut their lists if the matter was given a high enough priority. The Department of Health is now making discreet noises about doing just that. It will not necessarily mean more money, nor should it: there seems to be no correlation between how hard up a health district is and the length of its waiting list.

If Mr Fowler wants to snatch triumph from the resignation of Mr Victor Paige, the first chairman of the NHS management board, this is his chance. He should brief Mr Paige's successor to do something about the NHS's queueitis. Why not give managers a choice: cut yo your contracts will not be rene new breed of managers—thei set by the management bo brought in to run the NHS more ly. But nobody will believe doing so until patients get int more quickly.

Waiting for a new Paige

Ch/ [illegible]
Terry: you would have [illegible] this, as he was working on his monetary paper (see discussion in box) [illegible] many quick points too
See below. RL 6/6

FROM: SIR T BURNS
DATE: 6 JUNE 1986

CHANCELLOR

cc Sir P Middleton
Mr Evans
Mr Culpin
Mr S Davies
Miss O'Mara

Thanks. [illegible] Mary [illegible] on [illegible] Fri. N.

THE BAD OLD DAYS

You asked for some comments on the article in today's Economist.

2. This is one of those irritating articles that contains more than an element of truth but then proceeds to exaggerate in such a way as to distort the conclusions. I will present some of their statements followed by my comments.

3. ..the government is trying to keep the lid on prices - and thus on earnings - by using high interest rates to preserve a strong exchange rate. The cost of this pay policy is weaker investment and exports, and booming imports.

We acknowledge that the labour market has behaved in a disappointing way so that supply performance has been damaged. And since early 1985 you have tended towards a policy of higher interest rates and a bracing exchange rate. In time this will shift the composition of demand towards consumption and away from exports and investment. But so far it is not really possible to identify much of this effect from the figures.

4. Next year, Britain faces....of the big seven industrial countries..the highest rate of inflation...

It is well understood that the fall in oil prices gives less benefit to inflation in the UK than in other countries because of the effect on sterling. Even so the statement is not true of the NIESR forecast as the article claims. It is true of the OECD forecast but again it is a matter of overstatement; 5 of the major 7 countries are forecast to have inflation in the range 2 to 4 per cent in 1987, a range which is trivially small relative to the margin of forecasting error.

5. The decline in the rate of inflation is solely the result of the fall in petrol prices and the mortgage rate..inflation could bounce back to 4-5 per cent.

The first part of this statement is again exaggerated; private sector prices excluding food, housing and petrol have been growing at 4.5 per cent, compared with 5.4 per cent last year. The key issue now is whether we see a follow through into lower pay settlements. We will not know until the Autumn.

6. Next year, Britain faces the ...slowest rate of growth of the big seven..

Again the differences between the growth forecasts for the G7 are very small compared with the forecasting error.

7. ..since the middle of last year the recovery seems to have run out of steam.

This has happened in other major countries with falls in industrial production in the first quarter in Japan, Germany, and France for example. The consensus forecast is that the slowdown will not persist in these countries or the UK.

8. During 1986 and 1987, consumer spending will replace investment and exports as the main engine of growth....However consumers will spend much of their extra cash on foreign goods.

The latest DTI Intentions Survey implies business investment will rise marginally faster than overall GDP this year and so far there is no sign of an imports boom. However there is something in the point. Real after tax earnings are growing very rapidly. A rapid growth of real gross earnings has been further increased by tax cuts. This will tend to put pressure on the balance of payments. The balance of the demand components is something we will have to watch carefully as the oil price effects work through.

9. The recent fall in the pound against other European currencies and the yen should help to boost exports later this year, but not by enough to offset the drop in oil revenues.

There is no presumption that we have to fully offset the drop in oil revenues as we begin from a position of current account surplus. And calculations of this kind are very difficult to make. But again this is something we will have to watch carefully. The combination of a bracing exchange rate and lower oil prices could begin to put pressure on the balance of payments.

10. Mrs Thatcher will be able to say that she has cut inflation dramatically. But with the labour market working as badly as ever, that cut is a remission, not a cure, of the British disease. Other countries have achieved as much, at lower cost in lost jobs and output.

depending on what that is, you have made a similar point yourself

A comparison with the 1974-79 average shows that UK inflation has fallen a good deal more than other major countries. Unemployment has risen by more but some of that is due to the very low productivity growth between 1974 and 1979.

CONCLUSIONS

11. As I have suggested in an accompanying note "Monetary policy and the economic situation" there are some difficulties ahead. And in the Autumn it will be critical whether we see any improvement in UK supply performance. But this article paints much too gloomy a picture of our performance relative to other countries.

p.p. A. [illegible]
Private Secretary

T BURNS

BRITAIN

The bad old days return

Britain's economy has done well for the past four years. As Conservative ministers often boast, it has had the fastest growth rate in Europe and lower-than-average inflation. That period now seems to be ending. Next year, Britain faces the unenviable combination of the slowest rate of growth of the big seven industrial economies, the highest rate of inflation—higher even than Italy's—the highest unemployment rate and a return to current-account deficit. This is the view not just of the perpetually gloomy forecasters at Britain's National Institute of Economic and Social Research, but also of their counterparts at the OECD, normally a more cheerful bunch.

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Coping with the cycle

remained weak in the second quarter: a balance of 16% of firms reported that their order books were below normal.

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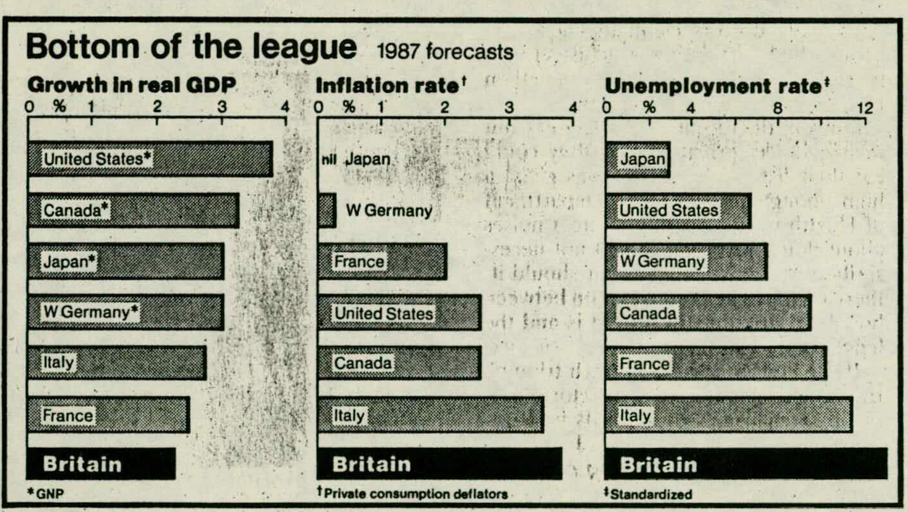

Source: OECD

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These forecasts suggest that Britain, by the time of the general election, will be suffering from many of the economic woes familiar from the 1960s and the 1970s. Mrs Thatcher will be able to say that she has cut inflation dramatically. But with the labour market working as badly as ever, that cut is a remission, not a cure, of the British disease. Other countries have achieved as much, at lower cost in lost jobs and output.

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Bad housekeeping

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The main source of money is still direct donations by companies and wealthy individuals to Central Office. A group of sophisticated collectors under the guidance of 73-year-old General Sir Brian Wyldbore-Smith, who has for 16 years been director of the Conservative Board of Finance, appeals to the baser and nobler instincts of company tycoons. Honours are not sold but they do sometimes follow outstanding munificence to the Tory party. It is easiest to make such appeals when the Tories are in opposition, or at least when a Tory government is popular. To some extent the general's collectors are being helped by the predatory noises being made by the Labour shadow chancellor of the exchequer, Mr Roy Hattersley, with his threats of higher taxation, renationalisation and direction of institutional investment.

Part of the problem is that constituencies do not pay their share to Central Office funds. Each constituency is given a quota which varies with how "Tory" it is. In 1984-85 the total quota was set at £1.8m but only about half of that—£892,000—was actually collected. Some constituencies paid two or three times their quota and some paid nothing—among them that of Mrs Thatcher's predecessor, Mr Edward Heath. Constituencies can get credits towards their quota when Central Office collectors tap a local businessman or when constituencies lend money to the Board of Finance.

One Central Office initiative is to try to persuade constituencies to make better use of their extensive property, which is to be surveyed by a property review committee, just set up by the Board of Finance. All constituency chairmen have

Is queueing healthy?

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Many of the recently installed NHS unit managers say privately that they could cut their lists if the matter was given a high enough priority. The Department of Health is now making discreet noises about doing just that. It will not necessarily mean more money, nor should it: there seems to be no correlation between how hard up a health district is and the length of its waiting list.

If Mr Fowler wants to snatch triumph from the resignation of Mr Victor Paige, the first chairman of the NHS management board, this is his chance. He should brief Mr Paige's successor to do something about the NHS's queueitis. Why not give managers a choice: cut your lists or your contracts will not be renewed? The new breed of managers—their agendas set by the management board—was brought in to run the NHS more efficiently. But nobody will believe they are doing so until patients get into hospital more quickly.

Waiting for a new Paige

RESTRICTED

FROM: H P EVANS

DATE: 6 June 1986

CHANCELLOR

cc: Chief Secretary
Economic Secretary
Sir P Middleton
Sir T Burns
Mr F E R Butler
Mr Cassell
Mr Kemp
Mr Peretz
Mr Sedgwick
Mr Scholar
Mr Culpin
Mr Davies
Miss O'Mara
Miss Noble
Mr Brooks
Ms Goodman
Mr Ross Goobey
Mr Hosker T. Sol
Mr Lewis T. Sol

Ch/ better tomorrow? RC 6/6

Yes. (I v. much agree with N.) N.

P.S. Incidentally Mr Fowler has withdrawn his objections to our EPR box on RPI less MI payments

good –

RETAIL PRICES INDEX ADVISORY COMMITTEE

The Committee is meeting on 12 June for what is intended to be its last meeting. The timetable from then on is set out in Lord Young's letter to you which arrived on 4 June. For the record the timetable is expected to be as follows:

12 June: RPIAC meeting

19 June or soon after: report finalised and submitted to Secretary of State

Same day: written answers to PQ from Secretary of State, announcing both receipt of report and arrangements for early publication at the same time as decisions on the recommendations. This written answer will also be repeated in a Press Release.

Late June/first half July: DE consult other departments about report and its recommendations, though with a strong presumption that all will be accepted.

Some time in July: publication of report as a White Paper, together with final decisions as soon as they are made. Announcement as further written answer to PQs, together with press notice

and were content with the proposed timetable, set out in the Young letter

2. You have seen Mr Peretz' minute to the Economic Secretary ("Changes to the RPI: Implications for index-linked gilts and savings certificates"). I attach a reply drafted by HF after discussion with Mr Hosker which says yes to the timetable, but suggests some official discussion nearer the time of the various announcements. There is a potential difference between us and DE about how far the prior announcement should go in indicating the significance of the proposals - where the more that can be said the better protected our position will be. But it will be easier to judge this when we have a text of the announcement to look at.

3. I also attach a summary of the Committee's 16 main recommendations, as now drafted. The great majority are minor technical improvements, likely to have a negligible effect on the index. But two are of substance.

4. Recommendation ix) refers, rather obscurely, to price discounts. It affects mainly housing benefit: in future, it is proposed to treat this as a form of income support, not as a price reduction. Hence all rents and rates will in the future be measured gross of housing benefit, instead of the current practice of treating supplementary benefit recipients gross and others net. This change is in line with Treasury views. Its effect on the index will depend on whether housing benefit in future increases faster or slower than the RPI: if, as I understand it, the intention is to uprate housing benefit in line with some measure of inflation, there should be little or no effect of this proposal on future RPI changes.

5. The major area of disagreement is of course on mortgage interest payments, recommendation (x). The proposals are a slight improvement, both conceptually and in practice - since there is a

slight reduction in the weight below what it would otherwise have been. But the major unsatisfactory features of the previous system remain. As far as I can see, the proposed treatment will make virtually no difference to future changes in the RPI.

X 6. In all, it would seem very difficult to regard the proposed changes to the index either as "fundamental" or as "materially detrimental", and least of all both.

7. When the final report is available we will provide more briefing on the proposed changes. A paper is being drafted, initially at least for internal purposes, on the treatment of owner-occupiers' housing costs - in the expectation that the DE paper - an Annex to the main report -will not be satisfactory.

HPE

H P EVANS

2935/052

pwp

ECONOMIC SECRETARY TO THE TREASURY

FROM: M NEILSON
DATE: 6 June 1986

PPS

cc: Chief Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Evans
Mr Peretz
Mr Sedgwick
Mr Culpin
Mr Walsh
Miss O'Mara
Mr Mathews
Mr Richardson
Ms Goodman
Mr Ross Goobey
Mr Hosker T.Sol
Mr Lewis T.Sol

CHANGES TO THE RPI: IMPLICATIONS FOR INDEX LINKED GILTS AND SAVINGS CERTIFICATES

The Economic Secretary has seen your minute of 5 June giving the Chancellor's views on this subject. The Economic Secretary also accepts the advice in Mr Peretz's minute, and is content with Lord Young's timetable. He has two further points:

(i) To withdraw Index Linked National Savings would draw attention to the problem and perhaps be seen as a sign of uncertainty or weakness in the Government's position.

(ii) He would be grateful if Mr Peretz could indicate when the results of the Bank's preliminary consideration of the changes will be available.

MJN

M NEILSON

CONFIDENTIAL

FROM: DAVID PERETZ
9 June 1986

PS/ECONOMIC SECRETARY

cc PPS
PS/Chief Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr H Evans
Mr Sedgwick
Mr Culpin
Mr H Walsh
Miss O'Mara
Mr T Mathews
Mr M Richardson
Ms Goodman
Mr Ross Goobey
Mr Hosker T.Sol
Mr Lewis T.Sol

CHANGES TO THE RPI: IMPLICATIONS FOR INDEX LINKED GILTS AND SAVINGS CERTIFICATES

You asked if I could indicate when the results of the Bank's preliminary consideration of these changes will be available.

2. The answer I am given is that the Bank is moving as fast as it can, subject to the need to give the changes a full and rigorous examination (of a kind that would stand up to challenge). I have strongly urged Mr Plenderleith to do his best to let us have at least a preliminary view in good time before the meeting on 12 June.

D L C PERETZ

cc Mr Plenderleith B/E

1t/NGF

FROM: N G FRAY

DATE: 9 June 1986

MR P DAVIS

PRODUCER PRICES FOR MAY

The Chancellor has seen and was grateful for your minute of 9 June.

Nigel Fray

N G FRAY

RR7.21

FROM: MRS R LOMAX
DATE: 9 June 1986

SIR T BURNS

cc Sir P Middleton

CONFERENCE ON THE BRITISH ECONOMY

The Chancellor was grateful for your minute of 3 June, attaching a copy of the comments you made at this conference.

2. The Chancellor hesitates to suggest amendments to what are after all your own comments, but he has a number of points on paragraphs 19, 20 and 22, as follows:-

- Paragraph 19: The Chancellor has commented that if Professor Fischer thinks we have an interest rate target - which we do not - what does he think it is?

- Paragraph 20, final sentence: The Chancellor would put this as follows "But it has been accepted that some of the pressure should be borne by money supply and exchange rate variation rather than it all being passed on to interest rates".

- Paragraph 22: The Chancellor would prefer to see all of this paragraph, after the first sentence, deleted.

3. The Chancellor has observed that, regrettably, there continues to be some difference between the two of you over the fiscal monetary mix, though he does not think it is very great in practice. As for the Fischer paper, the Chancellor is still brooding over it.

RL

RACHEL LOMAX

57/DR/LT

FROM: MRS R LOMAX

DATE: 9 June 1986

MR KING

cc PS/Financial Secretary
PS/Economic Secretary
PS/Minister of State
Sir P Middleton
Sir T Burns
Sir G Littler
Mr H P Evans
Mr Odling-Smee
Mr Scholar
Mr Culpin
Miss O'Mara

ECONOMIST : 'THE BAD OLD DAYS RETURN'

The Chancellor was grateful for your minute of 6th June. He wonders if we really think that our inflation is going to be higher than Italy's?

RL.

RACHEL LOMAX

3083/015

CONFIDENTIAL
UNTIL 11.30 a.m. 9 June then
UNCLASSIFIED

FROM: PAUL DAVIS
DATE: 9 June 1986

SJD 9/6.

1. MR S J DAVIES
2. CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir Peter Middleton
Sir Terrence Burns
Mr Monck
Mr H P Evans
Mr R Culpin
Mr Gilhooly
Miss O'Mara
Mr Pickford
Mr S Brooks
Mr Hacche
Mr Pickering
Mr Cropper
Mr Ross Goobey
Mr Tyrie

Nigel

PRODUCER PRICES FOR MAY

The Producer Price Indices for May will be published at 11.30 a.m. on Monday 9 June. The annual increase in output prices has fallen slightly to 4.5 per cent. The fall in input prices over the year to May was about a percentage point smaller than the fall over the year to April.

CONFIDENTIAL
UNTIL 11.30 a.m. 9 June then
UNCLASSIFIED

Producer Prices (percentage change over a year earlier)

	Output Prices		Input Prices		
	All	All excl FDT*	All	All (Seasonally Adjusted)	All excl FDT*
1985 Q2	5.6	6.4	3.4	3.4	6.8
Q3	5.6	6.5	- 0.7	- 0.7	- 1.2
Q4	5.1	5.9	- 5.4	- 5.4	- 5.1
1986 Q1	5.0	5.0	- 9.4	- 9.4	- 11.9
March	4.9	4.7	- 11.1	- 11.1	- 14.9
April	4.6	4.4	- 9.4	- 9.3	- 12.0
May	4.5	4.4	- 8.5	- 8.3	- 11.8

* Excluding the food, drink and tobacco industries.

2. Before seasonal adjustment the producer price index for inputs to manufacturing industry fell by 0.4 per cent between April and May reflecting lower prices for petroleum products and a seasonal fall in the costs of industrial electricity.

3. After seasonal adjustment, the index for manufacturing industry was unchanged. The overall fall in the year to May 1986 was 8.3 per cent, compared with a revised figure of 9.3 per cent in the year to April.

4. Between April and May, the producer output price index rose by 0.2 per cent. Excluding the food, drink and tobacco industries, the increase remained 0.2 per cent.

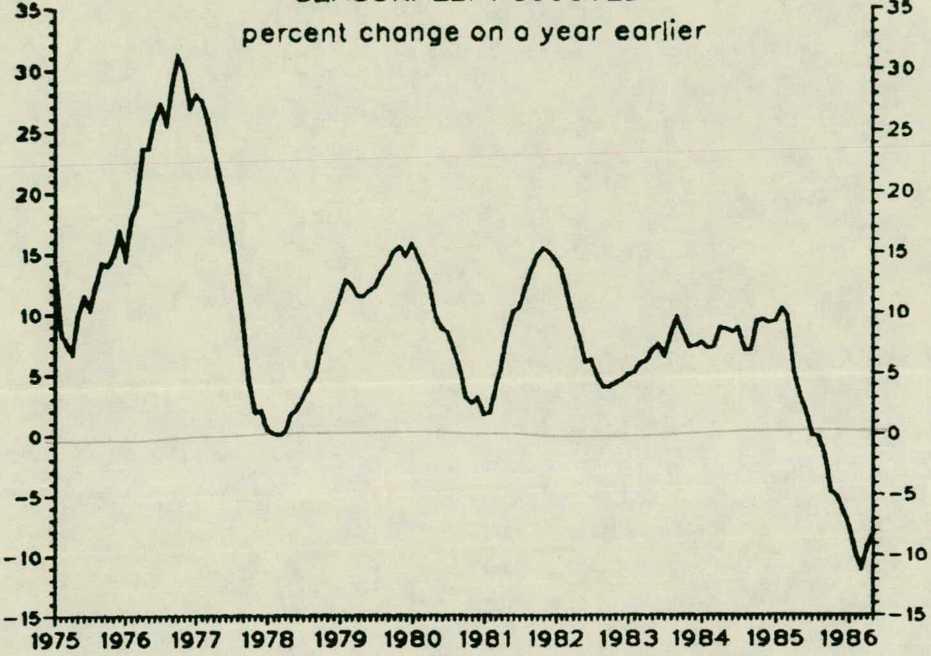
5. I attach two charts showing the movements in producer input and output prices from January 1975.

Paul D

PAUL DAVIS
EA1 Division
x 3434

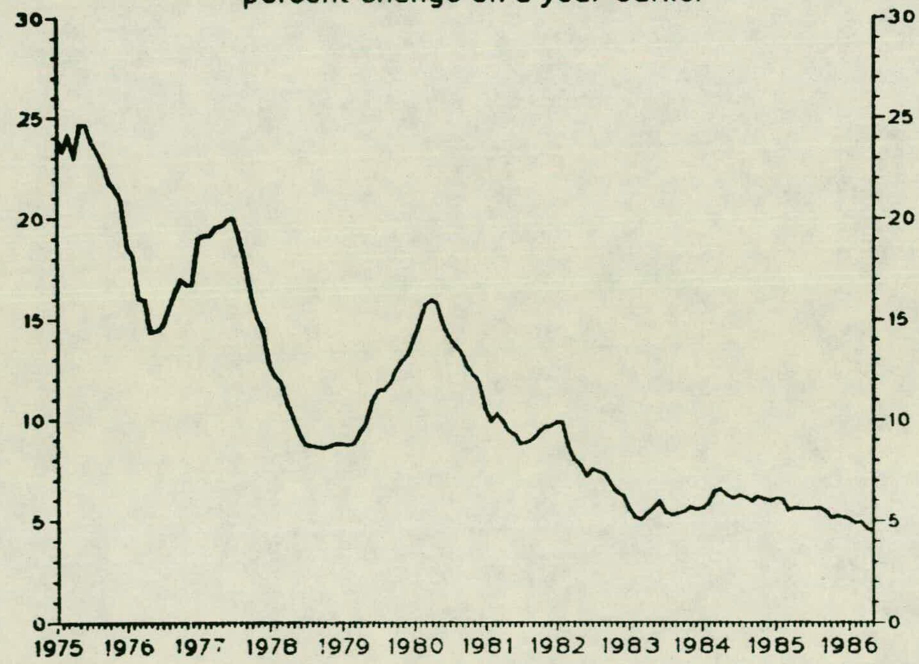
MATERIALS AND FUEL PURCHASED BY MANUFACTURING INDUSTRY
SEASONALLY ADJUSTED

percent change on a year earlier



PRODUCER OUTPUT PRICES

percent change on a year earlier



61/DR 1/1t

cc CST
EST
Sir P Middleton
Sir T Burns
Mr F E R Butler
Mr Cassell
Mr Kemp
Mr Peretz
Mr Sedgwick
Mr Scholar
Mr Culpin
Mr Davis
Miss O'Mara
Miss Noble
Mr Brooks
Ms Goodman
Mr Evans
Mr Ross Goobey
Mr Hosker - T. Sol
Mr Lewis - T. Sol

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

Lord Young
Secretary of State for Employment
Caxton House
Tothill Street
London
SW1H 9NF

10 June 1986

Dear David

RETAIL PRICES INDEX ADVISORY COMMITTEE

Thank you for your letter setting out the timetable you propose to follow for announcing the publication of the RPIAC report and your decisions. I am content with what you suggest.

I suggest that nearer the time, officials meet to agree the precise wording in the announcement, including the significance of the changes, taking legal advice to ensure that our position is as well protected as possible.

Yours ever
Nigel

N LAWSON

FROM: S J DAVIES
DATE: 10 JUNE 1986

① [illegible]

② 1st order / Overseas briefing 13/6

CHANCELLOR OF THE EXCHEQUER

cc:
PS/Financial Secretary
PS/Economic Secretary
PS/Minister of State
Sir Peter Middleton
Sir Terence Burns
Sir G Littler
Mr Odling-Smee
Mr Evans
Mr Scholar
Mr Culpin
Mr Matthews
Miss O'Mara
Mr S King

ECONOMIST: 'THE BAD OLD DAYS RETURN'

1. You asked (Mrs Lomax' minute to Mr King of 9 June) whether we believed that our inflation rate is going to be higher than Italy's. (The OECD have Italian consumer price inflation at 3.5 per cent in 1987, while UK consumer prices are forecast to rise by 3.75 per cent.)

2. The answer is that we do not expect Italian inflation to fall below UK inflation in 1987. The OECD are out of line with other forecasts of Italian inflation: for example the IMF's April forecast put Italian inflation at 5.8 per cent in 1987, and EEC forecasts completed recently put Italian inflation at 4.8 per cent in 1987.

3. We expect Italian inflation to be a point or more above UK inflation in 1987.

SJD

S J DAVIES

LD/053

FROM: MRS R LOMAX
DATE: 10 JUNE 1986

SIR T BURNS

bf 12/6
(for 1st Order Questions meeting)

cc Sir P Middleton
Mr Evans
Mr Culpin
Miss O'Mara

THE BAD OLD DAYS

The Chancellor was most grateful for your minute of 6 June. He has noted that it is relevant to briefing for First Order Questions this month.

RACHEL LOMAX

27:2

PERSONAL AND CONFIDENTIAL
Until 11.30am on Thursday 12 June

You already have the DEm. [illegible] note

FROM: GWYN HACCHE
DATE: 10 June 1986

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

The figures are again not good, though they probably reflect the pause in activity which the industrial world as a whole has experienced. But the popular press may seize on the fall in the headline count.

MOM 10/6

Nigel

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
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 Cropper
Mr Ross Goobey
Mr Tyrie
HB/01

COMBINED RELEASE OF LABOUR MARKET STATISTICS ON 12 JUNE: UNEMPLOYMENT AND EMPLOYMENT FIGURES

Unemployment

Seasonally-adjusted adult unemployment (excluding school leavers) rose by nearly 6,000 in May to 3,209,000, 13.3 per cent of the employee labour force. The headline total fell by 54,000 to 3,271,000 and is expected to fall sharply again next month. The stock of unfilled vacancies, seasonally adjusted, rose slightly in May to 171,000.

2. The average monthly increases in unemployment for both the three months and six months to May was 16,000.

	Average monthly changes		thousands
	April to May	6 mnths to May (previous six months in brackets)	3 mnths to May (previous three months in brackets)
Seasonally adjusted	+6	+16 (+14)	+16 (+17)

Features of the figures compared with April are shown below (figures not seasonally adjusted except where indicated):

Thousands (rounded)

	Levels		Change
	April	May	
Stock of unfilled vacancies (s.a.)	169	171	+2
Effect of employment and training measures on unemployment count (excluding school leavers)	end* 363 (Mar)	end* 375 (April)	+12
Headline total	3,325	3,271	-54
less claimant school leavers	112	111	- 1
less seasonal factors	10	-49	-59
Adult unemployment (seasonally adj): of which	3,203	3,209	+ 6
- Males	2,208	2,210	+ 2
- Females	995	999	+ 4

4. Points of interest are:

(a) Seasonally adjusted total highest on record. April saw sixth consecutive monthly increase.

(b) Headline total highest May level recorded - equivalent to 13.5 per cent of employee labour force.

Employment figures

5. There have been some minor revisions to the figures for the whole economy employed labour force which is now estimated to have increased by 995,000 between March 1983 and December 1985, and by 953,000 between June 1983 and December 1985. However, this does not lead us to revise our statement that the number of new jobs has risen by almost 1 million since June 1983. Figures for 1986Q1 will be available next month.

6. The number of employees in employment in manufacturing industries is estimated to have fallen by 7,000 in April. The average decrease of 13,000 per month over the three months ending April included an unusually large reduction in February. (The average decrease over the two years to April is 3,000 per month)

*Given that the unemployment count date is early in the month, the effect at the end of the previous month is more relevant than the effect at the end of the same month.

Assessment of Unemployment and Employment Statistics

7. The latest labour market statistics seem to confirm that the underlying picture is now less favourable than it was in the autumn.

8. Seasonally adjusted unemployment has now risen in each of the past six months, by some 16,000 per month on average. The rises over the past two months of 4,000 and 6,000 have been relatively modest, compared with sharp rises in December, January and particularly March; but, taken together, the figures indicate a continuing upward trend. This is despite the favourable impact on the trend from employment and training measures, particularly the growth in the Community Programme. Without the growth in these measures, it seems that the underlying upward trend in adult claimants would be above the range of 10 to 15,000 per month experienced in the 2 years up to spring last year.

9. Manufacturing employment may also be decreasing more rapidly than in the autumn after a period in the middle of last year when there was only a very slow downward drift. The picture is complicated, however, by large monthly fluctuations. The exceptional decrease of 30,000 in February (affected by falls in the newspaper industry and probably by the very cold weather) is reflected in the average decrease of 13,000 per month for the three months ending April. This compares with an average decrease of 4,000 per month in the previous three months.

10. Overtime and short time working also provide indications of a slackening in labour market activity and flows of vacancies are a little lower than in the second half of last year.

11. The apparent deterioration in the labour market picture since last autumn is consistent with the indicators for demand and output for recent months.

Press Release and briefing for No 10

12. You have seen Caroline Slocock's letter of 9 June to No 10 which encloses briefing for the Prime Minister on the combined press release. Though containing a number of gloomy references (for example in the press notice: 'the figures for the past few months clearly indicate a continuing upward trend' in unemployment) there are helpful references to the number of new jobs created since March 1983.

13 We understand that, as on previous occasions, Lord Young will probably be issuing a statement to accompany the press notice. This is not normally cleared with the Treasury and we do not know what he is planning to say this month. Your office may therefore like to contact his to ensure the tone is appropriate.

g agree, but he always tries to be as upbeat as possible.

14. From next month additional unemployment rates will also be provided taking account of the self-employed. This is referred to in notes to editors in the press notice. We will provide full briefing on this next month.

LINES TO TAKE

15. **Unemployment:-**

Positive

On May figures

Modest increases in April and May confirm large increase in March was erratic, connected with bad weather. Male unemployment has fallen slightly over last 2 months.

On vacancies

Over three months to May seasonally adjusted vacancies have increased on average by 2,000 per month.

Defensive

(i) On deterioration in unemployment trend

UK unit labour costs still outstripping those of major competitors. Until rate of pay settlements comes down, cannot expect major improvement in unemployment trend.

(ii) FSBR wrong about prospects for unemployment/MSC predict gloomy future for unemployed

(FSBR stated 'with output and employment continuing to grow and labour force slowing down, prospects for unemployment are better than they have been for some years'. Foreword to MSC's new corporate plan states 'unemployment, especially long term unemployment, is likely to remain at historically high levels.)

Reasons for optimism still stand: labour force expected to grow less rapidly and recent revisions to employment figures show even stronger employment growth than we had previously thought. But cannot expect major improvement in unemployment trend until rate of pay settlements comes down.

(iii) Long term unemployment expected to fall over next six months

[Lord Young 4 June 'I would venture a forecast that in six months' time we may well see it (long term unemployment) lower'.]

National Restart programme will have beneficial effect on long term unemployment. But cannot expect major improvement in unemployment trend until rate of pay settlements come down.

Employment

The data have been revised slightly but otherwise contain nothing new and are unlikely to attract attention. The line therefore remains as in Mr Vernon's minute of 15 April. Key points are:

Positive

(i) Nearly one million more jobs created since June 1983.

(ii) Extra employment in UK since June 1983 more than in rest of European Community combined.

Defensive

(i) Employment growth in 1985 less than that in 1984. Still 279,000 more jobs in 1985. Growth in employment in 1985Q4 larger than in earlier quarters of year.

(ii) Large fall in manufacturing employment in last 3 months.

Most of fall occurred in one month, February, which was adversely affected by very bad weather. Falls averaging 5,000 a month since June 1983 well down on average 10,000 a month fall under Labour Government

Gwyn Hacche

GWYN HACCHE

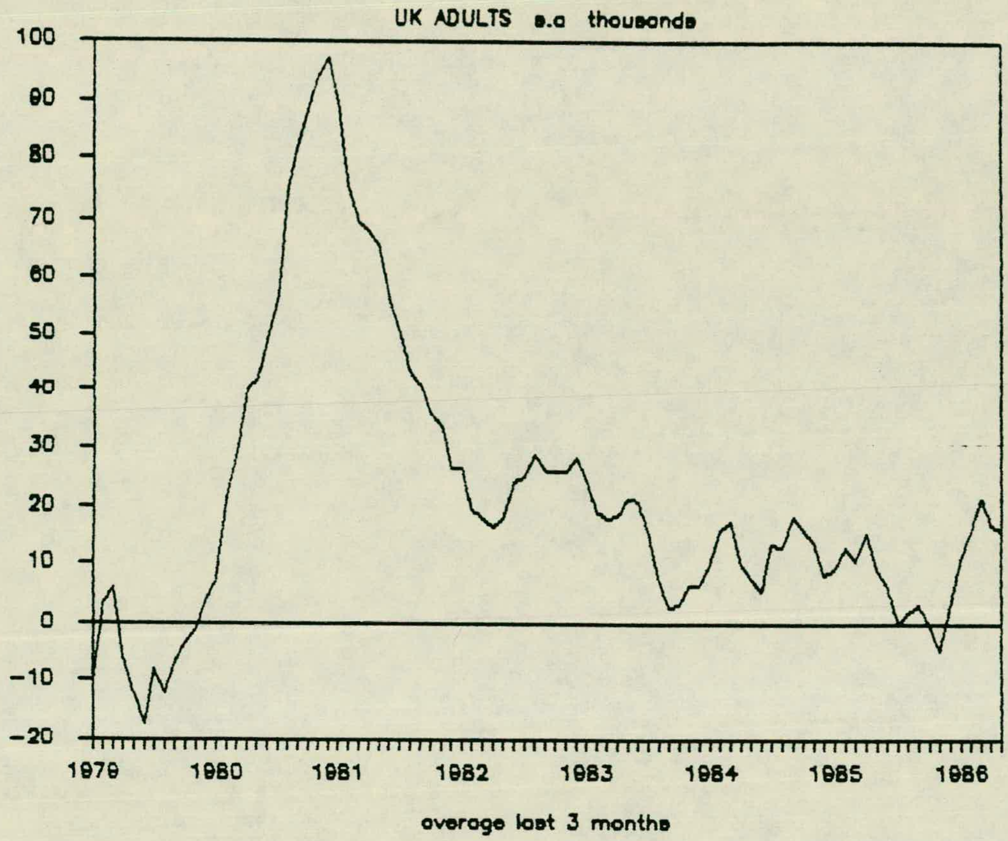
LABOUR MARKET TRENDS

all figures seasonally adjusted

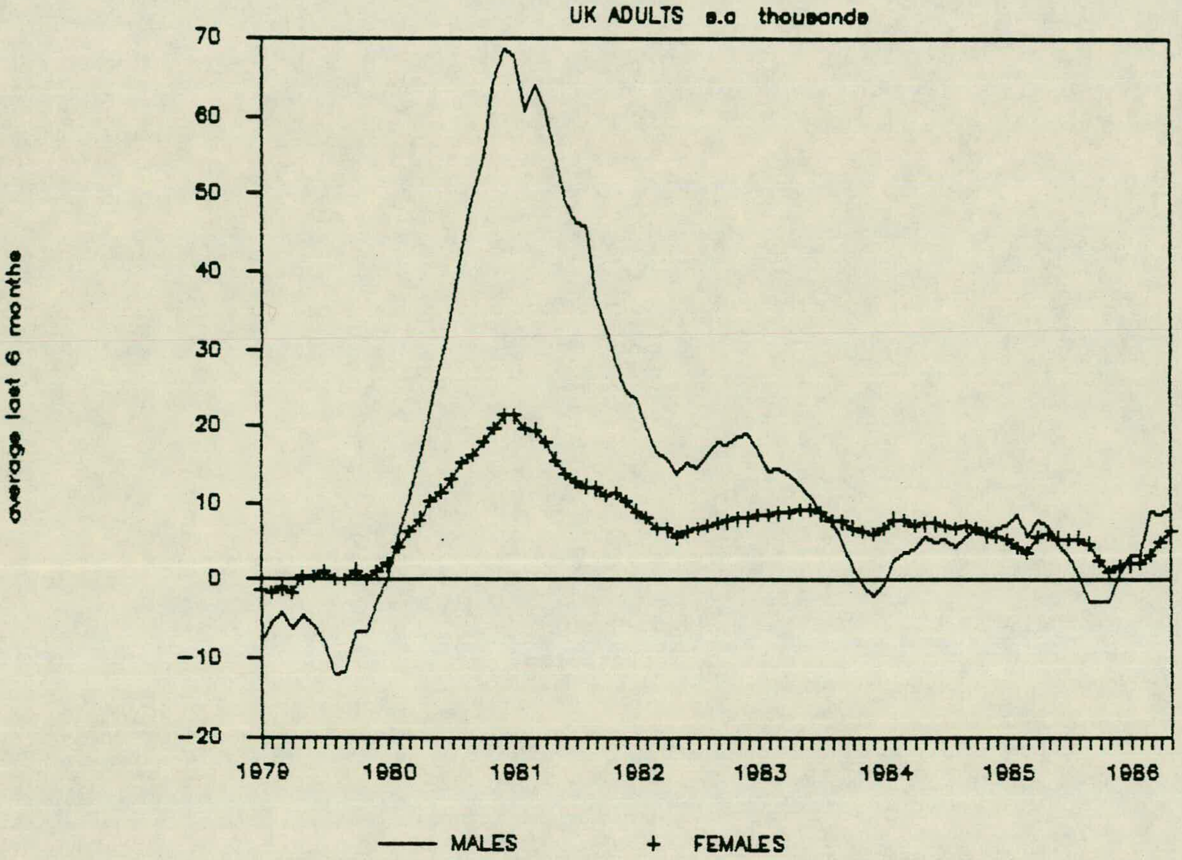
	Whole Economy (UK)		Great Britain					
					Manufacturing			
	Adult Unemployment changes	Stock of Notified Vacancies	Employed Labour Force ** Changes (Quarterly)	Employees in Employment Changes (Quarterly)	Employees in Employment Changes	Short-time (operatives)	Overtime (operatives)	Average Weekly Hours 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	70	90	-237	-264	-55	5.9	8.5	96.8
June	56	82	-211	-238	-45	4.6	9.2	98.6
Sept	41	90	-118	-132	-27	2.6	9.9	100.2
Dec	27	102	-145	-155	-28	1.9	10.0	100.1
1982 Mar	18	113	-44	-52	-18	1.8	10.3	100.6
June	25	113	-110	-118	-31	1.8	10.2	100.6
Sept	26	113	-125	-138	-29	1.6	9.8	100.4
Dec	29	116	-137	-148	-29	1.6	9.7	100.7
1983 Mar	17	123	-62	-74	-21	1.3	9.8	101.0
June	21	133	42	27	-16	1.1	9.6	101.0
Sept	3	145	129	58	-12	0.6	11.0	102.0
Dec	7	148	153	84	-6	0.5	11.2	102.4
1984 Mar	17	146	99	29	-9	0.6	11.2	102.5
June	6	149	85	17	-1	0.7	11.6	102.6
Sept	18	152	76	47	-1	0.7	11.5	102.5
Dec	8	154	132	105	3	0.5	11.9	103.2
1985 Mar	11	154	63	38	-5	0.5	11.9	103.1
June	7	162	61	33	0	0.3	12.4	103.3
Sept	3	164	49	19	0	0.4	12.2	103.4
Dec	3	168	106	79	-4	0.3	12.2	103.6
1986 Mar	22	165			-12	0.5	11.7	103.0
Apr	17	168				0.6	11.6	102.8
May	16	170						

**UK employees in employment,armed forces,plus an assumed 31,000 increase per quarter in self employment from 1985Q3

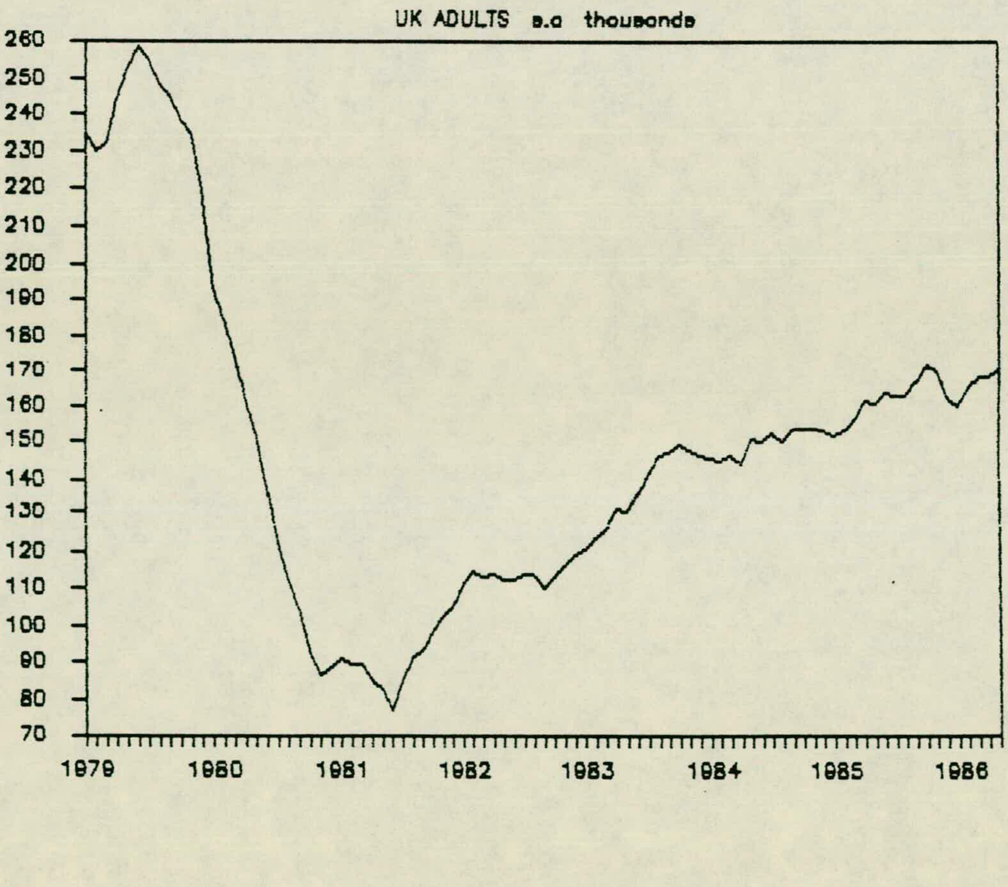
CHANGES IN UNEMPLOYMENT



CHANGES IN UNEMPLOYMENT BY SEX

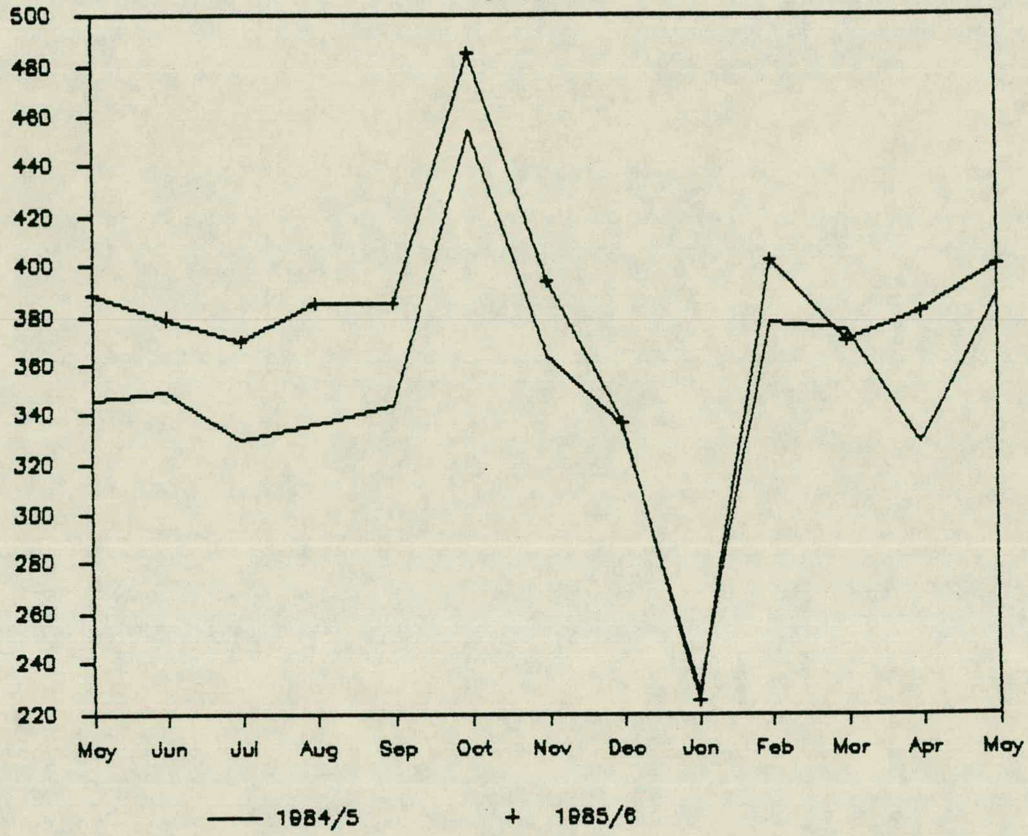


VACANCIES



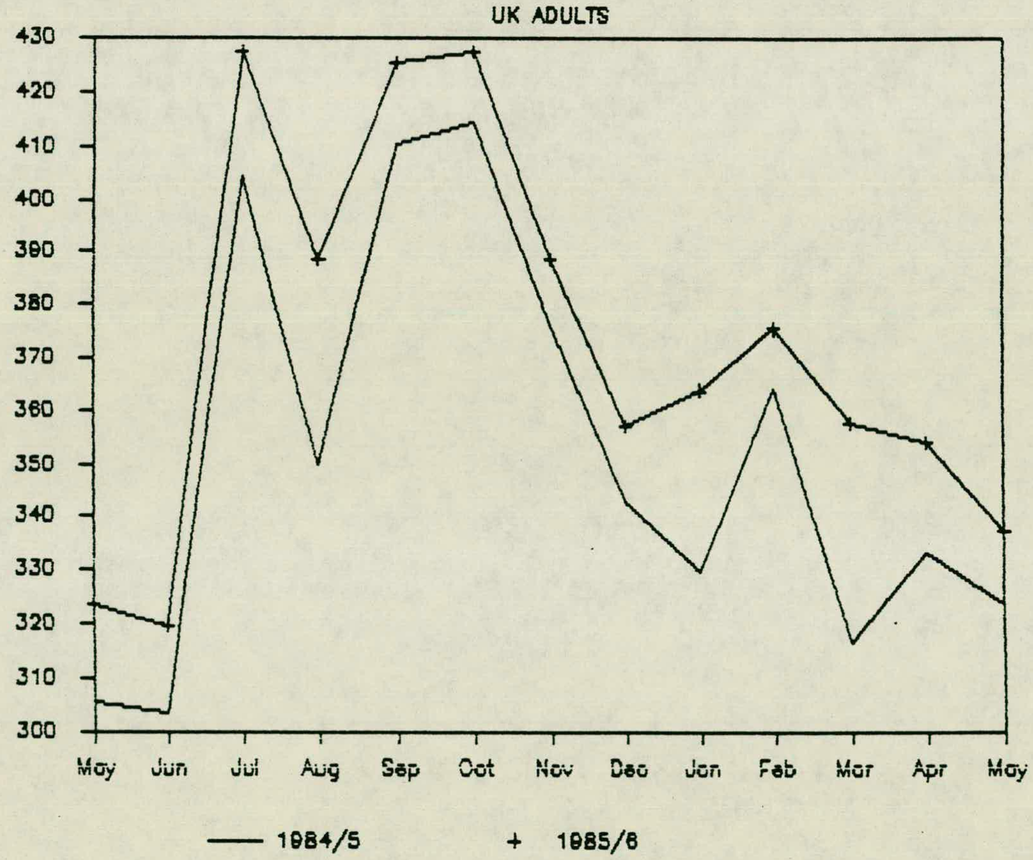
OUTFLOWS

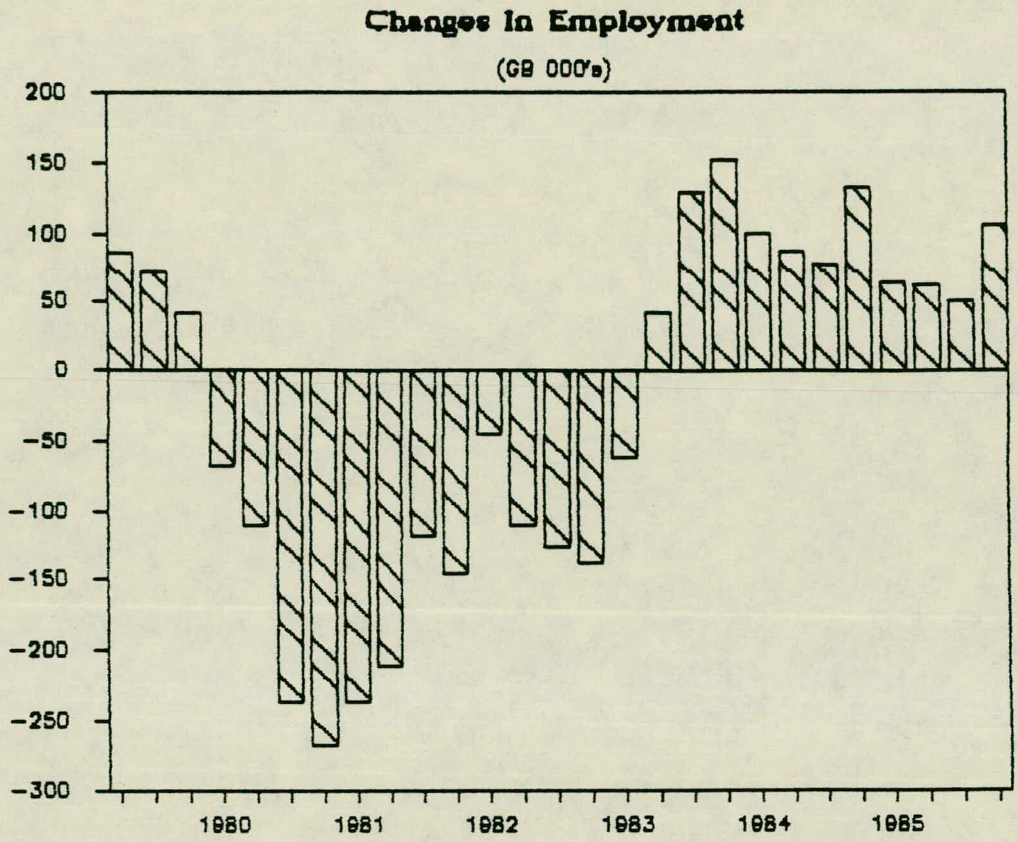
UK ADULTS



INFLOWS

UK ADULTS




Changes in Employment
(GB 000's)
200
150
100
50
0
-50
-100
-150
-200
-250
-300
1980
1981
1982
1983
1984
1985

CONFIDENTIAL

FROM: S BROOKS
DATE: 11 JUNE 1986

1. MR S J DAVIES
2. CHANCELLOR OF THE EXCHEQUER

cc: PS/Chief Secretary
PS/Financial Secretary
PS/Minister of State
PS/Economic Secretary
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 o/r
Mr Scholar
Mr Culpin
Mr Gilhooly
Miss O'Mara
Mr Pickford
Mr Hacche
Mr Halligan
Mr P Davis
Mr Westwater
Mr Ross Goobey
Mr Cropper
Mr Tyrie

THE MAY RPI (to be published at 11.30 a.m. on Friday 13 June

The level of the RPI rose by 0.2 per cent between April and May. The twelve month rate of inflation fell from 3.0 per cent in March to 2.8 per cent in April. This is in line with what we expected, and is the lowest twelve month increase since January 1968 (2.6).

2. Excluding mortgage interest payments, the twelve month rate fell from 3.4 per cent in April to 3.1 per cent in May. Excluding housing, the twelve month rate fell from 2.6 per cent to 2.4 per cent.

3. Some of the reduction in mortgage rates in April did not affect the index until May. Coal prices fell as summer discounts took affect. Petrol prices fell by nearly 9 p per gallon. However, there was marked rise in the price of cigarettes - probably the delayed effects of Budget duty increases which did not seem to show up fully in the April index. Also the prices of some fresh vegetables, especially tomatoes, increased sharply. Otherwise there were a number of minor price reductions and increases.

4. In June, we expect the twelve month rate to decline to around 2.5 per cent. The index will be affected by a reduction of 1 per cent in the mortgage rate effective for most borrowers on 1 June. Petrol prices, on the other hand, will probably show a small rise over May. The adjustment of petrol prices to the lower oil price is now more or less complete and any residual downward pressure may be more than offset by seasonal factors which tend to increase petrol prices at this time of year.

5. The RPI figures are as expected in the City. Wood MacKenzie and James Capel are correctly anticipating a twelve month rate of 2.8 per cent, while Phillips & Drew and Laing Cruickshank expect a rise of 2.9 per cent.

S BROOKS
EA1 DIVISION
X 7946

FROM: A ROSS GOOBEY
DATE: 12 JUNE 1986

CHANCELLOR

cc Sir P Middleton
Sir T Burns
Mr Monck
Mr Evans
Mr Burgner
Mr Scholar
Miss O'Mara
Mr Culpin
Mr Cropper
Mr Tyrie

SHORT TERM ECONOMIC INDICATORS

I have been in contact with BOC, who, as we have discussed, produce compressed oxygen and argon products which are extremely sensitive to short term demand factors.

2. BOC will be pleased to supply us with these figures on a monthly basis (in confidence) a week after month end.

3. The current position is quite depressed, falling quite sharply in Jan-March and May. The attached graph plots CSO Industrial Output (dotted line) against compressed oxygen volume (but not argon which they will add in to future figures) and steel output (which does not take compressed oxygen and is merely another proxy for industrial activity). BOC supply 225,000 individual customers in many trades.

4. If divisions think it would be useful, I could approach one or two other companies which I think would provide good real-time data. For instance - RS Components (the biggest electrical/electronic component suppliers), BET (for road transport loadings) which we could link with existing statistics (steel production, vehicle registration/production, brick production, John Lewis Partnership Sales) to produce an internal index of activity which would be more timely than CSO statistics and would not appear at the same time as, say the CBI statistics.

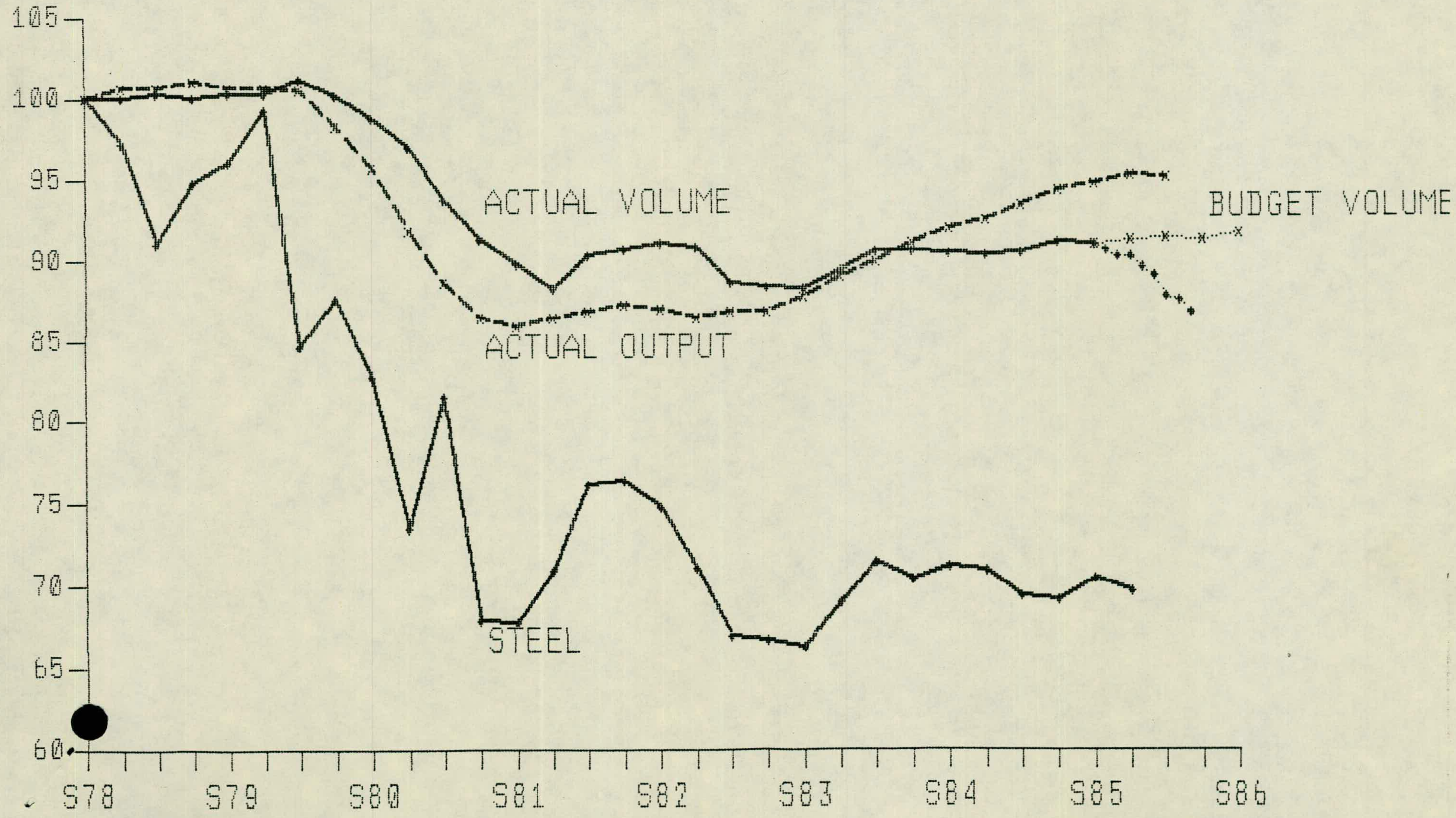
ARG

A ROSS GOOBEY

compressed

MAT's - OXYGEN VOLUME & MANUFACTURING OUTPUT

2225/< customer



FROM : P N SEDGWICK
DATE : 13 JUNE 1986

MRS LOMAX

cc Sir P Middleton
Sir T Burns
Mr Evans

COMPETITION TO PREDICT INFLATION AND GROWTH IN 1986 AND 1987

You asked me to specify more precisely how to carry out the forecasting competition that the Chancellor suggested at his meeting last Monday on monetary policy.

Time periods

2. As I understand it the idea is to predict for growth and inflation

(a) the outcome for 1986

and (b) what the forecasters will be predicting for 1987 in the immediate pre-budget period next year.

3. I suggest that for GDP the participants are asked to predict the changes between 1985 and 1986 and between 1986 and 1987. For prices the participants could predict the increase in the RPI in the years to the fourth quarters of 1986 and 1987. These are the time periods on which the Industry Act forecast in the FSBR (Table 3.14 in the 1986 FSBR) concentrates.

4. Of course predictions of what the forecasters will say about 1987 at the beginning of the year is a rather odd exercise, but still an interesting one.

5. It might help to illustrate what is required of participants if you include the table below in the competition questionnaire.

	Per cent	Changes on a year earlier	
	FSBR* forecast	Average of outside forecasts as at May 1986	Prediction of HMT January 1987 forecast
GDP 1986	3	2.5	
1987	2.4	2.7	
RPI 1986Q4	3.5	3.5	
1987Q4	3.3	4.3	

* explicit for 1986; unpublished for 1987, but consistent with short term forecast to mid 1987 and MTFS assumptions thereafter.

What constitutes the outturn

6. The 'outturn' - if that is the right term - with which predictions made today will be compared is the pre-budget forecast delivered at the end of January. (NB this can differ from both the forecast eventually incorporated in the FSBR and the very short summary note on economic prospects that is circulated for the Chevening weekend.) It is worth bearing in mind that for GDP the forecasters will still be forecasting 1986. The RPI, for which there is never any revision of back figures, for the end of 1986 will be known by mid-January.

7. An alternative to use of the January Treasury forecast would be to use an average of outside forecasts. I am not in favour of this, partly because, as I understand it, one of the purposes of this exercise is to predict how our own views will develop.

8. You ought to make it clear to participants that strikes, wars, elections (or the fear of them), etc. are all hazards of the course and that there will be no allowance for them.

How to measure errors

9. This raises some problems. What the Chancellor decides to do will depend on whether he wants to know who best predicts inflation and growth separately, or whether he wants to know who has the best

overall record taking account of both inflation and growth. If he wants to deal with inflation and growth separately the winner could be the person whose 'forecasts' for the two years have the lowest <u>average absolute error.</u> (This is the measure used in the authoritative Royal Society lecture on <u>"The interpretation and use of economic prediction"</u> by Sir T Burns.)

10. If the Chancellor wants to know who has the best overall record on growth and inflation it is rather more difficult to devise a satisfactory criterion. I have been surprised to discover that there is no acceptable criterion for weighting forecast errors on different variables, eg the components of demand. (The <u>Financial Times</u> tried to do this in a rather unsatisfactory way recently.) The problem is that for a variety of reasons the size of average percentage errors on different variables can differ by large amounts. I attach two tables from the recent Burns paper that illustrate this point. For four and eight quarters ahead respectively the average absolute percentage errors on the RPI have been twice and 2.3 times those on growth in the period 1980-85. I suggest that the measure of absolute forecasting performance should give half weight to errors on the RPI, ie

half of wt. [illegible]

$$\text{Measure of overall performance} = \text{Average absolute error on growth} + \frac{\text{Average absolute error on RPI}}{2}$$

<u>Who should compete</u>

11. Although participation in this competition would not in any way influence the expressed views of the forecasters next January it would probably be better for them not to participate. Huw Evans should therefore unambiguously be the umpire rather than a player*. I don't think there is any need for the same considerations to apply to Sir T Burns, even though he chairs the important meetings on the forecast.

---

*He would prefer <u>not</u> to know the predictions in advance! The The Chancellor's idea was that the predictions should be in sealed envelopes and kept, presumably, in his private office.

12. The participants could therefore be those who attended the monetary policy meeting, namely

Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mr Peretz
Mr Sedgwick

plus one or two others closely involved in macroeconomic policy making such as

Mr Butler
Mr Odling-Smee
Mr Scholar

I leave it to you to decide whether anyone from private office or any of the political advisers should participate.

13. Finally I suggest that departure from the Treasury, for whatever reason, should automatically lead to the persons concerned dropping out of the competition.

Prizes or penalties

14. Finally you ought to consider whether the possibility of a reward or a penalty will help to motivate participants to provide properly considered forecasts. All participants could make a small contribution (say £1-5 per head) which the winner could take (the sweepstake principle), or a magnanimous benefactor could, say, provide a bottle (or bottles) of whisky. It is difficult to think of realistic penalties - perhaps the possibility of having to lead the post-budget team of officials to the TCSC, an honour usually falling to the head of Central Unit, might be an incentive to be realistic.

P.N.S

P N SEDGWICK

Table 1

Forecast Errors for GDP by Sub-Period: 1970-1985

(Index of variation in brackets)

Forecast Horizon (Quarters)

	2	4	6	8
1970-74	2.1 (3.2)	2.7 (4.0)	3.3 (4.8)	4.5 (5.6)
1975-79	1.4 (2.0)	1.3 (1.9)	1.7 (3.3)	1.9 (4.3)
1980-85	.9 (1.4)	.9 (2.7)	1.3 (3.6)	1.9 (5.1)

Table 3

Forecast Errors for RPI by Sub-Periods: 1970-1985

(Index of variation in brackets)

Forecast Horizon (Quarters)

	2	4	6	8
1970-74	.7 (1.6)	2.2 (4.1)	5.9 (8.4)	10.5 (12.1)
1975-79	.7 (3.3)	1.5 (6.1)	3.4 (8.8)	5.2 (12.7)
1980-85	.7 (1.6)	1.9 (2.6)	3.4 (5.8)	4.4 (10.2)

Within the sub-periods the reduction of error in later years is concentrated in quarters 6 and 8; in the final period there is also a lower measure of variation of inflation.

CONFIDENTIAL

P A

FROM: S BROOKS
DATE: 13 JUNE 1986

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

cc: PS/Chief Secretary
PS/Financial Secretary
PS/Minister of State
PS/Economic Secretary
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 o/r
Mr Scholar
Mr Culpin
Mr Gilhooly
Miss O'Mara
Mr Pickford
Mr Hacche
Mr Halligan
Mr P Davis
Mr Westwater
Mr Ross Goobey
Mr Cropper
Mr Tyrie

THE MAY RPI: ADDENDUM

The figure given for the twelve month change in the RPI excluding mortgage interest payments in May should be amended to 3.1 per cent from 3.2 per cent. More precise information is now available from Department of Employment.

S Brooks

S BROOKS
EA1 DIVISION
X 7946

Pls let me have, ASAP, a table showing G7 output/GDP, jobs since ... consumer prices, ... current ... by country

GRS 550

RESTRICTED
FM TOKYO
TO PRIORITY FCO
TELNO 650
OF 140055Z JUN 86
INFO ROUTINE BANK OF ENGLAND, HM TREASURY, DTI, WASHINGTON
INFO ROUTINE UKREP BRUSSELS

MY TELNO 597: JAPAN: GENERAL ELECTION

SUMMARY

1. MARGINAL SEATS WILL BE CRUCIAL FOR THE LDP. MOST OBSERVERS SEE LITTLE LIKELIHOOD OF A MAJOR LDP VICTORY ON 6 JULY. PUBLIC INTEREST IS NOT YET ENGAGED.

DETAIL

2. WITH JUST OVER ONE WEEK TO GO BEFORE THE OFFICIAL CAMPAIGN FOR THE HOUSE OF REPRESENTATIVES ELECTION BEGINS AND ONLY FIVE DAYS UNTIL THE START OF THE HOUSE OF COUNCILLORS CAMPAIGN, THERE IS A NOTICEABLE LACK OF PUBLIC OR PRESS INTEREST IN THE ELECTIONS. THE BUSY PERIOD WAS WHILE THE POSSIBILITY OF AN ELECTION WAS IN THE BALANCE. NOW EVERYONE IS WAITING UNTIL THE CAMPAIGN STARTS IN EARNEST.

3. THE MAIN EVENT OF THIS WEEK IN POLITICS WAS THE ANNOUNCEMENT ON 9 JUNE OF THE NAMES OF THE 311 OFFICIAL LDP CANDIDATES. THIS NUMBER HAD BEEN REDUCED FROM WELL OVER 400 APPLICANTS. THERE MAY BE A FEW ADDITIONS TO BRING THE NUMBER CLOSE TO 320, BUT THE LDP SEEM TO HAVE MANAGED TO REDUCE THE RISK OF RIVAL LDP CANDIDATES CUTTING EACH OTHERS' THROATS IN MARGINAL CONSTITUENCIES AS HAPPENED IN 1983, WHEN THE LDP FIELDED 338 CANDIDATES. THIS WILL NOT HOWEVER PREVENT SO-CALLED INDEPENDENT CANDIDATES STANDING WITHOUT OFFICIAL LDP RECOGNITION: THESE WILL STILL DRAW VOTES FROM THE SAME SECTION OF THE ELECTORATE. FOREIGN MINISTER ABE IS REPORTED TO BE VERY DISSATISFIED WITH THE NUMBER OF NEW CANDIDATES FROM HIS FUKUDA FACTION ACCORDED OFFICIAL RECOGNITION (ONLY 14 OUT OF 26). THIS IS LIKELY TO BE ADJUSTED WHEN ADDITIONS ARE MADE TO THE TOTAL. CONVERSELY, THE NAKASONE FACTION WILL PROBABLY BE REINFORCED AS A RESULT OF THE ELECTION.

4. THE DEMOCRATIC SOCIALIST PARTY AND KOMEITO ANNOUNCED AN AGREEMENT ON 12 JUNE TO COOPERATE IN 20 LOWER HOUSE CONSTITUENCIES, 8 FEWER THAN IN 1983. THEIR FAILURE TO AGREE ON WIDER COOPERATION DEMONSTRATES THE DIFFICULTY FOR THE OPPOSITION PARTIES OF AGREEING TO WORK TOGETHER AT THE LOCAL LEVEL WHEN IN A DOUBLE ELECTION THEY MUST ALSO COMPETE IN THE NATIONAL CONSTITUENCY WHERE SEATS ARE ALLOCATED BY PROPORTIONAL REPRESENTATION.

5. NO-ONE IS YET PREPARED TO GUESS HOW FAR THE LDP CAN ADVANCE FROM ITS PRESENT TOTAL OF 250. MUCH WILL DEPEND ON THE TURNOUT. IN PREVIOUS ELECTIONS THE LDP HAS BENEFITTED FROM A HIGH TURNOUT. THE DESIRE TO INCREASE VOTER INTEREST WAS PART OF THE RATIONALE FOR CALLING A DOUBLE ELECTION. NAKASONE, AFTER FIRST SETTING A RATHER HIGHER TARGET, HAS SET HIS SIGHTS ON 257, AN ABSOLUTE MAJORITY, WHICH WOULD FREE THE LDP FROM DEPENDENCE ON THE NEW LIBERAL CLUB. OTHER LDP LEADERS SAY THAT ONLY A VICTORY OF 271 SEATS, GIVING THE LDP A STABLE WORKING MAJRITY AND CONTROL (INCLUDING CHAIRMANSHIP) OF ALL STANDING COMMITTEES, WILL BE ENOUGH. MIYAZAWA HAS GONE SO FAR AS TO SAY THAT NOTHING LESS THAN A RETURN TO THE 284 LEVEL OF 1980 WOULD CONSTITUTE SUCCESS FOR THE LDP. LDP HEADQUARTERS ARE CONFIDENT OF 249 SEATS: 28 OTHERS ARE UP FOR GRABS. THE OUTCOME IN THESE MARGINALS WILL BE CRUCIAL TO THE LDP AND TO NAKASONE HIMSELF.

GIFFARD

FCO/WHITEHALL (PALACE)
FED

PWP

Ch/ This looks a very hazardous calculation. EB are trying to work out exactly how DES converted their raw education statistics
RL 16/6

MOM 16/6

FROM: S D KING
DATE: 16 JUNE 1986

1. MISS O'MARA

2. PRINCIPAL PRIVATE SECRETARY

cc Mr Hacche
Mr Kelly
Mr Webb
HE/17

INTERNATIONAL COMPARISONS OF GDP PER HEAD

The figures you requested, using purchasing power parity, are given below, using 1984 prices.

Country	1984($)	1984(£)
US	15,343	7,840
Germany	13,129	6,709
France	12,591	6,434
Japan	12,036	6,150
UK	11,022	5,632

Source: OECD

2. For background information, I set out below figures going back to 1980 in terms of 1983 sterling prices (these were the basis for the original education spending comparison published in 'Hansard'), and in index number form, where UK=100.

1983 prices

Country	1980	1981	1982	1983	1984
US	6,972	7,091	6,842	7,026	7,412
Germany	6,184	6,134	6,357	6,230	6,342
France	5,993	5,940	6,057	6,133	6,082
Japan	5,127	5,270	5,421	5,598	5,814
UK	5,099	5,002	5,122	5,324	5,324

UK=100

Country	1980	1981	1982	1983	1984
US	136.7	141.8	133.6	132.0	139.2
Germany	121.2	122.6	119.2	117.0	119.1
France	117.5	118.8	118.3	115.2	114.2
Japan	100.5	105.3	105.8	105.1	109.2
UK	100.0	100.0	100.0	100.0	100.0

Stephen King

S D KING

PPS/Chancellor 12/2

PUP

FROM: H BREDENKAMP
DATE: 17 JUNE 1986

CSR 17/6

1. MR RILEY
2. PS/MINISTER OF STATE

cc PPS/Chancellor
PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
Mr Odling-Smee
Mr Melliss

NEW TREASURY WORKING PAPER ON THE MACROECONOMIC MODEL

1. The Minister of State asked for information concerning the forthcoming Working Paper on the Treasury Macroeconomic Model.

2. A manual or working paper describing the Treasury model appears at fairly regular intervals. The last full edition of the manual appeared in 1982, updated by a supplement issued as Treasury Working Paper No.31 in June 1984.

3. The manual/working papers contain a description of the theoretical basis of the model, a listing of the model's equations, and some simulations designed to illustrate the overall properties of the model.

4. Work on a new edition of the manual, along these lines but relating to the latest publicly available version of the Macroeconomic Model, is almost complete. A draft will be submitted to Ministers within the next few months.

5. Other points raised in the minute from the Deputy Parliamentary Clerk to Mr Riley (13 June) will be dealt with in a separate note.

Hugh Bredenkamp

H W BREDENKAMP

MP1

8:2

PERSONAL AND CONFIDENTIAL
until 11.30am Wednesday 18 June
then RESTRICTED

FROM: S D KING
DATE: 17 JUNE 1986

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

2. **CHANCELLOR OF THE EXCHEQUER**

While too much weight cannot be placed on a single month's figures, the increase in manufacturing output is encouraging

MOM
17/6

Thanks. Re X, pse let me know when Ind Prod. surpasses pre 1979 peak.
N

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 Hacche
Mr Naisbitt
Mr Pickering
Mr Dyer (+1 for No 10)
Mr Cropper
Mr Ross Goobey
Mr Tyrie
Mr Stirling - CSO
Mr Kingaby - CSO
Mr Lang - CSO
HB/02

INDEX OF OUTPUT OF THE PRODUCTION INDUSTRIES - APRIL 1986

This will be published at 11.30am on Wednesday, 18 June.

2. The <u>index of production</u> in the three months to April rose by 1½ per cent from the level of the previous three months: manufacturing was broadly unchanged. The divergence can be accounted for by strong growth of around 5 per cent in "energy and water supply".

3. Between March and April the index of production rose by 1 per cent. "Energy and water" fell by around ½ per cent after two particularly strong months, and manufacturing rose by almost 2 per cent. However, the CSO have emphasised that monthly figures can be erratic (NOT FOR USE: there may have been seasonal adjustment problems associated with the unusually early Easter this year, possibly leading to a rather high April figure at the expense of a low March figure).

4. **Recent movements**

percentage changes	1985 on 1984	3 months to April on previous 3 months	3 months to April on previous year	April on March
Index of Production	+4½	+1½	+ 2	+ 1
within which:				
Manufacturing	+3	0	- ½	+ 2
Energy and Water	+9	+5	+ 8½	- ½
adjusted for strikes, weather etc*				
Index of Production	+2½	+ 1 ½	- 0	+1
Manufacturing output	+2½	-0	- ½	+1 ½

*NOT FOR USE.

5. The CSO estimate that manufacturing output reached at least a temporary peak in 1985Q2. Production as a whole declined in underlying terms from 1985Q1 but in the first four months of 1986 the fall in manufacturing output was more than offset by a large increase in energy and water supply. In underlying terms, production in the three months to April 1986 is unchanged from the previous year.

6. The CSO will continue to make bias adjustments upward to recent estimates of manufacturing output. Historical experience suggests that such adjustments are still warranted.

7. Manufacturing output in the latest three months was 11½ per cent above its 1981Q1 trough but was 8 per cent below 1979Q2 peak. The index of production was 2½ per cent above its average 1979 level, although still slightly below the peak recorded in 1979Q2.

Other industrial detail

8. A good increase in output in the three months to April compared with a year earlier was recorded by mechanical engineering [+5½ per cent]. Falls over the same period were recorded by electrical and instrument engineering [-5 per cent] and chemicals [-5 per cent] - two industries which had, until recently, shown good year on year growth - and by metals [- 4½ per cent]. However, electrical and instrument engineering showed a significant increase of 5½ per cent in April.

Assessment

9. Manufacturing output rose strongly in 1984 and 1985 as a whole but has declined since 1985Q2. CSO believe that at least a temporary peak was reached in 1985Q2 and that it is too early to assess whether the April figure points to a resumption in growth.

10. Press comment may be varied, emphasising either the year on year fall in manufacturing output or the encouraging April figure.

11. Manufacturing output grew by 3 per cent in 1985, the fourth year of uninterrupted growth - the longest such period since 1970. But this point should be deployed carefully, given the decline over the last 12 months.

Lines to take

12. Possible lines for IDT to take are:

13. Positive:-

(i) Manufacturing output up by 2 per cent and total production up by 1 per cent in April on previous month.

(ii) Manufacturing output has now grown for four successive years - longest period of uninterrupted growth since 1970 - and a fifth year of growth is forecast.

(iii) Manufacturing profitability in 1984 best since 1973. Exports up 6 per cent in 1985 to beat 1984's all time and expected to rise by further 6 per cent in 1986. Manufacturing industry expected to be major beneficiary of fall in oil price.

Defensive:-

(iv) Manufacturing output peaked in 1985Q2. Expected to be temporary. Chancellor made clear in speech to Association of Economic Representatives in London on 28 May that growth is expected to pick up later in 1986 following benefit of lower oil price.

(v) Downward revisions to manufacturing output show bias adjustment unjustified

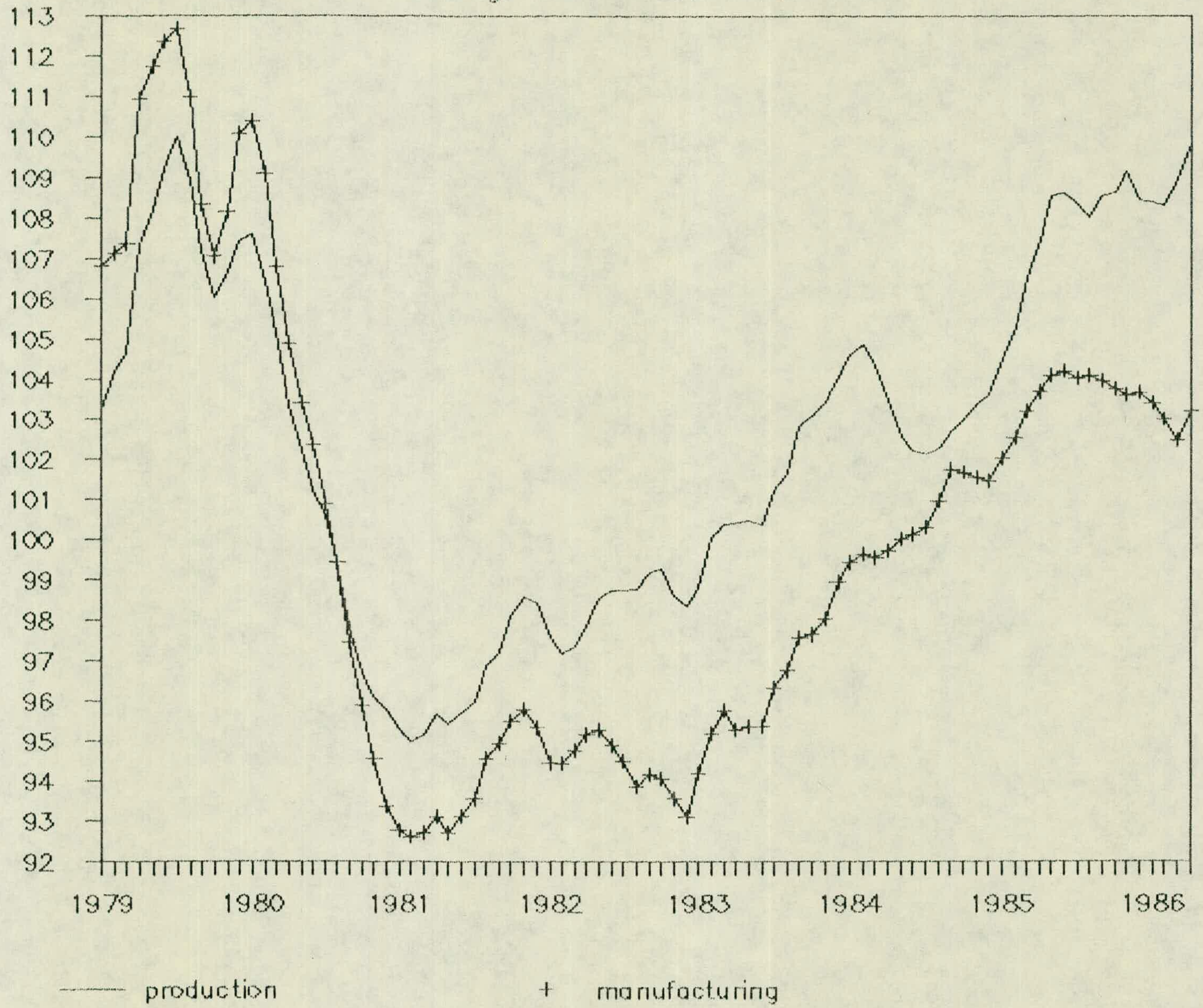
No. Historical experience shows initial estimates of manufacturing output have been underestimated on average. Therefore bias adjustments completely justified.

Stephen King

S D KING

INDEX NUMBERS OF OUTPUT

Average last 3 months 1980=100



47/55

FROM: ROBERT CULPIN

DATE: 17 JUNE 1986

CHANCELLOR

Content - & R should ... final para ... would be ... point ... Rather ... market-sensitive ... NL

Ch
Content for Robert to write as below, & to include the ... job at Ld Young.
RL 17/6

cc CST
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Kemp
Mr Monck
Mr Evans(esp last para)
Mr Scholar
Miss O'Mara
Mr Pickford

MONTHLY RPI FORECASTS

I have looked into last Friday's Reuters' report that inflation, when next seen, will be 2½%.

2. I am satisfied that Employment officials did not say this. Reuters, as often, were pushing their luck.

3. However, officials said more than they should about prospective changes, in particular for the average price of petrol.

4. I do not think this an occasion for yet another protest from you to Lord Young; but I thought I might send the attached letter to his Press Secretary. Are you content?

5. If so, shall I include the penultimate paragraph? No.10 attribute to Lord Young the Sunday stories to which it refers.

6. I should be grateful if Mr Evans could have the draft checked for accuracy.

RC

ROBERT CULPIN

ENC

47/53

DRAFT LETTER TO: **Adrian Moorey Esq,**
Department of Employment
Caxton House
Tothill Street
SW1H 9NF

MONTHLY RPI FORECASTS

Reuters, on Friday, attributed to Government sources a forecast of the next RPI announcement - not due until 11 July. This caused the Chancellor considerable irritation. It also annoyed a number of newspaper journalists, who were more careful in what they reported.

This is not the first time Reuters have done it - Stephen Pickford spoke to you after a similar incident two months ago. If we are not careful, it will become a habit.

As I understand it, the standard rule at your monthly briefings is that, while officials give guidance on price changes known to be in the pipeline, they never forecast the RPI, and always tell journalists that any conclusions they draw are their own. The briefings are only given on condition that they are unattributable.

It looks as if Reuters are breaking the terms on which these briefings are given. If so, would the best response be to exclude them?

The Chancellor remains concerned that, if it is as easy as it seems for Reuters to make forecasts, the briefings may be becoming a bit too explicit. It does not help us to have good news on inflation discounted a full month in advance.

We ought to be clear that we are all working to the same ground rules. Would the following summary be fair?

- If, but only if, an administered price change has been announced, it is reasonable, if asked, to give the RPI effect. Anyone can calculate it from the published weights. Examples are changes in mortgage rates or electricity prices.

- Where average price movements are estimated from survey data not (yet) in the public domain, we should neither reveal our first impressions of the likely survey findings nor give RPI effects. An example might be the average change in petrol prices between the make-up day for one month's RPI and the time that month's RPI is announced. We can give the weight of petrol in the RPI, but should leave journalists to do their own sums.

- When journalists bounce off us their own guesses, either for individual items or for the full index, we should not rise to them.

Contain to include ? [illegible]

[In addition to the problem that each month's RPI announcement is now accompanied in the press by some tentative forecast for the next month, it is hard to avoid noticing that each month's Friday announcement is now accurately trailed in the preceding Sunday's newspapers. This, too, is in danger of becoming institutionalised. How does your Department propose to respond?]

I am sending a copy of this letter to Bernard Ingham.

(SIGNED)

VL/65/lt

RESTRICTED

1. [illegible] 2 by 19/6

FROM: A W KUCZYS

DATE: 18th June 1986

~~B/F with~~ response

MR S MATTHEWS

cc PS/Chief Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Fitchew
Mr Scholar
Mr Cropper
Mr Ross Goobey

WORLD GROWTH

The Chancellor would be grateful if you could let him have urgently a table showing output/GDP figures, in the G7 countries (country by country) since the onset of the "pause".

(Output in the G5 already provided in 1st Order briefing. Jonathan Webb to extend to G7, with GDP as well)

AWK
19/6

AWK

A W KUCZYS

VL/68/1t

FROM: MRS R LOMAX

DATE: 18th June 1986

MR CULPIN

cc Chief Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Kemp
Mr Monck
Mr Evans
Mr Scholar
Miss O'Mara
Mr Pickford

MONTHLY RPI FORECASTS

The Chancellor has seen your minute of 17 June, attaching a draft letter to Department of Employment. He is content - but suggests that the final paragraph could well be redrafted to point out that this is market sensitive information.

RL

RACHEL LOMAX

VL/69/lt

p7

FROM: MRS R LOMAX
DATE: 18th June 1986

MR KING

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir Peter Middleton
Sir Terence Burns
Mr H P Evans
Mr Scholar
Miss O'Mara

INDEX OF OUTPUT OF THE PRODUCTION INDUSTRIES - APRIL 1986

The Chancellor was most grateful for your minute of 17 June. He has noted that production is still slightly below the peak recorded in 1979Q2. He would be grateful if you would alert him when it surpasses this peak.

RL.

RACHEL LOMAX

CHANCELLOR OF THE EXCHEQUER

CL/

The further figures you asked for. They appear in the growth brief attached to the Knox PQ - 16. (I've altered that too).

RL,

19/6.

pmg.

6. **Outside forecasts**

Forecast growth in GDP in 1986 - per cent

LBS	2½
Phillips & Drew	2½
Simon & Coates	2½
NIESR	1¾
Average of 12 forecasts	2½

7. **Index of industrial production**

In three months to April rose by 1½ per cent on previous three months and by 2 per cent on previous year (flat adjusted for coal strike).

8. **International comparison of industrial production**

	Apr 1985 to Apr 1986	Latest 3 mths on previous 3 months (Revised)	Latest 6 mths on previous 6 mths
UK	1	1½	½
US	¾	−¾	1
Japan	¾	¼	−1
Germany	1¾	−½*	1
France	-1*	-1½*	−¼

*March

Industrial production flat throughout G5.

9. **Manufacturing output**

a) **Record**

Percentage changes

	1974H1 to 1979H1	1979Q2 to 1985Q4	1981Q1 (trough) to 1985Q4	June 83 to 1985Q4	1984 to 1985
UK	-2½	-8¼	+12	+9½	+3
OECD (Maj 7)	+11	+11	+12¾	+14½	+3

b) **Prospects**

IAF is for 3 per cent growth in manufacturing output in 1986.

What I want (want quarter ~~3 months~~) actually was latest quarter on previous quarter but one — rather than 6 month comparison

CONFIDENTIAL
until 11.30 a.m. on FRIDAY 20 June then
UNCLASSIFIED

FROM: S J DAVIES
DATE: 19 JUNE 1986

CHANCELLOR OF THE EXCHEQUER

cc : Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir Peter Middleton
Sir Terence Burns
Mr Cassell
Mr Monck
Mr H P Evans
Mr Odling-Smee
Mr Sedgwick
Mr Culpin
Miss O'Mara
Mr Allum
Mr Hacche
Mr Cropper
Mr Tyrie
Mr Ross Goobey

Mr R Clare (CSO)

1. Rachel
2. C.

CR 19/6

The last [illegible] taken [illegible] strong GDP numbers yet another rise in Q1 1986, before getting all the rather defensive guff. But do we really know? X I think [illegible]

GDP FIGURES FOR THE FIRST QUARTER OF 1986

The CSO's provisional estimate of GDP in the first quarter of 1986 will be published tomorrow (Friday) at 11.30 a.m. It shows a 0.7 per cent increase in GDP between 1985 Q4 and 1986 Q1 (just under 3 per cent growth at an annual rate). Over the year to 1986 Q1, the increase in GDP was about 2.5 per cent (but half of this increase is attributable to recovery from the coal strike).

2. The 0.7 per cent increase in GDP between 1985 Q4 and 1986 Q1 is a bit more than we had been expecting, and is above the 0.4 per cent increase in the preliminary estimate for the output measure of GDP published a month ago. But the underlying position is weaker than the actual GDP increase suggests.

hard to see other major changes in

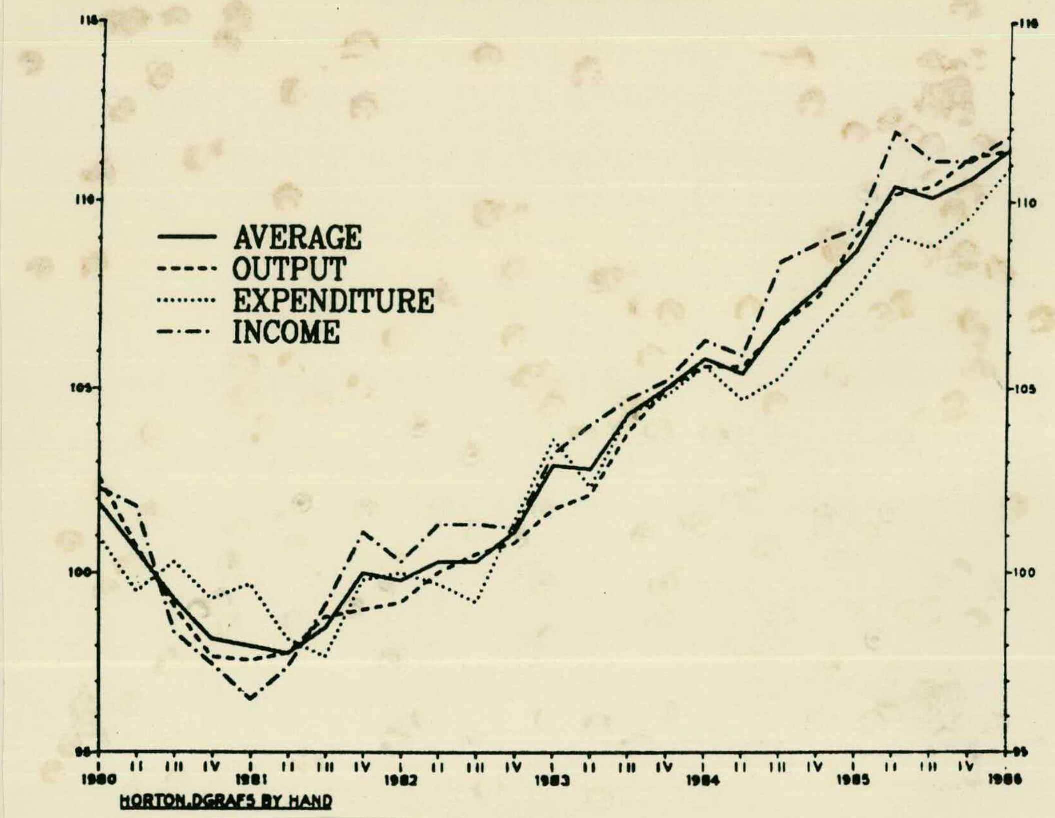
3. There is a substantial discrepancy between the three separate measures of GDP growth in the first quarter. While the average estimate quoted above is of a 0.7 per cent increase, GDP(O) suggests only a 0.2 per cent increase, GDP(E) suggests a 1.2 per cent increase.

Output, expenditure, and income estimates of real GDP

4. The output measure of GDP is now estimated to have risen by only 0.2 per cent between 1985 Q4 and 1986 Q1, less than the preliminary estimate published last month. But for the increase in North Sea oil production in the first quarter GDP(O) would have fallen marginally between 1985 Q4 and 1986 Q1. GDP(O) has proved in the past to be the most accurate measure of quarter to quarter movements in GDP, and what it is telling us now about recent developments in the economy - that the economy was very flat in the first few months of 1986 - is likely to be nearer the truth than the more buoyant message that is coming from the expenditure measure.

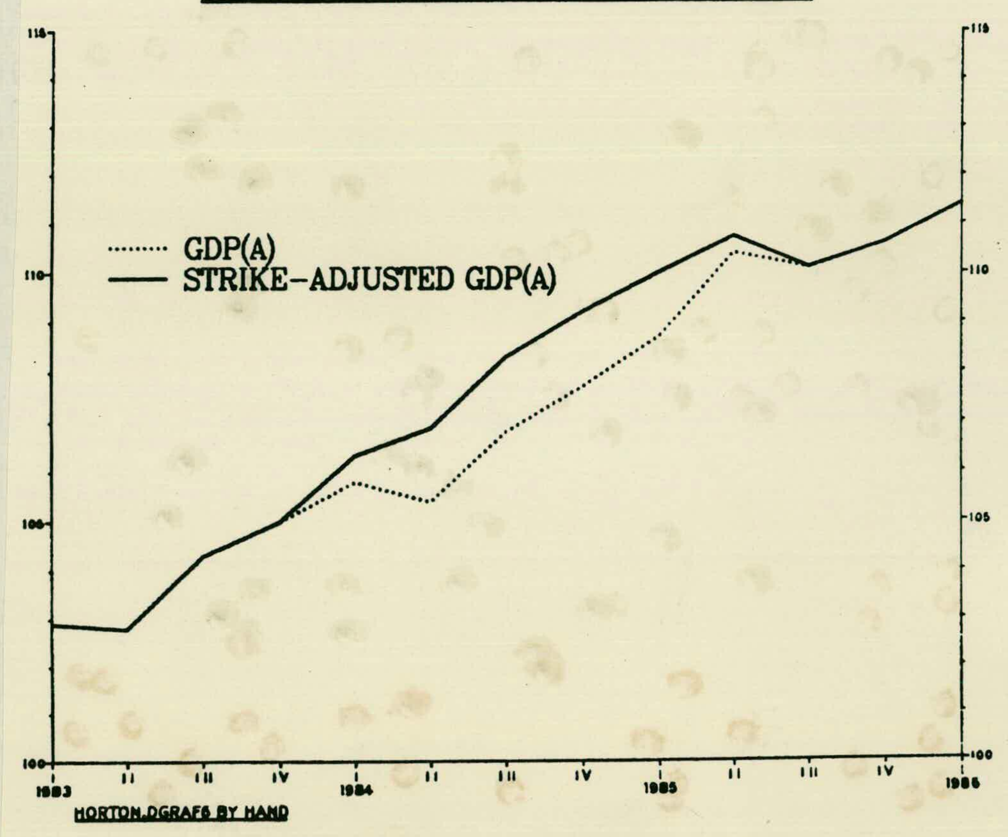
5. The income measure shows about half a per cent increase between 1985 Q4 and 1986 Q1; it has been above the other measures of GDP since 1982, but has come back more in line with the average measure over the last year. The expenditure measure has made the main contribution to the rise in average estimate of GDP over the last quarter. Having fallen behind the other measures of GDP in 1984, it rose by 3 per cent in the year to 1986 Q1, and by 1.2 per cent between 1985 Q4 and 1986 Q1. The chart overleaf shows the path of the three measures and the average measure since 1980.

REAL GDP INDICES



6. Adjusted for the coal strike, GDP grew fairly steadily at over 3 per cent a year in the two years up to early 1985. It fell in the third quarter of 1985, and has recovered over the last two quarters (partly because of a recovery of oil output from last summer's depressed levels).

GDP AND STRIKE-ADJUSTED GDP



Money GDP and GDP Deflator

7. The figures published on Friday will include the first published estimates for money GDP and the GDP deflator for the financial year 1985-86. The published figures are not materially different from the estimates given in the FSBR.

Percentage change 1984-85 to 1985-86	**FSBR**	**Published Figures**
Deflator for GDP at market prices.	6	6.2
Nominal GDP at market prices.	9.5	9.6

In the year to 1986 Q1, nominal GDP at market prices rose by just under 8.5 per cent (7.5 per cent strike adjusted); the deflator for GDP at market prices rose by about 5.75 per cent over the same period.

Components of Expenditure

8. Consumers' expenditure rose by about 4.5 per cent in real terms in the year to 1986 Q1; and is now estimated to have risen by about 0.75 per cent between the fourth quarter of 1985 and the first quarter of 1986 (preliminary estimates published two months ago had suggested no increase in consumer spending over the period).

9. Fixed investment was almost 4 per cent higher in 1986 Q1 than in the previous quarter; however it was 2.5 per cent below the very high 1985 Q1 figure. As at the beginning of 1985, the investment total was swollen by firms' bringing forward expenditure ahead of the reduction in capital allowances; this effect was on a smaller scale this year than last.

10. Stockbuilding had little effect on growth between 1985 Q4 and 1986 Q1. Both export and import volumes fell; but exports fell more, and net movements in trade took about 0.4 per cent off the increase in GDP between 1985 Q4 and 1986 Q1.

Company Profits

11. Industrial and commercial companies' profits net of stock appreciation were some £0.7 billion (5 per cent) lower in 1986 Q1 than a year earlier. Separate figures for oil and non-oil companies' profits are not yet available, but non-oil ICCs' profits will certainly have shown a healthy increase over this period, while oil companaies' profits will probably have fallen by a third or more.

Line to Take

12. The slowdown in growth over the last year is not news. The FSBR (paragraph 3.42) noted that strike adjusted GDP had fallen between the first and third quarters of 1985. These latest GDP figures, in fact, confirm that growth has resumed since then. Against the background of generally weak world ~~demand~~ activity in early 1986 (for example, German GDP actually fell in the first quarter), the latest figures are ~~as good as could reasonably have been expected~~ a relatively encouraging.

13. The growth in consumers' expenditure of nearly 5 per cent over the year to the first quarter of 1986, together with the further rise in retail sales in the second quarter, confirms that ~~the FSBR forecast for consumers' spending (4 per cent growth in 1986) is well within reach.~~ Tuesday's bearish press comment following the May retail sales figures was quite unwarranted.

14. A fall in company profits was anticipated in the FSBR (paragraph 3.48 and Chart 3.11); the published figures are consistent with the FSBR forecast of a rise in profits of non-North Sea industrial and commercial companies.

SJD

S J DAVIES

ST

covering CONFIDENTIAL

b/f 20/6 P

FROM: J WEBB

DATE: 19 June 1986

cc PS/Chief Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Fitchew
Mr Scholar
Mr Cropper
Mr Ross Goobey
Mr Matthews (or)
Mr Dolphin (or)
Mr Patterson
Mr King

CHANCELLOR

~~Ch/ As requested~~ AWK 19/6

WORLD GROWTH

I attach a table showing changes in output and GNP for each of the G7 countries. The figures are actual percentage changes, rather than at an annual rate; this is the same format as was requested for today's First Order subject brief on Growth and Manufacturing.

Jonathan Webb

JONATHAN WEBB

[illegible]

[illegible] 86Q2 on 85Q4

[illegible]!

R

ST

UK GDP FIGURE **CONFIDENTIAL** UNTIL 11.30 am 20 JUNE

Recent changes in Industrial Production and GNP in the G7 countries

		Industrial Production Percentage change over			GNP/GDP Percentage change over	
		3 mths*	6 mths**		last qtr*	last ½ year**
US	(Apr)	– ¾	1	(86Q1)	¾	1
Japan	(Apr)	¼	–1	(85Q4)	1¾	2¼
Germany	(Mar)	– ½	¾	(86Q1)	–1	¼
France	(Mar)	–1½	–¼	(86Q1)	¼	1¼
UK	(Apr)	1½	½	(86Q1)	¾	¾
Italy	(Mar)	3	1¼	(85Q4)	½	1¼
Canada	(Mar)	–	2½	(85Q4)	1¼	2¾
G7	(Mar)	–	½	(85Q4)	¾	1¼

* Average of latest 3 months compared with the average of previous 3 months.

** Average of latest 6 months compared with the average of previous 6 months.

EB

Ch.

Rachel

MR KUCZYS

Now in the form you requested

AK
20/6

Nigel

FROM: J WEBB

DATE: 20 June 1986

cc PS/Chief Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Fitchew
Mr Scholar
Mr Cropper
Mr Ross Goobey
Mr Matthews (or)
Mr Dolphin (or)
Mr Patterson
Mr King

WORLD GROWTH

I attach a revised table showing changes in output and GNP for each of the G7 countries. As requested the figures are now based on the percentage change of the latest 3 months on the same period ending six months earlier.

Jonathan Webb

JONATHAN WEBB

EB

Recent changes in Industrial Production and GNP in the G7 countries

		Industrial Production*		GNP/GDP*
US	(Apr)	¼	(86Q1)	1
Japan	(Apr)	-¼	(85Q4)	2½
Germany	(Mar)	-	(86Q1)	-1¾
France	(Mar)	-2	(86Q1)	1
UK	(Apr)	1	(86Q1)	1¼
Italy	(Mar)	3¼	(85Q4)	¾
Canada	(Mar)	1¼	(85Q4)	3
G7	(Mar)	¼	(85Q4)	1½

*Percentage change of average of latest 3 months compared with 3 month period ending six months earlier.

DEPARTMENT OF TRADE AND INDUSTRY
1-19 VICTORIA STREET
LONDON SW1H 0ET
Telephone (Direct dialling) 01-215) 4887
GTN 215)
(Switchboard) 01-215 7877

Mrs R Lomax
Principal Private Secretary
Chancellor of the Exchequer
H M Treasury
Parliament Street
LONDON
SW1 3AG

C/ The divisions submission has still not arrived & we are chasing them. In the meantime you might like to see this

23 June 1986 CR 25/6

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

Phoned to say c content

Publication is set for Thursday 26 June at 11.30 am and I should be grateful if you would arrange for the Notice to be cleared by 12.00 noon Wednesday 25 June and to inform me accordingly.

A copy of this letter and draft Press Notice is being sent to Sir Peter Middleton and Mr Walker, H M Treasury.

Yours sincerely

W. E. Boyd

W E BOYD

If Flitten's submission hasn't arrived by 5.00pm please chase. & let me have this back

CR 25/6

999-64

M423

333/30

RP

FROM: J M BIRD
DATE 23 June 1986

1. MR ROBSON SM 23.6
2. CHIEF SECRETARY

cc Chancellor
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Mr Monck
Mr Gilmore
Mr Kitcatt
Mr Turnbull
Mr Norton

REVIEW OF SUPER-PRIORITY ECONOMIC KEY POINTS

This is your brief on OD (T) (86)2, below (you have seen) a paper by officials on the construction of High Security Fences (HSF) at key oil and gas terminals. OD(T) is the Ministerial Sub-Committee on Terrorism, chaired by Viscount Whitelaw. Others present will be the Home Secretary, the Foreign Secretary, the Secretaries of State for Energy, Defence, Scotland and Transport, the Atourney-General and the Chancellor of the Duchy of Lancaster. (Meeting on Thursday)

Objectives

2. Your aim should be to avoid providing a HSF at the oil terminals at Sullom Voe and the Forties installations, saving some £15m in public expenditure. Failing this, you should ensure that the public expenditure consequences of any decisions taken are absorbed within existing baselines either by savings provided by D/Energy or by contributions from other departments.

Background

3. In 1978, the then Government decided that the 5 oil and gas installations should be designated as Super Priority Economic Key Points (SPEKPs). This was because they were considered to be of vital importance to the national economy and were particularly vulnerable to attack by terrorists. They were the only sites so designated; the designation meant that they would be given (at Government expense) a higher standard of protection than had been considered necessary for other EKPs, including the means of providing a rapid reaction against the possibility of armed attack.

4. The two main elements of the protection were to be a High Security Fence, with an associated Intruder Detection system, and a rapid police response capability. The HSF would be capable of delaying entry by an intruder for a matter of some minutes until the police arrived. The HSF would not be capable by itself of preventing entry and would have limited value without the ability of police to arrive extremely rapidly.

5. The responsibility for constructing and paying for these Fences fell to D/Energy. Until last year, they had resisted making a start on any of the Fences on the grounds that they had no PES provision (your predecessor was not prepared to permit a bid against the Reserve for the Fences). However, under pressure from the Home Secretary and other Ministers concerned with security they agreed to find offsetting savings to cover the cost of fencing the two gas terminals. These were by far the most important since a disruption to gas supply would require immediate disconnections and substantial disruption before customers could be reconnected. Construction is now going ahead and there is no disagreement about the need for HSFs at the Bacton and Fergus gas terminals. You can therefore agree with the conclusions at para 22 (a) of the note by officials.

6. At the same time, Mr Walker indicated that he could find savings towards fencing the two outstanding oil terminals (Forties Landward and Sullom Voe - Flotta was considered too small to require such protection) from savings arising from reducing the department's involvement with the Offshore Protection Force. (I minuted you on 16 June about the £4½m a year saving which is resulting from this area). There would however be a shortfall which would need to be made good either by a contribution from other departments or from the Reserve. Your predecessor argued against the fencing of Sullum Voe on the grounds of its remoteness and the difficulty of providing an adequate police response. At an ad hoc meeting of Ministers chaired by Viscount Whitelaw last July, it was agreed that the question of whether to build a HSF at Sullum Voe should be referred to OD(T). Construction of the other HSFs should now proceed whether a claim on the Reserve was needed would depend on the outcome of discussions on the OPF.

7. It has taken until now to prepare a note for OD(T). Although consideration initially focused on whether an adequate police response could be provided at Sullom Voe (without which the HSF would be virtually useless), I

succeeded in steering the discussion towards consideration of whether HSFs were needed in any case at oil terminals given the present oil supply position. The paper now concludes that on economic grounds the oil terminals should all be down graded to Priority I EKPs (i.e. no Government-Funded security measures). However, an uneasiness was expressed by D/Energy, Home Office and Security Service officials about the political embarrassment that might be caused in the event of a terrorist attack on an oil terminal which did not have HSF protection. It was not therefore possible to present agreed recommendations to Ministers that HSFs should not be provided at these sites. Thursday's meeting of OD (T) has therefore been arranged to resolve the issues.

Consideration

8. The arguments against providing HSFs at the oil terminals are strong:

(i) The decision in 1978 to designate the oil installations as SPEKPs was taken against a background of OPEC dominance of the oil market, a tight oil supply situation and political instability in the Middle East, particularly in Iran. Since then world-wide production capacity has expanded substantially, exceeding demand in 1985 by nearly 20%. And, crucially, oil production from non-OPEC countries has expanded significantly and now exceeds OPEC production. D/Energy support the view that the probability of a tight market developing over the next few years is low and that if there were a supply shortfall as a result of terrorist activity at oil terminals, there is more than enough spare capacity, much in less politically sensitive areas, to make good any temporary shortfall. It is unlikely that this view will be challenged by other Ministers.

(ii) Although a temporary disruption in oil supplies from the UKCS would cause a consequent loss of tax revenue, the effect would be recognised as temporary by the City, and so there would be little direct effect on interest rates or exchange rates. We do not therefore see any direct repercussive effects on the economy or on the Government's economic policies as a result of such a disruption. Although other departments recognise that this judgement is for the Treasury to make, they have queried it (although without putting forward alternatives arguments). It is possible that you may be challenged on this at the meeting. You could reiterate that it is for the Treasury to make such judgements and that previous experience of temporary Revenue disruptions e.g. the Civil Service pay dispute of a few years ago, support this case.

9. Any opposition to these economic arguments is likely to be half-hearted at best. Tactically, it may be worthwhile to try to seek early agreement to downgrade the 3 oil terminals to Priority I EKPs. This would at the least provide a prima facie case for not providing HSFs.

10. Logic demands that if the oil installations are to be downgraded in status they should not be provided with HSFs. The public expenditure savings would be £3.4m for Forties and £11.4m for Sullom Voe. But the Home Secretary in particular may well argue that fencing at one or more of the sites would be desirable. There is a general arguments on political grounds and specific arguments relating to the sites themselves.

11. The political argument is that it would cause the government considerable embarrassment if there were a successful terrorist attack on one of these sites. But terrorist attacks on any target always cause the Government embarrassment and it would be impossible to provide a level of protection against terrorism which could under all circumstances save Ministers' face. These sites were designated as being in need of special protection because of their economic status and not because of political considerations. We accept that the gas terminals still merit protection on economic grounds but there is now no case for providing special protection to the oil installations beyond that which would apply to any other conceivable terrorist target. It is important to nail this argument , otherwise a precedent could be created for significant increases in expenditure on security elsewhere.

12. There may also be attempts to pick off the sites individually. There is a real difficulty in providing an adequate police response at Sullom Voe. Not only is there a cost (capital expenditure of about £1m and annual running costs of around £0.7m) which the Scottish Office is reluctant to bear, but there would be practical and political difficulties in providing a permanent police presence at Sullom Voe when there is considerable criticism of the poor level of policing in much of the Highlands. The Police had told the Scottish Office that such a presence could only be provided if there was an over-riding national interest, and it would be likely that full cost would fall on the Government. It is likely that the

Secretary of State for Scotland will oppose providing a permanent police presence at Sullom Voe.

13. An alternative proposal put forward by the Security Service which may be supported by the Home Secretary, is to provide an HSF at Sullom Voe and make available a police response if there were advance intelligence that an attack was likely. This approach would rely on the deterrent effect of an HSF (small, since these fences can be scaled by skilled men in under two minutes) and the likelihood of any advance intelligence of an attack (Ministers can judge for themselves the success of the Security Service in predicting terrorist attacks over the last few years). The likelihood is that we would have spent an additional £11m without making Sullom Voe any safer against attack. You should oppose this proposal on the basis of its lack of cost-effectiveness.

14. It is possible that Viscount Whitelaw may attempt to deal with Sullom Voe first, reaching agreement that it should not be fenced because of the policing difficulties, but then proposing that the Forties installation should be fenced as previously agreed. You should oppose this: the only reason for fencing the Forties installation would be to prevent political embarrassment, since the economic arguments are against such protection. If you were to concede on this, it could well set a precedent for increased expenditure on security measures elsewhere. You could point out, if there continues to be nervousness, that it is important to use objective criteria for deciding on security measures, precisely because of the difficulty of reaching a view which takes into account a political embarrassment factor. On these objective criteria, none of the oil terminals should be fenced.

Costs

15. If you are successful in reaching agreement that none of the oil sites should be fenced, there will be a public expenditure saving of around £15m. If it is agreed that only the Forties site should be fenced, the cost of £3.4m can be met by offsetting savings on the D/Energy Vote. Mr Walker has already agreed to this. If however, it is decided to fence all the sites, there will be a shortfall in 1988/89 of £3m. This outcome is likely only if there is considerable pressure from the Home Secretary and you should aim to ensure that before a decision is taken those pressing to build the fence at Sullom Voe should make available sufficient funds to avoid a

Reserve bid. You could point out that this year's Survey is in its early stages, public expenditure is likely to be under considerable pressure and that you will have no scope for conceding any bids on the Reserve for this expenditure. If however those concerned were prepared to make up D/Energy's shortfall, you would not stand in the way of expenditure.

Summary

16. To summarise, I recommend that you can:

(a) Agree that the gas terminals should remain SPEKPs and be fenced.

(b) Press for the oil terminals to be down graded.

(c) Argue that on economic grounds the oil terminals should not be fenced and that it would be unwise to allow questions of political embarrassment to cloud the issue.

Jon Bird

J M BIRD

2470/26.IC

SECRET AND PERSONAL
until 11.30am on Thursday 26 June 1986
then CONFIDENTIAL

FROM: J E FLITTON
DATE: 24 June 1986

1. MR KELLY approved in draft John Fetter.
2. CHANCELLOR

cc as attached list

C/ Flitton's submission has finally arrived. content with press briefing attached?

OK - one small change. CR 25/6

MAY TRADE FIGURES

The May trade figures will be released on Thursday 26 June. The current account was in surplus by £34 million (c.f. £435 million surplus in April).

Summary

2. Visibles were in deficit by £666 million, offset by an estimated invisibles surplus of £700 million.

Main points

3. (i) The May current account surplus was £400 million below the April figure, reflecting an increased non-oil deficit of £350 million and a lower oil surplus of £50 million; some reaction to the erratic April surplus was only to be expected;

(ii) The underlying level of non-oil export volume now appears to have levelled off after its fall in the second half of-1985 (see chart);

(iii) There was a large increase in import volumes in May. But the last three months as a whole were still only 1 per cent up on a year ago. Non-oil import volume has fluctuated considerably in recent months.

(iv) The May oil trade surplus was £50 million below the April figure and over £400 million below the average surplus in the second half of 1985. Export volume was around the average of that period but price was 60 per cent lower;

(v) Manufacturing trade was in deficit by £306 million, £400 million worse than April. The deficit of £1.6 billion in the first five months of the year compares with £1.5 billion in the same period in 1985;

(vi) The invisibles surplus is now projected at £700 million a month in Q2.

Comparison with forecast

4. The current account deficit of £1 billion so far this year is almost £1 billion worse than that implied in the FSBR. The oil trade surplus is £0.5 billion below forecast and the non-oil trade deficit is £1.0 billion higher. Trade volumes except for oil, remain below those forecast in the FSBR.

Difference between FSBR forecast and actual

Figures Jan. to May (per cent)

	Export volume	Import volume
All goods	- 4	- 3
of which		
Manufactures	- 4½	- 5
Goods less oil and erratics	- 4	- 4

The terms of trade so far this year have also been worse than forecast, mainly because import prices, both oil and non-oil, have been higher than anticipated.

Trade prices

5. The non-oil terms of trade improved by 1.5 per cent in May, with import prices falling 1.5 per cent and export prices remaining

at approximately the same level as the previous two months. Import prices appear to have reacted rapidly to the 2 per cent rise in the exchange rate since March.

	Import prices % change compared to:	
	Previous Month	**One Year Ago**
Manufactures	- 1.0	- 0.5
Food	+ 1.0	- 4.0
Basic materials	- 2.0	-17.0
Fuel	- 1.5	-45.0
Total	- 1.0	-11.0

Oil trade prices may not have fully adjusted to the change in market circumstances. The import price of crude in May was almost 20 per cent above the export price of $12.7 a barrel. This probably reflects the difficulty involved in putting a price to netback deals, which have grown to 40 per cent of oil imports. It may also reflect the time delay between purchase and delivery of oil imports.

Effect on markets

6. The markets are expecting a current account surplus of £125 million (and a trade deficit of £425 million). The fact that the figures are slightly worse is, however, unlikely to have any significant market impact.

Press briefing

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

John Flitton

J E FLITTON

EF1

SECRET AND PERSONAL
until 11.30am on Thursday 26 June 1986
then unclassified

DRAFT BRIEFING FOR IDT

Positive

1. Substantial current account surplus of £1 billion in first five months of year despite lower oil prices.

2. Invisibles surplus now projected at £700 million a month.

3. Fall of 3 per cent in import unit value index in latest three months will help to maintain downward trend of UK inflation.

4. Import volumes have changed little since last summer. Excluding oil and erratics down 2 per cent since March peak.

5. Clear signs that fall in export volumes now come to an end. Excluding oil and erratics unchanged in latest three months and only 2 per cent below February 1985 peak.

Defensive

1. **Lower oil balance**

[Surplus of £8.2 billion in 1985; £2 billion in Q1 1986; £265 million in April; and £212 million in May.]

Reflects substantial fall in oil prices. Large oil surplus still expected in 1986.

2. **Realism of FSBR forecast in light of lower oil prices**

[Current account surplus of £3½ billion forecast for 1986 after £3.8 billion surplus in 1985.]

Too early to tell. Forecast ~~already~~ allowed for effect of ~~lower~~ reduction oil price~~s~~ to $15 a barrel. Volume of world trade may have been less than anticipated. On other hand, invisibles may have been more buoyant. Revisions to invisibles increased current account surpluses in 1984 and 1985 by £0.7 billion and £0.8 billion respectively.

3. **Manufacturing trade**

[March deficit of £775 million; April surplus of £90 million, May deficit of £306 million.]

May deficit half way between extreme March and April figures. Helps to put previous figures in context. UK exports of manufacturers have gradually improved volume share of world trade since 1981 after years of decline.

SECRET AND PERSONAL

until 11.30 am on Thursday 26 June 1986

then UNCLASSIFIED

TABLE 1: CURRENT ACCOUNT

£ billion

	1985	1986 Dec-Feb	Mar-May	Mar	Apr	May	1986 year to date
Oil	+8.2	+2.2	+0.8	+0.3	+0.3	+0.2	+2.5
Non-oil	-10.2	-2.4	-2.9	-1.5	-0.5	-0.9	-4.8
Total visible trade	-2.1	-0.2	-2.1	-1.2	-0.3	-0.7	-2.3
o/w trade in manufactures (BOP basis)	-3.0	-0.7	-1.0	-0.8	+0.1	-0.3	-1.6
Invisibles	+5.9	+1.9	+1.9*	+0.5	+0.7*	+0.7*	+3.3
Current account	+3.8	+1.7	-0.2	-0.7	+0.4	0	+1.0

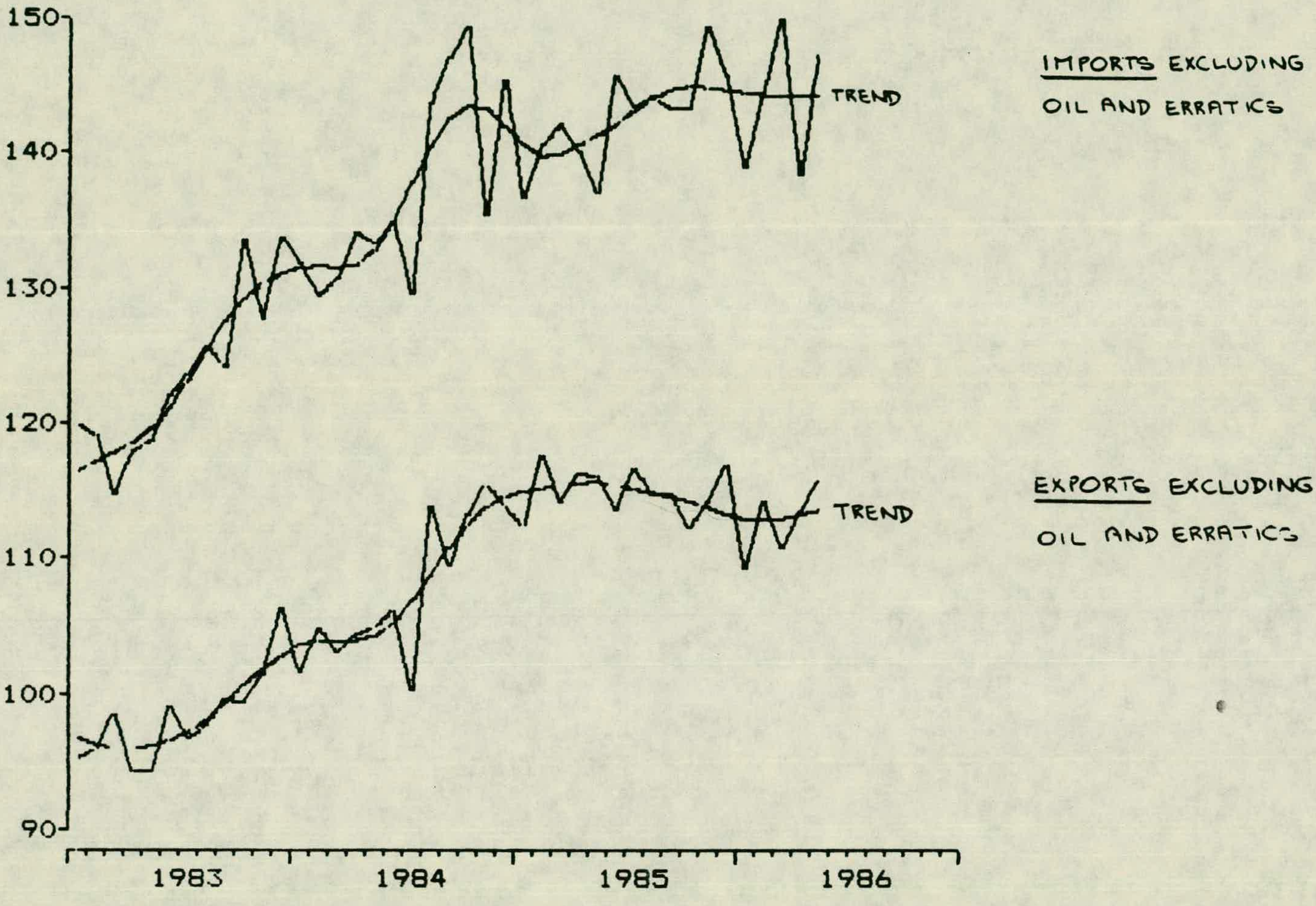
*projection

TABLE 2: EXPORTS AND IMPORTS (percentage change)

	1986 May on April	Mar-May on Dec-Feb	Mar-May'86 on Mar-May'85
i. Exports			
Total value	-3	-6½	-14
Total volume (BOP basis)	-1	-1	-1½
Total volume excl oil and erratics (BOP basis)	+2	0	-2
Manufactures volume (excl erratics) OTS basis	+2½	0	-2
Fuels (Volume)	-½	-8½	-5
ii. Imports			
Total value	+3½	+3½	-6½
Total volume (BOP basis)	+8	+3	+1
Total volume exc oil and erratics (BOP basis)	+6½	+1½	+4
Manufactures volume (excl erratics) OTS basis	+8	+1	+3
Fuels (Volume)	-2	+15	-11

SECRET AND PERSONAL UNTIL RELEASE OF PRESS NOTICE AT 11.30AM 26.6.86

VOLUME INDICES



ON A BALANCE OF PAYMENTS BASIS 1980=100 SEASONALLY ADJUSTED

SECRET - PERSONAL

TRADE FIGURES FOR MAY 1986

Advance Circulation

Chancellor of the Exchequer
Chief Secretary
Economic Secretary
Sir P Middleton
Sir G Littler
Sir T Burns
Mr Cassell
Mr H P Evans
Mr C W Kelly

Miss O'Mara
Mr Culpin
Mr S Robson
Mr Mowl
Mr Segal
Mr Barrell

Mr Gill - Bank
Mr Norgrove - No 10
Miss Deuchers - DTI

Circulation after 11.30am on Thursday 26 June 1986

Financial Secretary
Minister of State
Mr Lankester (Washington)
Mr Matthews (EF)
Mr Shaw
Mr Hacche
Mr Tyrie
Mr Ross Goobey
Miss Roche (No 10)

pbV

FROM: S W MATTHEWS
DATE: 25 June 1986

CHANCELLOR

cc: Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
PCC members
Mr Evans
Mr Odling-Smee
Mr Peretz
Mr Sedgwick
Mr Turnbull
Mr Davies
Mr Mowl
Mr Riley
Mr Cropper
Mr Tyrie
Mr Ross Goobey

WORLD ECONOMIC PROSPECTS: JUNE 1986

The latest WEP exercise is described in the attached report. This minute summarises and comments briefly on some of the main points of interest.

2. The pause in growth in early 1986. Over the last six months the growth of output in the major industrialised countries and of world trade has been comparatively slow. The slowdown is most evident in industrial production, which was on average no higher in 1986Q1 than in 1985Q3. There are insufficient data at present for us to be sure of the causes. Factors which may have adversely affected output in 1986Q1 include the severe winter in Europe, a fall in investment in oil and other energy-related industries, and destocking by producers expecting further falls in raw material prices.

3. Demand from outside the OECD area has been weak, with only small increases in imports by NODCs (because of depressed commodity prices and capital inflows) and substantial cuts in OPEC imports (as first oil export volumes fell and then prices collapsed). The counterpart to this is improved terms of trade and higher real incomes in OECD countries, but this is likely to stimulate higher activity only with a lag.

4. Fiscal and monetary policies have remained fairly tight in Europe and Japan, and budget deficits in France, Germany and Japan were all lower in 1985 than in 1984. The adverse effects of the strong dollar in boosting inflation and interest rates in other major countries may also have still been depressing output in these countries in the second half of 1985 and early 1986, after the direct boost from strong US import growth had faded. The depreciation of the dollar has now helped reduce inflation in the other major countries and permitted lower interest rates. This should enable stronger growth in Europe and Japan within existing monetary frameworks, but there is inevitably some lag before growth picks up.

5. The fall in oil prices and weak commodity prices will contribute to rises in real personal disposable income in the major countries of the order of 3½ to 4 per cent in 1986 and 1987 (compared with around 2 per cent in 1985). Company profits should also improve. While saving ratios appear initially to have risen, consumers' expenditure should pick up as the improvement in real incomes is seen to be permanent rather than transitory. The worldwide fall in interest rates and increases in equity and bond prices will also strengthen activity in the OECD countries. These positive factors are likely to outweigh the falls in developing countries' (notably OPEC's) demand for imports, producing faster growth of OECD output in the second half of 1986 and in 1987, although the growth of world trade could remain fairly modest.

6. <u>Oil prices, macro-economic policy and inflation</u>. The effect of the fall in oil prices on the price level will tend to be once-for-all, but this will depend on the policy response. Budgets have so far been revised only in a few countries, generally those with relatively high inflation and budget deficits, where governments have taken advantage of the fall in oil prices to increase taxation. There has been no explicit response in Japan or Germany. Both governments have encouraged public utilities to pass on the benefits of lower oil prices to consumers, but appear to be intending to press on with their plans for reducing their budget deficits further. In the US too we expect a gradual decline in the Federal deficit as a

proportion of GNP, but rather less than envisaged by the Gramm-Rudman Act. Overall we expect inflation in the major industrialised countries to average 1-2 per cent this year and next. By 1986 the bounce-back could well be greater in the US, reinforced by the depreciation of the dollar. Uncertainties on inflation include those on commodity prices, which have been exceptionally low in real terms in recent months - we have allowed for some recovery from current levels as the growth of world GNP strengthens.

7. Current account imbalances. This time last year the outlook for the world economy was clouded by a number of uncertainties: large current account imbalances had already emerged in the US and Japan, protectionist sentiments in the US were becoming stronger, the dollar looked unsustainably high and there was a risk that the depreciation, when it came, would be sudden and disruptive. Exchange rate movements over the past year have reduced these problems, but far from eliminated them. The US current account deficit is likely to fall only slowly, so that the US could remain vulnerable to a break in confidence in the soundness of its fiscal and monetary policies. For the moment, though, Japan appears to remain keen to invest heavily abroad, particularly in the US. Continuing large current account deficits will, however, provide ammunition for protectionists in the Congress, and there are some signs that the Democrats will use a populist trade policy as an election issue.

8. Prospects for the US economy. One of the major factors accounting for the large current account imbalances has been the disparity in recent years in the relative rates of growth of domestic demand between the US on the one hand, and Japan and Germany on the other. Changing these relativities will be an important element of reducing the imbalances. The Americans would naturally prefer that this be achieved by other countries raising their growth rates, rather than by slower growth in the US. We are forecasting a recovery in growth in the US, helped by the effects of lower oil prices. There are, however, a number of risks to this prospect. The US recovery is now quite mature and, to some extent, has been sustained by relaxing monetary policy (without having first cut the budget deficit).

If the dollar's exchange rate were to collapse the US authorities might feel compelled to adopt a tighter monetary policy which could precipitate a recession.

9. Growth in Europe and Japan. The risks to our forecast of world output and trade are not all on the downside. Low inflation and the boost to real incomes from their improved terms of trade could produce stronger than forecast growth in Europe and Japan. There are, however, few signs of this at present (e.g. output in Japan in 1986 and 1987 looks likely to grow more slowly than productive potential) and there is a general reluctance to encourage a faster pick up in growth rates through more expansionary macroeconomic policies, lest this put at risk the gains made on inflation and controlling the growth of public sector debt.

SM.

S W MATTHEWS

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WORLD ECONOMIC PROSPECTS

JUNE 1986 REPORT

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WORLD ECONOMIC PROSPECTS: SUMMER 1986

SUMMARY

1. The forecast covers the period to 1989, but the numbers beyond 1987 are particularly speculative. The main features are summarised below.

(a) Growth in world output and trade volumes has been disappointingly slow over the past six months, but we expect low oil prices to give a significant boost to activity over the next two years.

(b) Real GNP in the major industrialised countries grows at an average annual rate of 3 per cent over the rest of the decade, rather faster in 1987 and 1988.

(c) Trade volumes are expected to rise by only 4-5 per cent per annum because of depressed levels of imports into oil-producing countries.

(d) Inflation in the major seven OECD economies is already down to 2 per cent and should remain low throughout next year. After the once-and-for-all benefits of low oil prices, inflation may rise to 3 per cent in 1988, and further if inflationary fears in the US are realised.

(e) We assume that world oil prices average $15 from now until the end of 1987, the same assumption that was used in the FSBR.

(f) Non-oil commodity prices have continued to weaken in real terms. We expect some recovery from current extremely depressed levels as world activity grows strongly in 1987 and 1988.

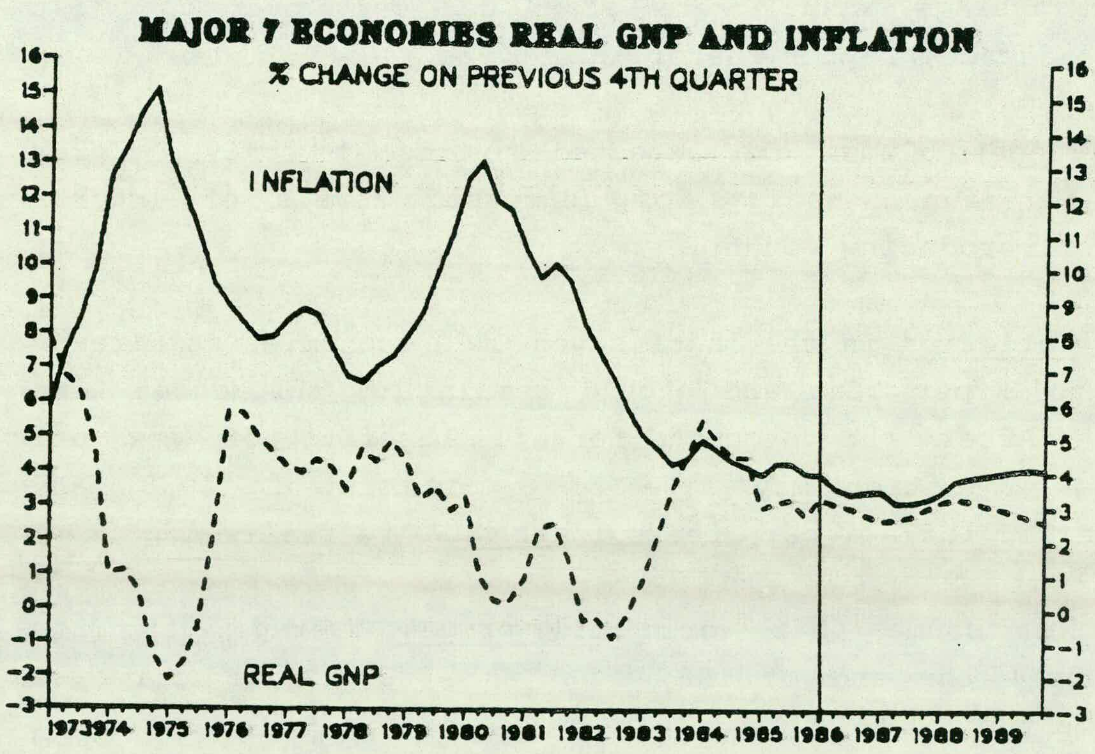
(g) Despite the depreciation of the dollar the US continues to run large current account deficits, albeit falling slightly as a proportion of GNP. Little reduction in the Japanese surplus is expected.

Table 1: Output, inflation and trade

Percentage change on year earlier	1984	1985	1986*	1987*	1988
Major 7 real GNP	4½	3	3 (3½)	3½ (4)	3½
Major 7 consumer's expenditure deflator	4½	3½	2 (2½)	1½ (1½)	2
UK export markets (manufactures)	8½	5	3 (5)	4½ (5)	5

* Figures in brackets were those in FSBR; for 1987 they are for first half only.

Chart 1:

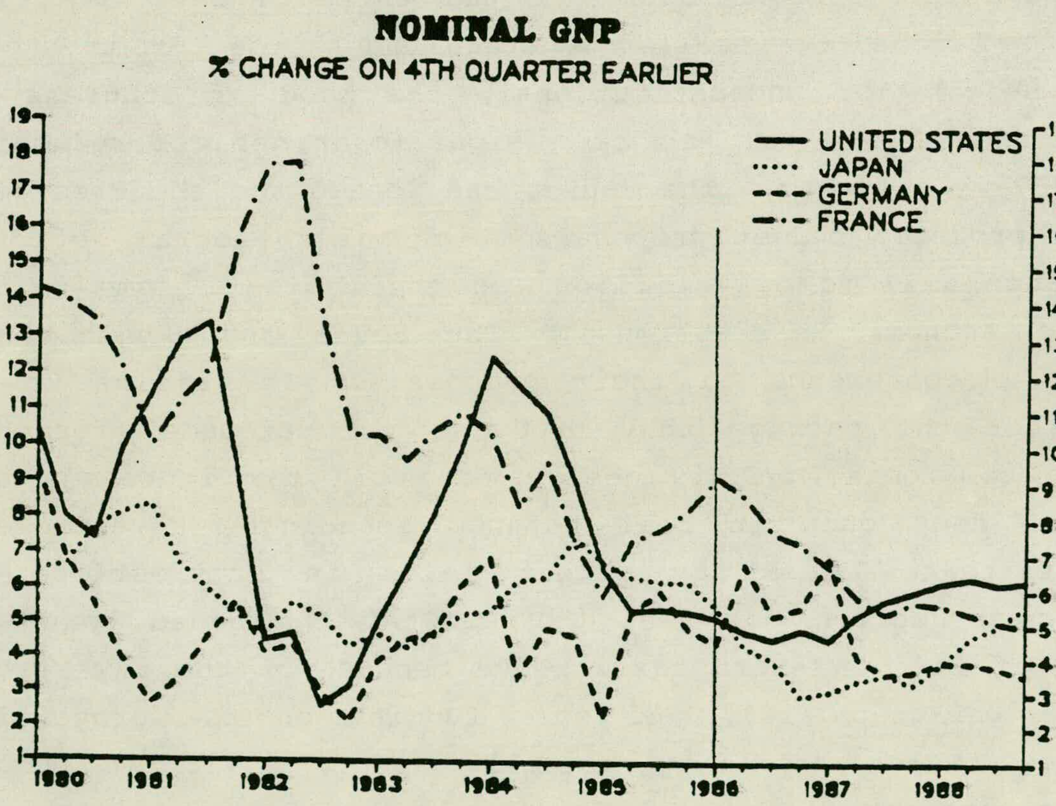


2. This report focuses on a "central" case only. A major source of uncertainty is the reaction of the world economy to the unprecedented fall in oil prices. Experience of the increases in oil prices in 1973 and 1979 indicates that such shocks can create conditions under which major forecasting errors may be made, e.g. the strength of inflationary forces in 1974 and the

depth of the recession in 1975 were underestimated. Moreover the response to a fall in oil prices may not mirror the effects of the rises of 1973 and 1979, e.g. because the propensity of OPEC to consume its revenues has increased. While there is some consensus between forecasters on the short-run effects on output, there has been little discussion of the supply-side mechanisms and the factors which may increase the long-run growth rates of productive potential.

3. Another source of uncertainty is the ability of the equations in our model to handle the response to the dramatic fall in the dollar's foreign exchange value over the past fifteen months. The conjunction of this and the oil price fall means that our forecasts of trade volumes and trade prices necessarily rely more on our own judgement, and less on the equations, than usual.

Chart 2:



FISCAL POLICY

Table 2: General Government Deficits

General Government Financial Balances as % of GNP	1968-73	1974-79	1980-84	1985	1986	1987	1988
US	-½	-1¼	-2½	-3½	-3	-2	-1½
Japan	1	-3½	-3½	-1¼	-1¼	-1	-½
Germany	0	-3	-2½	-1	-¾	-½	-¾
France	½	-1	-2	-2½	-2½	-2½	-2¼
Italy	-5	-9	-11½	-14	-13	-12¾	-12¼
Canada	1	-1½	-4½	-6	-6¼	-6	-5½
UK (* financial year)	-½	-4	-3½	-3*	-3½*	-3*	-3*
Major 7	-½	-2½	-3½	-3½	-3	-2¼	-2

4. Although the Supreme Court in the <u>United States</u> may find the role of the Comptroller-General under the Gramm-Rudman Balanced Budget Act unconstitutional, the mood of Congress is such that there is likely to be a significant deficit reduction in the 1987 fiscal year. The House, the Senate and the President have, all produced budget proposals which yield Federal deficits in the range $137 to $144 billion (on the basis of some fairly optimistic economic assumptions). The House and Senate have now gone to conference on their proposals. It remains to be seen whether the package they produce will persuade President Reagan to compromise on his desire to avoid tax increases and to prevent deep cuts in real defence spending. Nevertheless we expect that, helped by recent falls in interest rates, optimistic assumptions on real GNP growth, the added bonus of a likely $10 billion extra tax revenue because of the tax reform bill (see paragraph 14), and some fudging on the proportion of defence budget authority actually spent, a FY1987 budget broadly consistent with the Gramm-Rudman deficit ceiling of $144 billion will eventually be agreed. The out-turn, though, is likely to turn out somewhat higher at around $160 billion.

5. For FY1988 and beyond, the probable modification of the Gramm-Rudman procedures from their present stringent form will

make further cuts in the deficit more difficult. Furthermore the gaps between the Gramm-Rudman target and expected outturn deficits are likely to be viewed as insurmountable (especially with rising interest rates) if tax increases are ruled out. We are therefore forecasting Federal deficits to remain around $150 billion in each of fiscal years 1988 and 1989. This is sufficient to stabilise the debt-GNP ratio at around 43½ per cent.

Table 3: US Federal Budget Deficit

Fiscal Year	CBO baseline (Feb 86) ($bn)	Gramm-Rudman targets ($bn)	WEP ($bn)	WEP (% of Nominal GNP)	WEP Ratio of Federal debt to GNP (%)
1985	210	-	212	5½	38
1986	208	172	210	5	41
1987	181	144	160	3½	42½
1988	165	108	150	3	43½
1989	144	72	150	3	43½
1990	120	36			
1991	104	0			

6. In Japan and Germany, fiscal policy remains tight despite pressure from other countries, notably the US, for easing in the face of negligible inflation rates and falling export growth. In Japan the forecast assumes further small reductions in the central government deficit as a percentage of GDP. The German government continues to show its determination to restrict the budget deficit this year to its target of 1.2 per cent of GNP and there would seem to be little difficulty in continuing fiscal "consolidation", despite the introduction of tax reforms.

7. In France (despite its new government) and Italy the authorities are assumed to have their usual difficulties in reducing their deficits. They will be assisted by the beneficial effects of falling oil prices, but this is not expected to result in major reductions in their structural deficits. Italy, however,

is using the fall in oil prices to reduce government borrowing by raising petrol taxes. Lack of consensus on the deficit problem in Canada is limiting attempts to curb their federal budget deficit, but the markets have shown that they will react unfavourably if no action is taken.

MONETARY POLICY

8. Falling oil prices and currency appreciations outside the US have permitted sharp falls in nominal interest rates in many countries. However these factors create a difficult background for interpreting developments in monetary growth and for setting interest rates. Real interest rates (as measured by nominal rates less the current rate of inflation) have not fallen (perhaps because some of the fall in inflation due to lower oil prices is expected to be reversed), but money supply has been growing above target in several countries. Low nominal interest rates should persist over the next year or so, but rising real demand and the unwinding of the oil price effect on inflation may put upward pressure on interest rates by 1988.

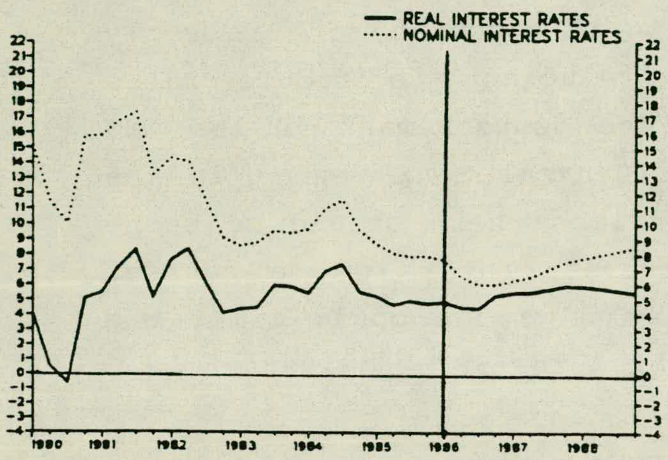
9. In the United States interest rates have fallen considerably over the past 18 months and the yield curve has become almost flat. The declines reflect good news on inflation, largely thanks to oil, and market perceptions of improved prospects for cutbacks in Federal borrowing. In the short-term there could be further interest rate cuts if growth in the second quarter is weak. Thereafter, stronger activity in the second half of the year, accompanied by concern over continued depreciation of the dollar could produce a period of gradually rising rates. There does not however seem much concern at present about the monetary aggregates, which are growing strongly, with M1 and the credit aggregate well above the top of their target ranges.

10. Japan and Germany are both facing international demands for the easing of monetary as well as fiscal policy, reinforced in the Japanese case by home pressures to ease the transition from export to domestic demand-led growth. In Japan, three

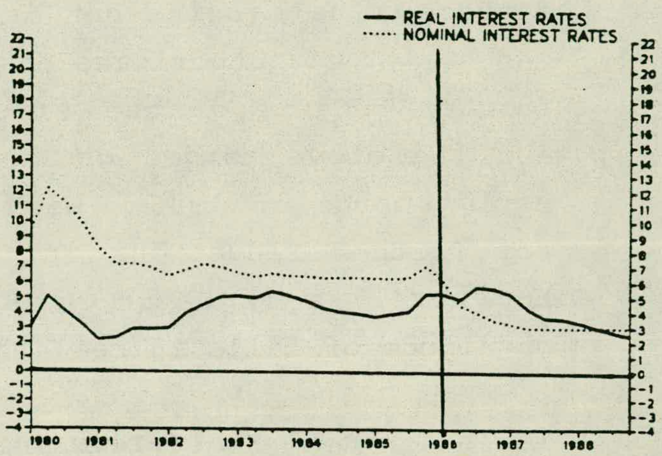
REAL AND NOMINAL 3-MONTH INTEREST RATES

CHART 3:

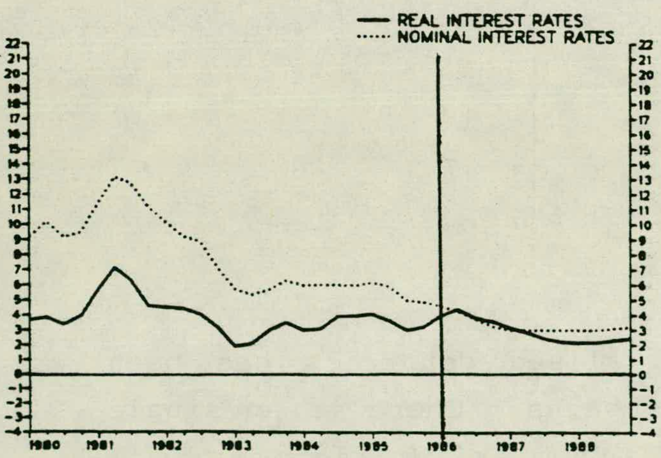
UNITED STATES



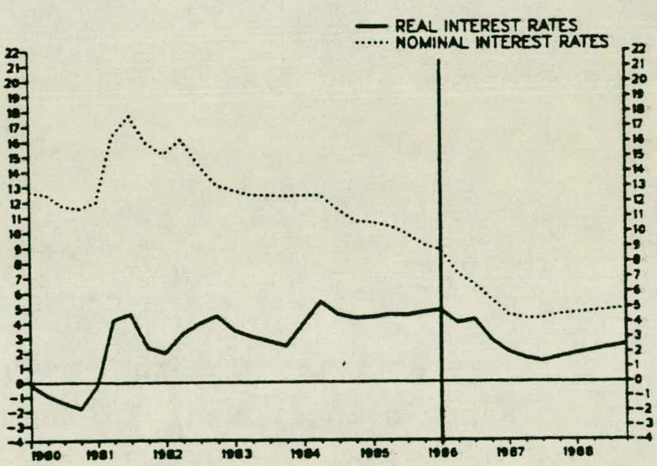
JAPAN



GERMANY



FRANCE



½ per cent cuts in the discount rate so far this year have brought most short-term interest rates down to levels last experienced in 1978. The monitored monetary aggregate, M2 + CDs, is growing at around 8½ per cent per annum, but further cuts in interest rates are thought likely later in the year. Short-term market rates in Germany have stayed at about 4½ per cent since January, despite a half point cut in the official discount rate in early March. The authorities have been reluctant to reduce rates further because of the weakness of the deutschemark in the EMS and the above target growth in CBM (Central Bank Money) in the early months of 1986. With stable prices there should be scope for further reductions in German interest rates in due course, but here, as in Japan, floors to nominal rates could limit the magnitude of falls in real interest rates in 1987 and 1988.

Table 4: Real Short-Term Interest Rates

Average annual three-month interest rates less annual change in consumer's expenditure deflator.

	1969-73 (ave)	1974-79 (ave)	1980-84 (ave)	1985	1986	1987
US	2	¼	6¼	5	4¾	5½
Japan	-½	-1	4¼	4¼	5¼	4¼
Germany	2¾	1	4¼	3½	4	2¾
France	1½	-1	2½	4½	4	1¾
Italy	1½	-4½	2½	6¼	7	6½
UK	1½	-3¼	3¾	7	6	6

ACTIVITY

11. Activity in the major industrialised countries has been disappointingly weak in the past six months. There is no single explanation for this slowdown, but a number of factors could have contributed -

(a) cutbacks in oil exploration and investment;

(b) a pause as the major countries alter the balance of domestic and external demand in their economies in response to a lower dollar and low oil prices;

(c) some destocking in the expectation of further falls in prices;

(d) severe winter weather in Europe;

(e) weak demand in developing countries.

The present poor output figures are not forecast to persist as the fall in oil prices should give a significant boost to activity. Real GNP should therefore accelerate markedly later this year and throughout 1987 and 1988.

Table 5: Growth of Real GNP and Percentage Contribution from Domestic Demand

	GDP/GNP			Domestic Demand		
	1985	1986	1987	1985	1986	1987
US	2.2	2.6	4.1	2.9	3.0	4.0
Japan	4.6	3.2	3.6	3.6	3.9	4.6
Germany	2.4	3.0	3.5	1.4	3.9	4.9
France	1.3	2.7	2.6	1.9	3.4	3.3
UK	3.3	2.4	3.1	2.5	3.7	4.6
Major 7	2.8	2.8	3.6	2.8	3.5	4.5

13. In the United States real GNP grew by an estimated 2.9 per cent (seasonally adjusted at an annual rate) between the fourth quarter of 1985 and the first quarter of 1986. This figure, boosted by strong growth in business inventories (especially cars) and government purchases, looks to be artificially high in relation to other current activity indicators; in particular, industrial production in May was 1 per cent lower than in December, and retail sales have been stagnant over the same period. Oil and gas drilling activity has been cut back, the former to a post-war low, and commercial property development is depressed. The principal bright spot comes from housing starts, with four months of strong figures fuelled by lower mortgage rates.

13. Beyond the very short term, the prospect is for some recovery in domestic demand growth although non-residential investment seems to be slowing (fulfilling the gloomy investment intentions figures). Housing investment looks likely to be strong over the next twelve months. The fall in oil prices is already showing up in lower inflation and higher real incomes and, although the initial effect may appear as higher savings, when consumers adjust their behaviour this will be translated into increased consumption expenditure. The saving ratio has risen from its recent low of 3½ per cent in September 1985 to about 4¼ per cent in April, but we continue to expect that a combination of factors (demographic trends, wealth effects from strong bond and equity prices, and low inflation and interest rates) will restrict the saving ratio to an average 5 per cent by the end of 1987 and through 1988, somewhat below its average level over the past 20 years.

14. Development of the US economy in 1987 is further complicated by the likelihood that agreement will be reached on a tax reform package which is acceptable to both Congress and the President. The package assumed in our forecast would transfer $100-140 billion from businesses to consumers over a period of five years. The net effect on activity may be slightly positive in 1987, with the cut in income tax further boosting consumers' expenditure to grow by nearly 4 per cent.

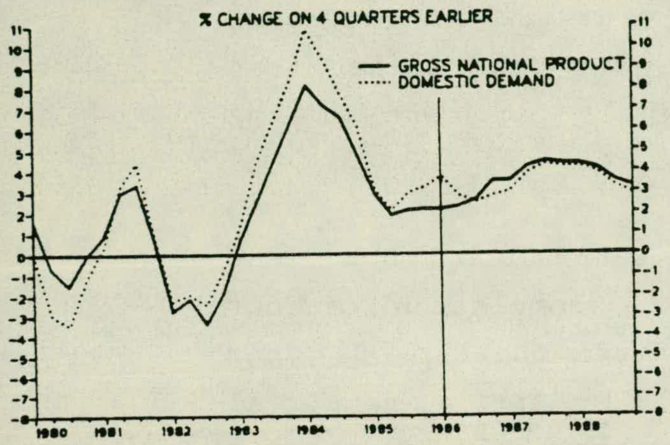
15. The volume of US exports has started to respond to the depreciation of the dollar. The scope for Japanese and other importers to maintain market share by squeezing profit margins must now be fairly limited, but strong domestic demand growth in the US will stimulate imports and limit the extent of the turnaround in trade volumes.

16. Our forecast therefore shows real GNP growth of 2½ per cent in 1986, and 4 per cent in 1987. This is in line with the latest "Blue Chip" consensus forecasts for the current year, but we are more optimistic in 1987. It should be noted however that projections for real GNP growth in 1987 show a wide

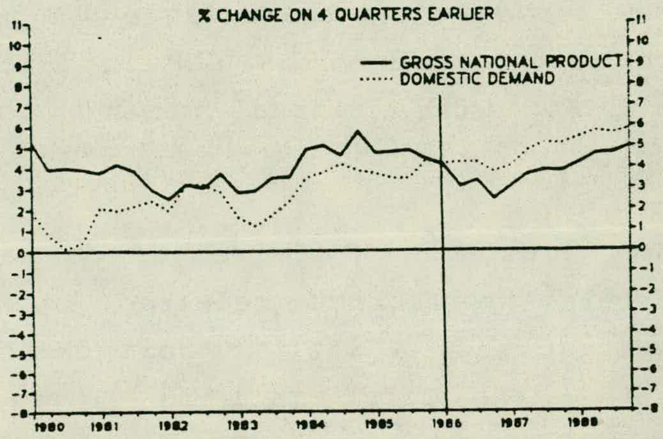
REAL GNP AND DOMESTIC DEMAND

CHART 4:

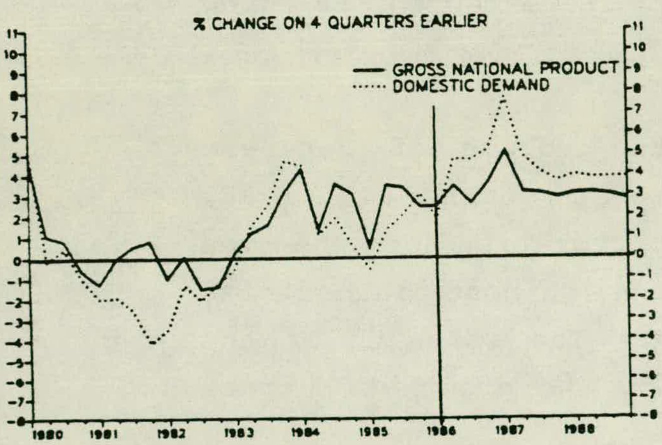
UNITED STATES



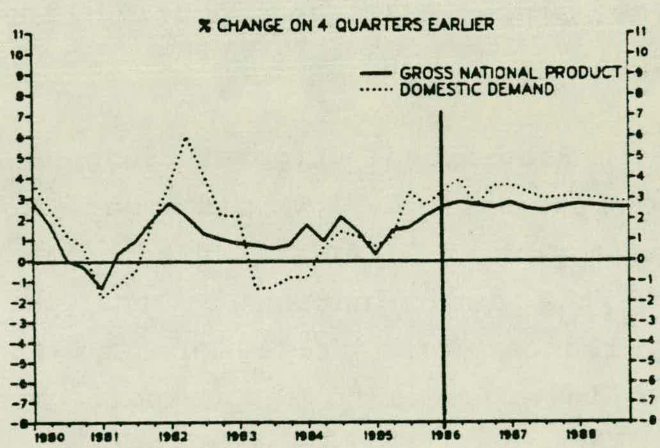
JAPAN



GERMANY



FRANCE



dispersion - several forecasters are expecting growth in the 2 - 3 per cent range while at the opposite extreme there are a few who predict 5½ per cent growth.

17. In Japan real GNP growth in the fourth quarter of 1985 was surprisingly high at 1.8 per cent. All forms of investment grew strongly and there was a 0.3 per cent contribution to growth from external demand. GNP in 1985 was 4½ per cent higher than in 1984, with external demand contributing 1 per cent of the growth.

18. Prospects for the early part of 1986 look much less favourable; figures released subsequent to completion of our forecast show a fall in real GNP in the first quarter of ½ per cent - the first fall in eleven years. In April industrial production was at the same level as in September 1985 and domestic machinery orders were only marginally higher than one year previously. Consumers expenditure continues to grow at a modest rate. Consequently, domestic demand growth is expected to be particularly weak - by Japanese standards - in the first half of 1986, before picking up as a result of increased consumers' expenditure in the latter part of this year and stronger growth of business investment in 1987. Government investment is expected to make a positive contribution to growth in 1986 for the first time since 1981 and housing investment is expected to grow modestly.

19. Provisional figures suggest that the volume of Japanese exports fell by 5 per cent in the first quarter of 1986, reflecting the first effects of the appreciation of the yen and the determination on the part of the Chinese authorities to reduce their trade deficit with Japan. The strength of the yen is expected to keep export growth below the growth of export markets over the next few years.

20. GNP in Germany fell by over 1% in 1986 Q1. The construction industry was once again badly hit by the weather and exports were weak, but consumers' expenditure was relatively buoyant. We expect domestic demand to be strong in 1986; in particular, consumption is expected to increase by nearly 4½%. Wage

settlements next year may be a little lower than in 1986 and no tax cuts have been assumed, but the saving ratio is forecast to decline as consumers adjust to slower inflation and lower interest rates. With a high degree of company profitability and a relatively good outlook, business investment is also forecast to grow rapidly over the forecast period. German exports have fallen in recent months and, with the loss of competitiveness resulting from the appreciation of the DM, exports are likely to remain weak.

21. According to preliminary French GNP data the slight slowdown in growth seen in the fourth quarter of 1985 continued into the first quarter of 1986. Both consumption and fixed investment remained strong, but there was substantial destocking (particularly of energy products) and a negative contribution from trade. With the exception of the destocking, which is likely to prove temporary and may be reversed, this broad pattern characterises our forecast for the year as a whole. Consumption will be boosted by the end-1985 tax cuts and by falling inflation, although the saving ratio may fall less sharply than it did in 1985. Business investment is likely to grow steadily through the year under the influence of increased profitability, while residential investment may start to level off after several years of decline. A similar pattern of growth is forecast for 1987.

Table 6: Unemployment*

%	1974-84 Average	1985	1986	1987
US	7½	7	7	6½
Japan	2¼	2½	2¾	2¾
Germany	4½	8½	8¼	8
France	6	10	10	10
UK	7½	13¼	13½	13¼

* OECD standardised rates

22. Unemployment is forecast to remain high in most developed countries despite the sustained output growth in the forecast. Growth rates well above potential would be needed to make substantial inroads into unemployment.

INFLATION AND COMMODITY PRICES

23. Recent indicators on price inflation have been better than we were forecasting in January. Consumer prices in April in the major seven OECD countries were less than 2 per cent higher than in April 1985 (only half the inflation rate of a year earlier) and have been virtually static since last December. In Germany prices are actually lower than they were a year ago. Already the fall in oil prices is leading to lower fuel and petrol prices and as these feed into industrial costs there should be further falls in inflation later this year. However, the once-for-all nature of the fall in oil prices and the oil-induced boost to activity will push price inflation back up towards its underlying rate of 2 - 3 per cent by 1988.

24. In Europe and Japan, the forecast continues to show a combination of factors (rising exchange rates, weak oil and other commodity prices, persistently high unemployment and firm monetary policies) which should perpetuate low rates of inflation. We do not expect price levels in Japan and Germany to change very much over the next four years, and French inflation is forecast to settle at around 3 per cent, having been around 12 per cent at the beginning of 1983.

25. The position is rather different in the US. Although consumer prices have fallen in each of the three months to April, there is a marked divergence between the energy and non-energy components - the latter were still rising at an annual rate of nearly 4 per cent in April. There are a number of reasons why the underlying rate of inflation may increase - the fall in the dollar, high rates of monetary growth, and overheating in regional labour markets bidding up real earnings - and the prospect of a significant inflationary spiral in the late 1980s cannot be ruled out.

Chart 5:

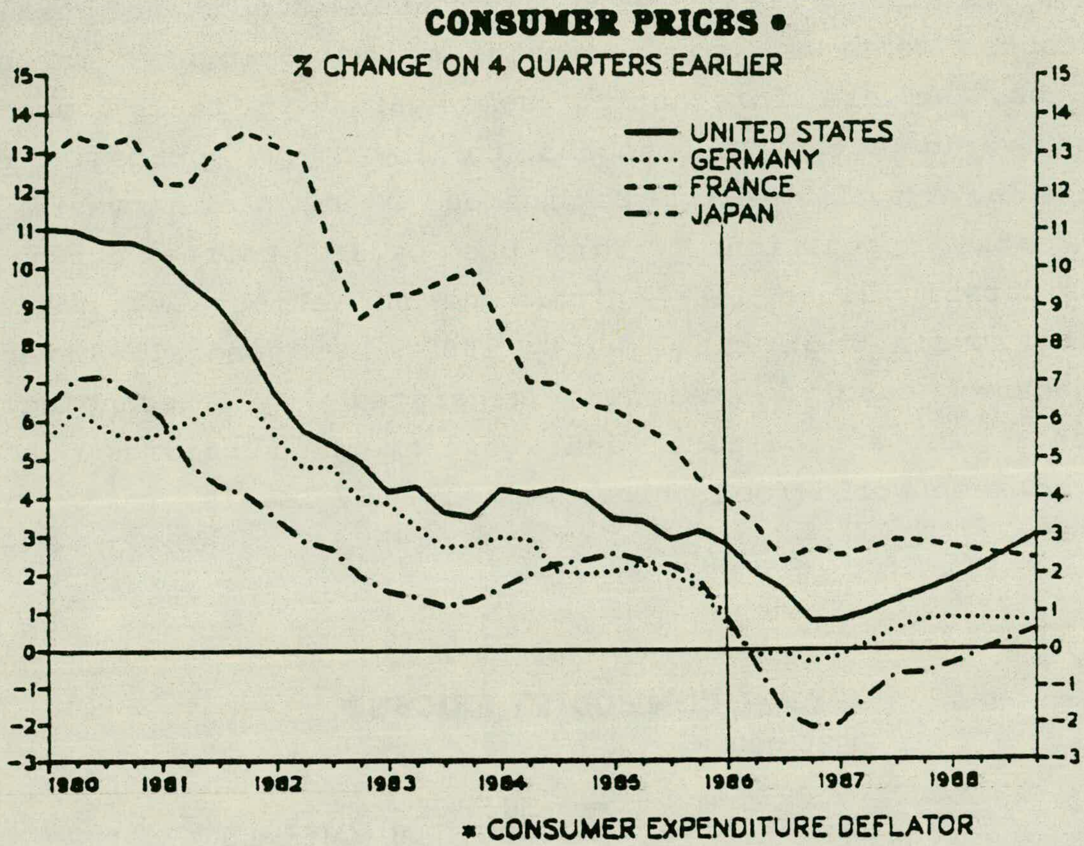


Table 7: Consumer price inflation in the Major 7 countries

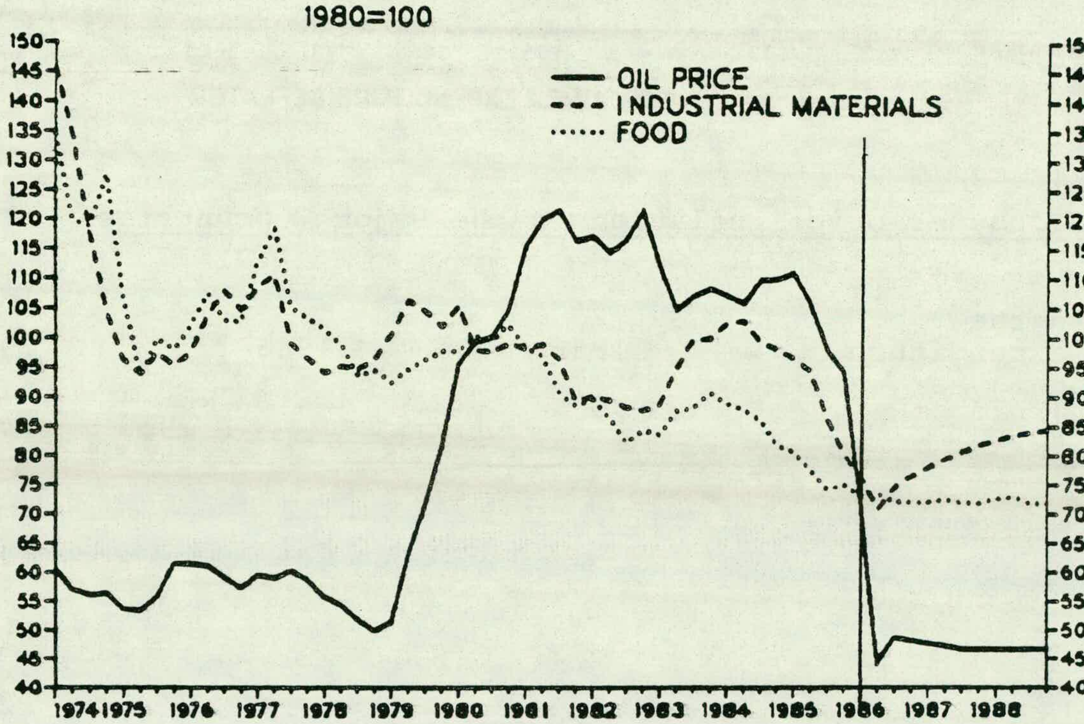
% change in the consumers expenditure deflator on a year earlier	1985	1986	1987
US	3	2	1
Canada	4	3½	2½
Japan	2	-1	1
Germany	2	0	½
France	5½	3	2½
Italy	9	6	4½
UK	5½	4½	3
Major 7	3½	2	1½

26. Once again commodity prices in recent months have turned out weaker than expected; industrial materials prices are at record low levels in real terms. Abundant supply and healthy world stocks continue to dominate most commodity markets. Nevertheless, we are forecasting some gains in real commodity prices as world activity responds to lower oil prices. Food prices are always liable to be pushed up by bad harvests and extreme weather conditions. This has caused coffee prices to firm considerably since last autumn and our expectation is that they could remain high until early 1987. In general, however, the abundant supply position generated by technological improvements in agriculture and government subsidies should continue to keep world food prices at very low levels.

Chart 6:

REAL COMMODITY PRICES *

1980=100



* IN RELATION TO PRICES OF MANUFACTURES

WORLD TRADE

27. Along with activity in the major countries, world trade slowed down in 1985 from its exceptional growth of nearly 10 per cent in 1984. Strong growth of imports into North America helped maintain moderate underlying growth of world imports through 1985, offsetting the depressing effect of an estimated fall of nearly 15 per cent in OPEC import volumes. Figures for the first quarter of 1986 are patchy but the indications are that trade may have fallen slightly. The US has recorded a small fall in the volume of imported goods, while exports from most of the major countries (apart from the US) seem to have been weak; in particular there was a large fall in Japanese exports.

28. Expansion of trade may be only moderate for the remainder of this year, reflecting a pause in world activity and the transition of Japan and Germany to greater domestic demand orientation (and the US vice versa) as well as economic difficulties in Australia and South Africa. Once lower oil prices start to stimulate world demand, the growth of import volumes can be expected to pick up. A 20 per cent cut in OPEC imports in each of 1986 and 1987, as well as relatively weak developing country imports, will reduce world import growth relative to real GNP growth in the major OECD countries as compared to the 1970s experience. (See chart 7). Within total world trade growth, trade in oil will grow relatively faster and imports of manufactures more slowly. The UK's relative dependence on OPEC markets, although declining, will depress UK-weighted measures of trade growth. The forecasts assume no major changes in levels of protection.

Chart 7:

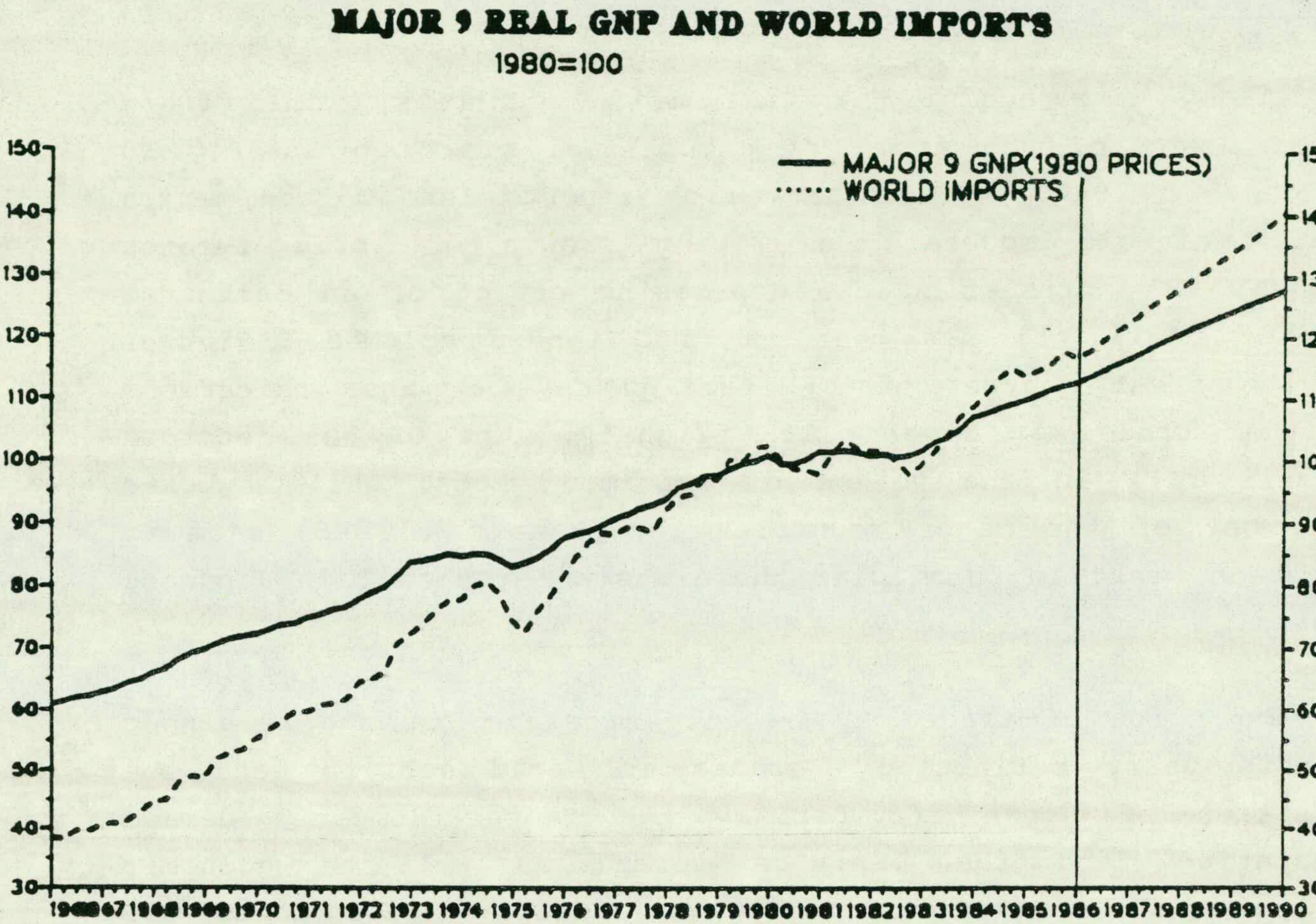


Table 8: World Import Growth

% change on previous year	1984	1985	1986	1987	1988
US	24	4	7	4	3
Japan	11	0	5	9	8
Europe+	6	5	4	8	6
Total Developed* Economies	12	5	6	6	5
OPEC	- 10	- 14	- 20	- 20	- 3
NODCS	8	3	1	6	5
Total	10	3½	3½	5	4½
UK export markets in manufactures	8½	5	3	4½	5

+Germany, France, UK, Italy, Netherlands, Belgium

*OECD + South Africa.

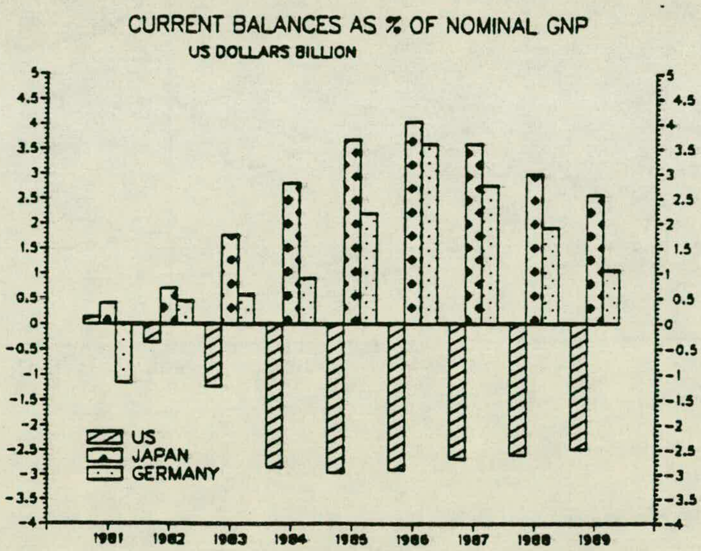
CURRENT BALANCES AND EXCHANGE RATES

29. Table 11 shows continued large current account imbalances. The US deficit is expected to fall only slowly in response to the depreciation of the dollar. Although trade volumes react to the gain in competitiveness, the sheer size of the initial deficit increases the importance of the continuing J-curve effects. In addition, the succession of deficits reduces the net stock of US assets held overseas and entails increasing net interest payments. Nevertheless the US current account deficit, and the Japanese and German surpluses, show some falls in relation to nominal GNP in 1987 and 1988.

Table 9: Current balances

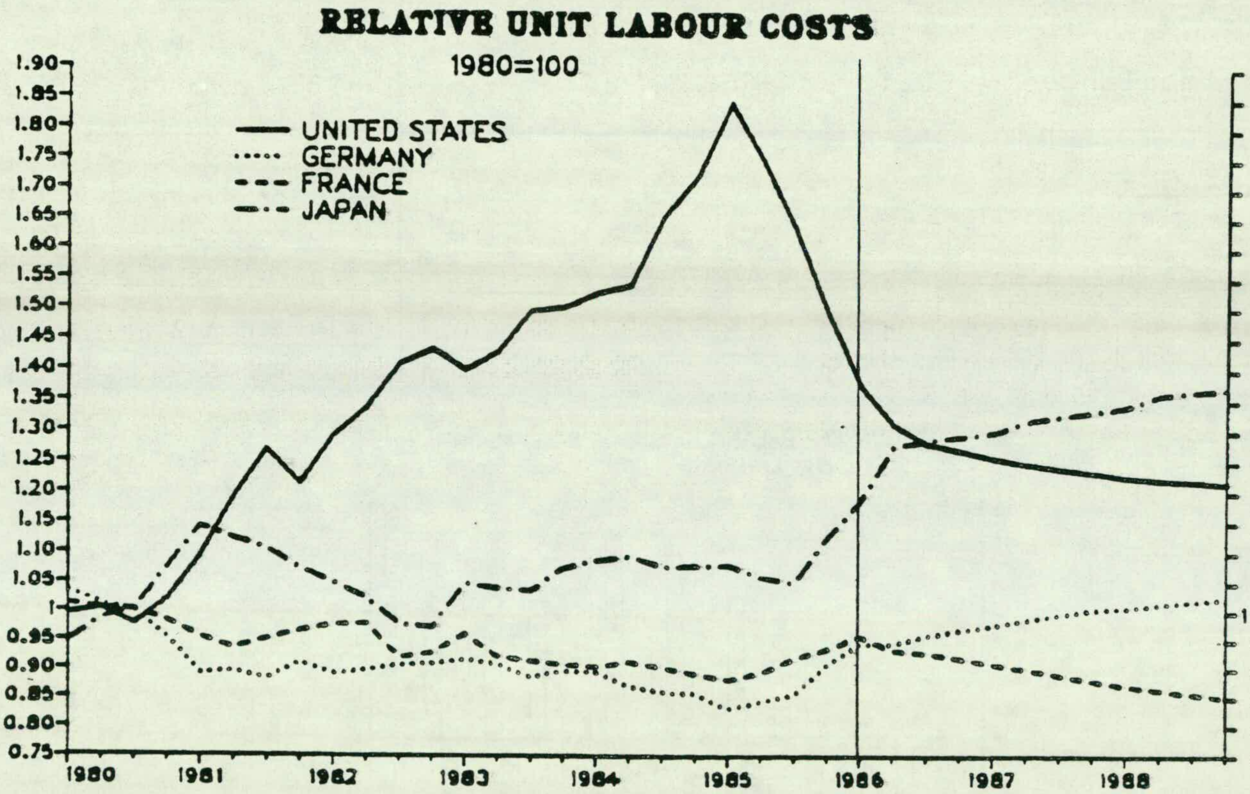
$ billion	1982	1983	1984	1985	1986	1987	1988
US	-11	-42	-107	-118	-121	-118	-122
Japan	8	21	35	49	79	81	77
Germany	3	4	6	14	31	27	21
NODCs	-61	-29	-13	-27	-6	-10	-13
OPEC	-16	-17	-9	-5	-54	-30	-16
World Imbalance	-114	-66	-85	-85	-75	-58	-67
as % of GNP							
US	-½	-1	-3	-3	-3	-2½	-2½
Japan	½	2	3	3½	4	3½	3
Germany	½	½	1	2	3½	3	2

Chart 8:



30. The dollar seems likely to depreciate further in response to continued US current account deficits and, in the medium term, its relatively high inflation. We have assumed that expectations of continued high real interest rates and confidence in the general strength of the US economy will prevent a further dramatic dollar collapse, and that Japan continues to show a strong desire to build up its external assets by direct and portfolio investment in the US and elsewhere. Even so we are forecasting further appreciation of the Yen by about 6 - 7 per cent per annum. Similarly the Deutschemark is expected to appreciate further against the dollar reflecting Germany's stable price level and large current account surplus. The EMS realignment in April has restored some of the competitiveness which other European economies had lost to Germany over the past three years. Over the forecast period we expect the French Franc and the Italian Lire to depreciate against the DM broadly in line with relative changes in prices.

Chart 9:



THE OIL MARKET, OIL PRICES AND OPEC

TABLE 10: THE OIL MARKET

Millions of barrels per day	1983	1984	1985	1986	1987	1988
Demand (including stockbuilding) in OECD, OPEC and developing countries.	44.6	45.7	45.4	47.6	49.3	51.3
Production						
OPEC	18.4	18.5	17.2	19.3	20.4	21.9
Non-OPEC	26.1	27.2	28.2	28.3	28.9	29.4
Oil Price[1] ($ per barrel)	29.0	28.1	26.9	16.2	15.0	15.7
Real (1980=100) price (relative to world manufactured export prices)	108.2	108.2	102.3	53.2	47.1	46.8

1 average price of oil imported into OECD countries (f.o.b.)

31. Spot oil prices fell dramatically from $26-27 per barrel in December to a low of $10 at the beginning of April and have since fluctuated between $10 and $15 per barrel. The prospects for the oil market in the short-term remain very uncertain. We have retained the assumption made for the FSBR forecast that world oil prices remain at $15 per barrel until late 1987, while recognising that prices could be quite volatile in practice; this assumption has also been adopted by the IMF, EC and OECD staff in their latest projections. After 1987 rising demand and further depreciation of the dollar should allow nominal (and perhaps some real) price increases.

32. World oil demand (outside the Communist area) has fallen steadily since 1979 in response to the two oil price increases in the 1970s, and has only shown signs of flattening off in the last two years with a pick-up in world activity. The Department of Energy's latest assessment, on which our forecast is based, shows OECD energy demand in 1986 and 1987 growing a little faster

than OECD real GNP, with oil's share, nearly 49 per cent in 1980, stabilising at around 42½ per cent of all energy consumption. This is a sharper turnaround in energy demand than other forecasters are expecting, but there is no previous experience by which to assess the effect of a halving of oil prices.

33. The response of oil production is also difficult to forecast. There has been little effect on oil supply in the US or the North Sea. A number of countries, including Mexico, Egypt and Norway, have said that they would be prepared to cooperate with OPEC in restraining production, but only if the OPEC members themselves come up with a realistic and viable agreement. There is, however, no consensus within OPEC on how to share out the production between members. The cartel is clearly in a weak position at present, but the longer prices stay low the stronger the pressure on OPEC to cooperate. Given the Saudis' wish to restore some stability to the market, the likelihood of their reaching an agreement, which would initially stabilise prices and then increase OPEC's market share, will increase over time.

34. Continuing low oil prices pose severe financial difficulties for OPEC and other countries highly dependent on oil exports. Further substantial reductions in import volumes are inevitable. Even Saudi Arabia can only finance two or three years of payments deficits of current magnitude without exhausting its limited reserves of liquid overseas assets and countries like Nigeria, with no foreign exchange reserves and no access to financial markets, are even harder hit.

NON-OIL DEVELOPING COUNTRIES

35. NODC export volumes are estimated to have grown by 4% in 1985, reflecting slower growth in export markets, particularly in the US. Export markets are likely to grow by only 3 per cent in 1986, but to grow faster thereafter as activity in the industrialised countries picks up. The currencies of developing countries have on average depreciated in effective terms, as some are linked to the dollar and others have adopted more realistic exchange rate policies. As a result NODCs should continue to make gains in market share, assuming no increase in protectionist measures by the industrialised countries.

Table 11: NODCs Current Account

	1984	1985	1986	1987	1988
Export volume growth (%)	14½	4	4½	6	6
Export market growth (%)	10	2½	3	5	5
Import volume growth (%)	8	3	1	6	5
Terms of Trade (% change)	½	-3	+1	-1	-1
Current Account ($bn)	-13	-27	-6	-10	-13
of which:					
trade[1]	13	5	19	17	19
invisibles	-26	-31	-25	-27	-33
MEMO ITEMS					
Change in reserves ($bn)	11	-10	14	12	12
Reserve/Import Ratio (%)	27	23	27	25	28
Capital Flows ($bn)	27	16	20	22	25

36. The sharp fall in oil prices will, of course, have different implications for the prospects of individual developing countries; but, on balance, it is unlikely to affect the overall terms of trade greatly. With coffee a temporary exception to generally weak commodity prices, the terms of trade improve marginally in 1986, but deteriorate thereafter. Import volumes appear to have fallen sharply in the second half of 1985 and this probably continued into the early part of 1986. Thus, despite a substantial recovery in the course of the year import volumes are forecast to be only slightly higher than in 1985. Chinese imports, in particular, are expected to fall from their very high 1985 levels. Given our assumptions about capital flows, NODCs should be able to increase import volumes by 5-6% a year from 1987.

Table 12: NODC Debt Indicators

	1977-84 average	1985	1986	1987	1988
Growth in Gross Debt Stock: (% change)					
Nominal	16	6	6	6	6
Real	10	4½	-8	3	1
Gross Debt/Export Ratio	1.2	1.6	1.6	1.5	1.5
Net Debt/Export Ratio	0.9	1.2	1.2	1.2	1.1
Gross Interest Service Ratio	0.10	0.14	0.12	0.12	0.12
Net Interest Service Ratio	0.06	0.10	0.09	0.08	0.08

37. Capital flows in 1985 appear to have been rather weak, although latest figures show that borrowing from banks picked up in the course of the year. There was also an increase in borrowing in the form of bonds, but this was concentrated on a small number of Asian countries. The forecast assumes a slight recovery in capital flows in 1986. IBRD lending is expected to increase in response to the Baker initiative, but commercial bank lending is likely to continue at low levels. Given the adverse effects of the oil price fall on the position of countries like Mexico, the commercial banks will be wary of lending any more to them than is absolutely necessary. Much will depend on the continuing negotiations between Mexico and the IMF.

Table 13: NODC Capital Account

	1984	1985	1986	1987	1988
Current balance	-13	-27	-6	-10	-13
ODA	13	14	16	17	18
Other Official Lending	13	9	11	12	14
o/w IBRD	9	9	10	11	13
Direct Investment	8	8	8	9	10
Bank Borrowing	10	9	9	10	11
Bonds	3	6	5	5	5
Other Capital Flows	-25	-29	-28	-28	-28
Capital Account	22	15	20	25	29
IMF Credit	5	1	0	-3	-4
Change in Reserves	11	-10	14	12	12

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THE CURRENT ACCOUNT OF THE UNITED KINGDOM
BALANCE OF PAYMENTS

MAY 1986

The current account for May is estimated to have been in surplus by £34 million compared with a surplus of £435 million in April. In May, exports were valued at £5871 million and imports at £6537 million so that trade in goods was in deficit by £666 million.

The balance on invisibles in May is projected to be in surplus by £700 million, a large surplus on the transactions of the private sector and public corporations being partly offset by a deficit on Government transactions.

MARCH TO MAY 1986

In the three months ended May, the current account showed a deficit of £0.2 billion compared with a surplus of £1.7 billion in the previous three months. There was a deficit on visible trade of £2.1 billion in the latest three months compared with a deficit of £0.2 billion in the previous three months. The surplus on invisibles is projected at £1.9 billion.

CURRENT ACCOUNT

TABLE 1

£ million, Seasonally adjusted

		Current Balance	Visible Trade			Invisibles Balance b
			Balance	Exports fob	Imports fob	
1984		+ 1563	- 4391	70367	74758	+ 5953
1985		+ 3763	- 2068	78072	80140	+ 5831
1985	Q1	- 58	- 1266	20070	21336	+ 1208
	Q2	+ 1587	- 124	20237	20361	+ 1711
	Q3	+ 1472	- 453	18748	19201	+ 1925
	Q4	+ 762	- 225	19018	19242	+ 987
1986	Q1	+ 528	- 1400	18204	19604	+ 1928
1985	Dec	+ 422	- 18	6387	6405	+ 440b
1986	Jan	+ 1090	+ 155	6289	6135	+ 935b
	Feb	+ 152	- 344	6192	6535	+ 496b
	Mar	- 714	- 1211	5723	6934	+ 497b
	Apr	+ 435a	- 265	6038	6303	+ 700a
	May	+ 34a	- 666	5871	6537	+ 700a
Dec-Feb	1986	+ 1664	- 207	18868	19075	+ 1871
Mar-May	1986	- 245a	- 2142	17632	19774	+ 1897a
Jan-May	1986	+ 997a	- 2331	30113	32444	+ 3328a

a Invisibles for April and May 1986 are projections and subject to revision as information becomes available. ~~VAT abatements received from the E.C in January have been included in the projection for that month.~~

b Monthly figures are one-third of the appropriate calendar quarter's estimate or projection, except for VAT abatements received from the European Community which are allocated to the month they are known to have been received. Information relating to credits and debits can be found in Table 3.

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VISIBLE TRADE IN MAY 1986

There was a deficit on visible trade in May of £666 million compared with a deficit of £265 million in April. The surplus on oil at £212 million was £52 million lower than in April while the deficit on non-oil trade increased by £348 million to £878 million.

At £5871 million, exports in May were £167 million (3 per cent) lower than in April. The fall was accounted for by oil (down £79 million) and the erratic items (down £214 million). Excluding oil and the erratic items, exports rose by £126 million (2½ per cent) in May.

Total imports were valued at £6537 million in May which was £233 million (3½ per cent) higher than in April. Imports of the erratic items changed little while imports of oil fell by £27 million. Non-oil imports other than the erratic items increased by 4½ per cent between the two months.

RECENT TRENDS

Visible balance

In the three months ended May, there was a deficit on visible trade of £2.1 billion a surplus on trade in oil of £0.8 billion offset by a deficit of £2.9 billion on non-oil trade. Between the three months ended February and the latest three months the deficit on visible trade increased by £1.9 billion - the surplus on oil fell by £1.3 billion and the defict on non-oil trade grew by £0.6 billion.

Exports

Exports amounted to £17.6 billion in the latest three months, £1.2 billion (6½ per cent) less than in the three months ended February. Exports of oil fell by £1.6 billion reflecting both lower oil prices and the high volumes of crude oil deliveries in January and February. Exports of the erratic items were £0.3 billion higher than in the three months ended March and non-oil exports excluding the erratic items increased by £0.1 billion (½ per cent).

By volume, total exports fell by 1 per cent in the latest three months to a level 1½ per cent down on a year earlier. Excluding oil and the erratic items export volume showed little change in the latest three months. Following a decline since mid-1985 the trend in the volume of non-oil exports has been flat in the last few months.

Imports

Total imports were valued at £19.8 billion in the latest three months, £0.7 billion (3½ per cent) higher than in the three months ended march. Imports of the erratic items increased by £0.3 billion while imports of oil fell by £0.3 billion. Excluding oil and the erratic items imports grew by 4 per cent in the latest three months.

In the three months ended May, total import volume was 3 per cent higher than in the previous three months and 1 per cent higher than a year ago. Excluding oil and the erratic items, import volume rose by 1½ per cent in the latest three months to a level 4 per cent higher than the same period a year earlier. The underlying level of non-oil import volume has shown little change in recent months.

Terms of trade and unit values

The terms of trade index was unchanged in the latest three months with both the export unit value index and the import unit value index falling by 3 per cent. Compared with the same period a year ago, the export unit value index has fallen by 7½ per cent and the import unit value index by 12 per cent. As a result, the terms of trade index is now 4½ per cent higher than a year earlier.

Export unit values for fuels fell by 36 per cent in the latest three months, while the unit value index for non-oil exports increased by 1½ per cent. Within the total for non-oil exports unit values for basic materials were down 1½ per cent in the latest three months but there were increases elsewhere.

Import unit values for fuels fell by 29 per cent in the latest three months while those for non-oil imports grew by 1½ per cent. As with exports, basic materials recorded a fall in unit values over the latest three months but elsewhere unit values increased.

<u>Analysis by area</u>

Reflecting the reduction in export of oil, exports to the developed countries fell by 9½ per cent in value terms over the latest three months. Exports to North America fell by 13 per cent while exports to Western Europe were down 9 per cent. Within Western Europe, exports to the European Community countries also fell by 9 per cent. Elsewhere, there was a 4½ per cent fall in deliveries to the 'other' developed countries but exports to the developing countries rose by 9½ per cent.

Imports from the developed countries rose by 3 per cent in the latest three months and imports from the developing countries by 5 per cent. Within the total for developed countries, arrivals

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from the European Community countries and from North America rose by 4 per cent.

NOTES TO EDITORS

1 REVISIONS

The figures for invisibles incorporate the revisions contained in the CSO quarterly Balance of Payments press notice published on 5 June.

2 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 (tables 11 and 15)

Low value consignments ie items of an individual value less than £475, are not analysed by country and are therefore excluded from the area data in tables 11 and 15.

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 MONTHLY REVIEW OF EXTERNAL TRADE STATISTICS

The Monthly Review supplements the information contained in this Press Notice. It gives longer historical runs of data and contains charts, tables on the UK Balance of Payments, UK exports and imports on an Overseas Trade Statistics basis, and certain international comparisons. The Monthly Review is available from the Department of Trade and Industry at the address given below for an annual subscription of £36 or £3 per copy.

The 1986 Annual Supplement, (price £4 per copy), giving longer historic runs of data, has recently been issued. Copies are available from the address below.

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 4895.

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CURRENT BALANCE, VISIBLE TRADE AND INVISIBLES

(Balance of Payments basis)

£ million seasonally adjusted

	Current Balance	Visible Trade					Invisible Balance b
		Exports fob	Imports fob	Visible Balance	of which		
					Oil	Non-Oil	
1984	+ 1563	70367	74758	- 4391	+ 6937	- 11328	+ 5953
1985	+ 3763	78072	80140	- 2068	+ 8163	- 10231	+ 5831
1985 Q1	- 58	20070	21336	- 1266	+ 1958	- 3225	+ 1208
Q2	+ 1587	20237	20361	- 124	+ 2411	- 2535	+ 1711
Q3	+ 1472	18748	19201	- 453	+ 1900	- 2353	+ 1925
Q4	+ 762	19018	19242	- 225	+ 1893	- 2117	+ 987
1986 Q1	+ 528	18204	19604	- 1400	+ 1994	- 3394	+ 1928
1985 Sept	+ 555	6242	6328	- 87	+ 662	- 749	+ 642b
Oct	+ 281	6329	6323	+ 7	+ 754	- 747	+ 274b
Nov	+ 59	6301	6515	- 214	+ 649	- 862	+ 273b
Dec	+ 422	6387	6405	- 18	+ 491	- 508	+ 440b
1986 Jan	+ 1090	6289	6135	+ 155	+ 987	- 832	+ 935b
Feb	+ 152	6192	6535	- 344	+ 678	- 1021	+ 496b
Mar	- 714	5723	6934	- 1211	+ 330	- 1541	+ 497b
Apr	+ 435a	6038	6303	- 265	+ 265	- 530	+ 700a
May	+ 34a	5871	6537	- 666	+ 212	- 878	+ 700a
Mar-May 1985	+ 857b	20486	21196	- 710	+ 2083	- 2793	+ 1567b
Dec-Feb 1986	+ 1664a	18868	19075	- 207	+ 2155	- 2362	+ 1871a
Mar-May 1986	- 245a	17632	19774	- 2142	+ 807	- 2948	+ 1897a
% Change							
Latest 3 months on - previous 3 months		- 6½	+ 3½				
Same 3 months one year ago		- 14	- 6½				

a Invisibles for April and May 1986 are projections and subject to revision as more information becomes available. ~~VAT abatements received from the EC in January have been included in the projections for that month.~~

b Monthly figures are one-third of the appropriate quarters estimate or projection except for VAT abatements received from the 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			Credits	Debits	Balance
				Services	Interest Profits Dividends	Transfers			
1983	65225	61227	+ 3998	+ 3671	+ 2467	- 2140	60614	52375	+ 8239
1984	77192	71239	+ 5953	+ 4225	+ 4025	- 2297	72304	61641	+ 10663
1985	81074	75243	+ 5831	+ 6233	+ 3120	- 3522	76691	64461	+ 12230
1984 Q2	17963	16910	+ 1053	+ 983	+ 818	- 748	16946	14528	+ 2418
Q3	19735	18175	+ 1560	+ 1145	+ 1146	- 731	18749	15839	+ 2910
Q4	21689	19590	+ 2099	+ 1056	+ 1336	- 293	20051	17058	+ 2993
1985 Q1	21914	20706	+ 1208	+ 1230	+ 1015	- 1037	20734	17812	+ 2922
Q2	20466	18755	+ 1711	+ 1711	+ 699	- 699	19440	16324	+ 3116
Q3	19639	17714	+ 1925	+ 1755	+ 1083	- 913	18440	14850	+ 3590
Q4	19055	18068	+ 987	+ 1537	+ 323	- 873	18077	15475	+ 2602
1986 Q1	19081	17153	+ 1928	+ 1301	+ 832	- 205	17900	14977	+ 2923

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	139.7	97.4	112.5	121.9
1985	143.5	145.2	98.8	118.6	125.7
1985 Q1	146.4	152.3	96.1	118.6	126.6
Q2	145.5	148.8	97.8	120.5	124.8
Q3	141.7	141.4	100.2	116.3	124.1
Q4	140.5	138.3	101.6	118.9	127.4
1986 Q1	139.0	137.6	101.0	117.4	126.1
1985 Sept	141.4	140.5	100.6	116.7	123.6
Oct	140.5	139.1	101.0	118.8	125.0
Nov	140.4	137.6	102.1	118.5	129.6
Dec	140.5	138.2	101.7	119.4	127.8
1986 Jan	140.7	138.3	101.7	118.7	120.3
Feb	138.7	137.8	100.7	120.7	125.8
Mar	137.5	136.6	100.7	112.7	132.2
Apr	135.3	133.0	101.7	122.2	121.9
May	134.4	131.5	102.2	120.7	131.4
Mar-May 1985	147.0	151.6	97.0	120.5	126.9
Dec-Feb 1986	140.0	138.1	101.4	119.6	124.6
Mar-May 1986	135.7	133.7	101.5	118.5	128.5
% Change					
Latest 3 months on					
- previous 3 months	- 3	- 3	-	- 1	+ 3
- same 3 months one year ago	- 7½	- 12	+ 4½	- 1½	+ 1

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	65746	71197	115.4	128.8
1985	73765	76598	123.0	133.4
1985 Q1	19171	20233	124.3	133.2
Q2	18948	19326	124.1	131.4
Q3	17835	18439	121.5	132.4
Q4	17811	18599	122.2	136.5
1986 Q1	17146	18656	121.5	133.2
1985 Sept	5899	6081	121.4	131.9
Oct	5921	6073	122.1	133.2
Nov	5898	6293	121.8	138.7
Dec	5993	6234	122.9	137.6
1986 Jan	5926	5877	123.0	127.6
Feb	5839	6229	125.2	133.2
Mar	5381	6550	116.5	138.8
Apr	5400	6004	121.2	129.0
May	5447	6230	123.8	139.4
Mar-May 1985	19319	19982	124.8	132.6
Dec-Feb 1986	17757	18340	123.7	132.8
Mar-May 1986	16229	18783	120.5	135.7
% Change				
Latest 3 months on				
- previous 3 months	- 8½	+ 2½	- 2½	+ 2
- same 3 months one year ago	- 16	- 6	- 3½	+ 2½

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

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TRADE IN OIL[g]
(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	+ 6937	14852	12173	75.9	160.4	2679	7915	3751	25.0	150.1	4163
1985	+ 8163	16050	12921	79.0	163.5	3128	7887	4155	26.1	159.0	3732
1985 Q1	+ 1958	4721	3923	21.5	182.3	798	2763	1211	6.9	176.5	1552
Q2	+ 2411	4336	3499	20.1	174.0	837	1925	1078	6.5	165.6	847
Q3	+ 1900	3410	2599	17.5	148.4	810	1509	816	5.6	145.4	694
Q4	+ 1893	3583	2900	19.9	145.9	683	1690	1050	7.2	146.9	640
1986 Q1	+ 1994	3117	2520	22.8	110.7	597	1123	678	6.2	108.7	445
1985 Sept	+ 662	1143	939	6.5	145.6	204	481	271	1.9	144.1	210
Oct	+ 754	1277	1050	7.2	145.8	227	523	291	2.0	143.9	233
Nov	+ 649	1180	974	6.7	145.8	207	532	327	2.2	150.6	205
Dec	+ 491	1126	876	6.0	146.1	249	635	433	3.0	146.2	202
1986 Jan	+ 987	1378	1133	8.2	138.6	244	391	246	1.8	136.0	144
Feb	+ 678	1048	859	8.2	104.4	189	370	227	2.2	101.4	143
Mar	+ 330	692	528	6.4	83.1	164	362	204	2.2	93.7	158
Apr	+ 265	662	450	6.8	66.5	212	397	225	2.8	79.4	172
May	+ 212	583	382	6.1	62.6	201	370	222	3.0	74.4	148
Mar-May 85	+ 2083	4615	3844	21.2	181.2	771	2532	1421	8.2	172.8	1111
Dec-Feb 86	+ 2155	3551	2869	22.4	128.0	682	1396	906	7.0	129.2	490
Mar-May 86	+ 807	1936	1359	19.2	70.7	577	1129	652	8.0	81.4	477
% Change											
Latest 3 months on											
- previous 3 months		- 45	- 53	- 14	- 45	- 15	- 19	- 28	+ 14	- 37	- 2½
- same 3 months one year ago		- 58	- 65	- 9½	- 61	- 25	- 55	- 54	- 2½	- 53	- 57

[g] 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 8 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	- 11328	55515	66843	133.5	136.2	98.0	105.1	128.2	50894	63282	107.6	137.0
1985	- 10231	62022	72253	141.8	141.9	99.9	110.6	132.9	57715	68711	115.0	142.6
1985 Q1	- 3225	15349	18573	142.2	147.1	96.7	109.2	131.6	14450	17470	114.8	139.8
Q2	- 2535	15901	18436	142.8	144.7	98.7	112.1	132.4	14612	17401	115.3	140.9
Q3	- 2353	15338	17691	141.6	139.3	101.7	110.0	132.9	14425	16930	115.4	143.6
Q4	- 2117	15435	17552	140.6	136.5	103.0	111.3	134.7	14229	16909	114.4	146.1
1986 Q1	- 3394	15087	18481	143.0	140.0	102.1	107.6	135.1	14029	17533	111.4	144.4
1985 Sept	- 749	5099	5847	141.5	138.5	102.2	109.9	132.5	4756	5599	114.8	143.2
Oct	- 747	5052	5799	140.7	137.3	102.4	109.4	132.7	4644	5550	112.3	143.2
Nov	- 862	5121	5983	140.6	135.8	103.5	111.1	137.8	4717	5761	114.1	149.3
Dec	- 508	5262	5770	140.6	136.3	103.2	113.5	133.6	4867	5599	116.9	145.7
1986 Jan	- 832	4912	5744	141.8	137.4	103.2	105.6	129.4	4549	5487	109.3	139.0
Feb	- 1021	5144	6165	143.0	140.6	101.7	110.1	134.7	4791	5859	114.2	144.4
Mar	- 1541	5032	6572	144.2	141.9	101.6	107.0	141.1	4690	6188	110.8	149.8
Apr	- 530	5376	5906	143.9	140.3	102.6	115.2	129.3	4739	5607	113.4	138.4
May	- 878	5288	6166	144.1	138.3	104.2	112.9	137.2	4865	5859	115.7	147.3
Mar-May 85	- 2793	15871	18664	143.3	146.7	97.7	111.5	132.4	14704	17450	115.5	139.7
Dec-Feb 86	- 2362	15317	17679	141.8	138.1	102.7	109.7	132.6	14206	16944	113.5	143.1
Mar-May 86	- 2948	15696	18645	144.0	140.2	102.8	111.7	135.8	14293	17654	113.3	145.2
% Change												
Latest 3 months on												
- previous 3 months		+ 2½	+ 5½	+ 1½	+ 1½	-	+ 2	+ 2½	+ ½	+ 4	-	+ 1½
- same 3 months one year ago		- 1	-	+ ½	+ 4½	+ 5	-	+ 2½	- 3	+ 1	- 2	+ 4

[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

Table 8

(Overseas Trade Statistics basis)

£ 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 (SNA): Passenger Motor Cars	Finished (SNA): Other Consumer	Finished (SNA): Intermediate	Finished (SNA): 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	70488	4693	1989	15308	46703	42169	16333	8217	8116	25835	1050	4673	11199	8912
1985	78331	4970	2145	16712	52514	48482	18449	9411	9038	30033	1343	5257	13493	9940
1985 Q1	20148	1192	579	4892	13035	12181	4692	2384	2307	7489	338	1292	3330	2529
Q2	20258	1284	529	4513	13436	12248	4704	2402	2303	7544	340	1304	3350	2550
Q3	18828	1300	531	3600	12879	12020	4532	2285	2246	7489	336	1342	3394	2416
Q4	19097	1193	506	3708	13164	12033	4522	2340	2182	7512	329	1319	3418	2445
1986 Q1	18257	1206	511	3297	12766	11807	4418	2293	2125	7389	293	1297	3346	2452
1986 Mar	5755	400	165	739	4281	3968	1457	740	717	2511	88	438	1149	836
Apr	6028	419	159	703	4577	4003	1497	788	709	2506	127	459	1082	838
May	5908	414	137	651	4532	4131	1533	795	738	2598	114	464	1132	888
Dec-Feb	18920	1201	529	3727	13004	11989	4493	2353	2141	7496	323	1315	3384	2473
May-May	17692	1232	460	2093	13390	12102	4487	2324	2163	7615	329	1361	3363	2561
Percentage Change	- 6½	+ 2½	- 13	- 44	+ 3	+ 1	-	- 1	+ 1	+ 1½	+ 2	+ 3½	- ½	+ 3½

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

Table 9

(Overseas Trade Statistics basis)

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 (SNA): Passenger Motor Cars	Finished (SNA): Other Consumer	Finished (SNA): Intermediate	Finished (SNA): 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	112.8	117.2	106.3	160.2	104.4	107.0	112.1	124.3	102.3	103.8	82.4	107.8	105.4	102.6
1985	119.3	119.1	107.0	170.9	110.8	115.7	118.9	133.3	107.5	113.7	99.4	111.6	121.4	107.6
1985 Q1	119.4	118	110	180	110	116	120	134	109	113	99	109	120	110
Q2	121.0	122	102	176	112	116	120	133	109	114	100	111	120	109
Q3	117.1	123	110	161	109	115	117	130	107	114	102	114	123	105
Q4	119.7	114	106	168	112	116	119	136	105	114	97	112	123	106
1986 Q1	118.0	117	113	184	107	111	115	131	102	109	88	108	117	103
1986 Mar	113.7	113	112	154	107	111	113	124	104	110	79	108	119	104
Apr	122.3	118	108	177	115	114	118	137	103	112	108	115	115	107
May	121.6	114	95	177	114	117	119	136	106	116	94	117	120	113
Dec-Feb	120.2	117	115	186	110	114	117	136	103	112	95	110	120	106
Mar-May	119.2	115	105	169	112	114	117	132	104	112	94	113	118	108
Percentage Change	- 1	- 1½	- 8	- 8½	+ 2	-	- ½	- 2½	+ 1	+ ½	- 2	+ 3	- 1½	+ 2

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: Capita
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	152	135	133	127	130	125	137	157	135	140	132
1985	143.4	134	140	155	143	142	135	139	132	147	162	147	150	141
1985 Q1	146.3	132	146	173	143	141	135	139	132	145	161	146	148	139
Q2	145.4	134	146	163	144	143	136	141	133	147	162	147	150	142
Q3	141.6	134	136	142	143	143	135	140	132	147	162	148	151	141
Q4	140.4	134	130	140	142	142	134	137	131	148	163	149	151	141
1986 Q1	138.9	136	128	114	145	145	137	142	133	150	166	153	153	144
1986 Mar	137.4	138	129	95	146	147	138	144	133	152	170	156	155	145
Apr	135.2	140	127	80	146	147	137	143	133	152	174	156	155	145
May	134.2	141	123	72	146	147	138	142	134	153	179	156	155	144
Dec-Feb	139.9	135	128	129	143	144	136	140	132	149	165	151	152	143
Mar-May	135.6	140	126	82	146	147	138	143	133	152	174	156	155	145
Percentage Change	- 3	+ 3½	- 1½	- 36	+ 1½	+ 2	+ 1½	+ 2	+ 1	+ 2½	+ 5½	+ 3½	+ 2	+ 1½

[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	North America USA	Other	Developing Countries Total	Oil exporting countries	Other	Centrally planned economies
1984	70488	55364	33127	7132	11416	10159	3688	13356	5806	7550	1630
1985	78331	62722	38200	7420	13310	11499	3792	13880	5957	7924	1587
1985 Q1	20148	15940	9992	1779	3179	2817	990	3758	1682	2077	389
Q2	20258	16210	9537	2034	3667	3189	972	3606	1510	2096	420
Q3	18828	15203	9312	1790	3182	2715	919	3314	1408	1906	386
Q4	19097	15369	9359	1817	3282	2778	910	3202	1357	1845	392
1986 Q1	18257	14652	8689	1779	3254	2784	930	3241	1405	1837	442
1986 Mar	5755	4575	2748	561	961	831	304	1106	486	620	125
Apr	6028	4619	2833	520	973	857	293	1172	566	606	144
May	5908	4492	2595	605	993	885	300	1280	563	717	129
Dec-Feb	18920	15139	8988	1834	3377	2882	940	3254	1409	1845	475
Mar-May	17692	13686	8177	1685	2927	2573	897	3558	1615	1943	398
Percentage Change	- 6½	- 9½	- 9	- 8	- 13	- 11	- 4½	+ 9½	+ 15	+ 5½	- 16

K See paragraph 3 of Notes to Editors.

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IMPORTS BY COMMODITY

(Overseas Trade Statistics basis)

£ 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	78967	8933	5418	10334	53011	49708	17930	6322	11608	31778	3670	8346	10218	9543
1985	84790	9274	5389	10517	58288	54953	19619	6903	12716	35334	4165	8887	11623	10659
1985 Q1	22565	2354	1468	3546	14844	13806	4817	1674	3143	8989	1014	2243	2975	2757
Q2	21548	2352	1366	2656	14848	13842	4920	1792	3128	8922	1116	2219	2928	2659
Q3	20321	2311	1312	2138	14250	13508	4913	1729	3184	8595	988	2189	2838	2581
Q4	20356	2256	1243	2178	14346	13798	4970	1708	3262	8829	1047	2237	2882	2662
1986 Q1	20670	2507	1225	1725	14839	14002	5024	1809	3215	8978	1152	2281	2881	2665
1986 Mar	7270	907	414	563	5255	4943	1773	627	1146	3170	435	795	1011	929
Apr	6692	770	390	616	4750	4461	1615	582	1033	2846	326	775	932	813
May	6921	807	420	509	5057	4764	1692	621	1071	3072	414	809	1016	834
Dec-Feb	20185	2330	1226	1945	14322	13646	4930	1772	3159	8716	1041	2232	2811	2631
Mar-May	20883	2484	1225	1688	15062	14168	5080	1830	3250	9088	1174	2379	2959	2576
Percentage Change	+ 3½	+ 6½	-	- 13	+ 5	+ 4	+ 3	+ 3½	+ 3	+ 4½	+ 13	+ 6½	+ 5	- 2

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	120.2	112.3	101.7	86.5	134.1	146.7	137.2	164.5	125.9	153.0	119.9	139.6	161.4	172.9
1985	124.3	113.6	102.2	85.0	140.7	154.5	143.9	176.2	130.6	161.5	127.9	139.6	172.8	187.2
1985 Q1	125.1	111	102	102	139	151	139	168	126	159	123	135	171	189
Q2	123.3	112	98	82	141	153	142	180	126	160	139	137	170	184
Q3	122.8	116	103	75	140	154	147	180	133	159	125	139	171	184
Q4	126.0	115	106	81	143	160	149	177	137	167	124	147	180	192
1986 Q1	124.5	126	105	71	141	155	148	183	133	159	130	145	171	175
1986 Mar	129.8	136	106	75	146	160	155	190	141	163	143	148	176	177
Apr	122.5	115	101	92	135	148	142	176	128	151	107	148	166	162
May	129.9	120	111	90	145	160	151	192	134	166	136	157	185	169
Dec-Feb	123.4	118	107	75	140	155	146	181	132	160	120	146	172	181
Mar-May	127.4	124	106	86	142	156	149	186	134	160	129	151	176	169
Percentage Change	+ 3½	+ 4½	- 1	+ 15	+ 2	+ 1	+ 2	+ 3	+ 1½	-	+ 7½	+ 3½	+ 2	- 6½

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	Passenger Motor Cars	Other Consumer	Intermediate	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	138.0	132	133	168	134	133	126	134	123	137	144	135	145	129
1985	143.1	137	130	172	141	141	133	139	130	146	152	147	155	134
1985 Q1	150.3	142	143	191	146	144	135	143	132	150	154	151	158	138
Q2	146.7	141	136	181	143	143	135	141	133	148	150	147	159	136
Q3	139.2	135	124	161	139	139	131	137	128	144	149	145	154	131
Q4	136.3	132	116	155	137	138	130	137	127	143	156	143	148	131
1986 Q1	135.6	134	116	132	140	142	132	141	129	148	165	145	152	138
1986 Mar	134.7	135	116	113	143	144	133	142	130	151	171	148	155	142
Apr	131.5	134	115	101	141	143	132	141	129	149	169	146	154	140
May	130.0	136	113	99	139	141	131	139	128	148	170	142	152	138
Dec-Feb	136.1	133	115	147	138	139	131	139	127	145	162	143	150	135
Mar-May	132.0	135	114	104	141	142	132	141	129	149	170	145	153	140
Percentage Change	- 3	+ 1½	- 1	- 29	+ 2	+ ~~1~~ 2	+ 1	+ 1	+ 1	+ 3	+ 5	+ 1½	+ 2½	+ 3½

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	78967	65279	37408	11184	11067	9368	5620	11514	2934	8579	2043
1985	84790	71520	41413	12025	11703	9920	6379	11233	2782	8451	1894
1985 Q1	22565	18709	10596	2940	3600	3074	1573	3296	812	2484	558
Q2	21548	17957	10271	3060	3044	2602	1582	2984	851	2133	441
Q3	20321	17293	10096	3083	2546	2166	1569	2499	499	2000	485
Q4	20356	17561	10451	2942	2512	2078	1655	2454	620	1834	410
1986 Q1	20670	17868	10695	3121	2395	2007	1657	2422	504	1918	424
1986 Mar	7270	6364	3809	1146	848	716	562	840	145	695	147
Apr	6692	5562	3337	941	815	681	470	876	152	723	152
May	6921	5845	3626	808	787	644	623	859	169	690	133
Dec-Feb	20185	17232	10360	2886	2354	1969	1632	2448	621	1827	415
Mar-May	20883	17772	10772	2895	2450	2042	1655	2574	466	2108	433
Percentage Change	+ 3½	+ 3	+ 4	+ ½	+ 4	+ 3½	+ 1½	+ 5	- 25	+ 15	+ 4

K See paragraph 3 Notes to Editors.

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Table 16

COMMODITY ANALYSIS OF VISIBLE TRADE
(Balance of Payments basis)

£ million, seasonally adjusted

SITC (R2)	Food Beverages and Tobacco 0 + 1			Basic Materials 2 + 4			Fuels 3		
	Exports fob	Imports fob	Visible Balance	Exports fob	Imports fob	Visible Balance	Exports fob	Imports fob	Visible Balance
1984	4672	8196	- 3524	2014	4864	- 2850	15308	9917	+ 5391
1985	4936	8481	- 3545	2161	4789	- 2628	16712	10094	+ 6618
1984 Q1	1138	1961	- 823	440	1150	- 710	3769	1758	+ 2011
Q2	1175	2037	- 862	493	1174	- 681	3520	2355	+ 1165
Q3	1142	2073	- 932	519	1192	- 673	3840	2507	+ 1333
Q4	1218	2126	- 908	563	1349	- 786	4180	3297	+ 883
1985 Q1	1186	2155	- 969	585	1315	- 731	4892	3387	+ 1505
Q2	1276	2153	- 877	533	1226	- 693	4513	2548	+ 1965
Q3	1290	2122	- 832	534	1162	- 628	3600	2067	+ 1533
Q4	1185	2052	- 867	509	1086	- 577	3708	2092	+ 1616

SITC (R2)	Semi-Manufactures 5 + 6			Finished Manufactures 7 + 8			Total Manufactures 5 - 8		
	Exports fob	Imports fob	Visible Balance	Exports fob	Imports fob	Visible Balance	Exports fob	Imports fob	Visible Balance
1984	18266	18410	- 144	28324	32059	- 3735	46590	50469	- 3879
1985	20042	19978	+ 65	32254	35335	- 3081	52296	55313	- 3017
1984 Q1	4247	4396	- 148	6684	7177	- 493	10932	11573	- 641
Q2	4502	4439	+ 62	6717	7775	- 1058	11218	12214	- 996
Q3	4558	4684	- 127	7126	8336	- 1210	11684	13021	- 1337
Q4	4960	4890	+ 69	7797	8771	- 974	12757	13662	- 905
1985 Q1	5017	4836	+ 182	7946	9263	- 1316	12963	14098	- 1135
Q2	5201	5050	+ 151	8223	9025	- 803	13423	14075	- 652
Q3	4852	5126	- 274	7960	8361	- 402	12812	13487	- 675
Q4	4973	4967	+ 5	8125	8686	- 560	13098	13653	- 555

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

5.94

(28

FROM: N G FRAY

DATE: 27 June 1986

MR J WEBB

WORLD GROWTH

The Chancellor has seen and was grateful for your minute of 20 June.

Nigel Fray

N G FRAY

33/3070
CONFIDENTIAL

p m l

FROM: DAVID PERETZ
30 June 1986

ECONOMIC SECRETARY

cc Chancellor
Chief Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Evans
Mr Sedgwick
Mr Culpin
Mr Walsh
Miss O'Mara
Mr Mathews
Mr Richardson
Ms Goodman
Mr Ross Goobey
Mr Hosker T.Sol

Ch
This seems OK
RC
30/6

RPI ADVISORY COMMITTEE: IMPLCIATIONS FOR INDEX-LINKED GILTS AND SAVINGS CERTIFICATES

You will recall the timetable for announcement of completion of the RPI Advisory Committee's Report, and for making Govenment decisions on it, as set out in paragraph 9 of my minute of 4 June. The Chancellor subsequently wrote to Lord Young, on 10 June, agreeing to the timetable - but suggesting officials agree the precise wording of the announcements at the time.

2. I attach the wording of the first announcement, to be made by way of an arranged PQ tomorrow - together with an associated press release. This is the announcement that the RPIAC has completed its work, and submitted its Report to Ministers. You will recall we then need to have a further announcement in a few weeks time, as soon as decisions on the Report have been taken.

3. I have discussed this first announcement with the Bank of England, the Department of Employment and Treasury Solicitor's Department (Mr Hosker).

4. We have been able to consider it in the light of the outcome of a considered assessment by the Bank of England of the significance of the changes proposed. The Bank have in fact been through the process that they will need to go through formally, once decisions about changes to the RPI are made, to

see if the changes are sufficient to trigger the clause in the prospectus for index-linked gilts that provides for premature repayment if a change is made to the coverage or basic calculation of the RPI which "in the opinion of the Bank of England is a fundamental change that would be materially detrimental to the interests of stockholders." The Bank have concluded (letter attached) that the changes proposed are not fundamental changes that would be materially detrimental to the interest of holders of indexed securities. So they will not be triggering the premature redemption clause.

surprise!

5. This is very much as expected. As explained in paragraph 7 of my minute of 4 June it much reduces the extent to which we are at risk in continuing to sell index-linked securities in the period before decisions are made and announced.

6. Nothing short of removing index-linked securities from sale completely (which we are agreed we do not want to do) can give us complete protection. But given the Bank of England's conclusion, I have agreed with Mr Hosker that the statement that Department of Employment propose making tomorrow reduces the extent to which we are at risk to a sufficient degree. I have so informed Department of Employment officials.

7. Press questioning about the announcement should be referred to the Department of Employment. But I have agreed that the Bank of England will, if asked about the implications for index-linked gilts, be prepared to say that they were represented on the Advisory Committee and do not believe the proposals will cause any problems. They will deal in a similar way with any queries from the gilt-edged market. The Bank cannot, of course, go any further than this without getting into questions about details of the proposals - which are not to be unveiled until Government decisions have been taken.

PP Woodall

D L C PERETZ

(dictated by Mr Peretz and signed in his absence)

0[illegible]54B

IAN PLENDERLEITH
Head of Gilt-Edged Division
01-601 4491

BANK OF ENGLAND
LONDON
EC2R 8AH

27 June 1986

D L C Peretz Esq
HM Treasury
Parliament Street
London
SW1P 3AG

Dear David,

INDEX-LINKED GILTS AND THE PROSPECTIVE CHANGES TO THE RETAIL PRICE INDEX

We have now completed our review of the proposals put forward by the RPI Advisory Committee, as set out in the final draft of their report (ref RPIAC (86) 52).

I can confirm that, on the basis of the proposals in that draft, none of them would in our opinion constitute a fundamental change in the index which would be materially detrimental to the interests of stockholders.

Yours sincerely,

Ian Plenderleith

DRAFT FOR A PRESS NOTICE TO BE ISSUED ON TUESDAY 1 JULY TO ANNOUNCE THE SUBMISSION OF THE REPORT OF THE RETAIL PRICES INDEX ADVISORY COMMITTEE

Improvements in the way the retail prices index is compiled and presented have been recommended in a report by the RPI Advisory Committee which advises the Secretary of State for Employment on the index. The Government announced today in answer to Parliamentary Questions that the report had been submitted to Ministers and would be published shortly. The full text of the Commons Question is as follows:

[SEE ATTACHMENT]

A similar reply was given to a parallel Question in the Lords.

Notes to Editors

1. The Retail Prices Index Advisory Committee is convened from time to time by the Secretary of State for Employment to advise on the coverage, construction and presentation of the retail prices index. It first met in 1947, when the present index was initiated, and has met nine times since then. The latest series of meetings began in September 1984, after the then Secretary of State for Employment announced on 6 June 1984 that he intended to reconvene the Committee to re-examine the treatment of housing costs in the retail prices index, to consider the possibility of rebasing the index and to consider certain points on its coverage and construction.

2. Since its inception the Committee has reported on all significant developments in RPI methodology and generally has maintained an oversight on the way in which the index is constructed. The recommendations have generally been published as command papers* and it is intended that the latest report should be made available in that way.

3. The Committee consists of representatives of both sides of industry, trade and consumer interests, academic experts and government departments, under the chairmanship of a Deputy Secretary from the Department of Employment, currently Mr D B Smith, CB. The membership of the present Committee was announced in a press notice issued by the Department of Employment on 20 September 1984, since when the National Consumer Council has nominated Ms J Johnstone to replace Ms F Williams and the Department of Health and Social Security has nominated Ms A Cleveland to replace Mr M V Wilde.

Cmd 7077 (1947), Cmd 8328 (1951), Cmd 8481 (1952), Cmd 9710 (1956), Cmd 1657 (1962), Cmd 3677 (1968), Cmd 4749 (1971) and Cmd 5905 (1975)

DRAFT FOR ARRANGED PQs IN BOTH HOUSES ON TUESDAY 1 JULY TO ANNOUNCE THE SUBMISSION OF THE REPORT OF THE RETAIL PRICES INDEX ADVISORY COMMITTEE

DRAFT QUESTIONS: To ask Her Majesty's Government [the Paymaster General] whether the Retail Prices Index Advisory Committee has submitted its report.

DRAFT REPLIES: The Committee's report has been submitted to me [my Rt. Hon friend the Secretary of State for Employment] today. It makes a number of recommendations for improving the way in which the retail prices index is constructed and presented. It will be published as soon as possible. The Government's decision on the recommendations will be announced in due course.

pr 7

A23/1

COPY NO 86

MONTHLY ECONOMIC BRIEF

Prepared by the CSO on 30 June 1986

Published estimates for the first quarter of 1986 confirm that GDP has been growing at a slower rate since the first part of 1985. The very limited information so far available for the second quarter of 1986 gives little indication of any change.

The trend in unemployment continues upward, despite the continuing favourable impact from employment and training measures.

The annual rate of inflation fell from 3.0 to 2.8 per cent in May. Although petrol prices are expected to have risen between May and June, the rate of inflation is expected to show a further fall in the year to June. This would primarily be due to the announced cut in mortgage interest rates which will affect most borrowers in June.

The PSBR in May was £1.1 billion, bringing borrowing in the first two months of 1986-87 to £1.9 billion. The British Telecom receipts in April reduced borrowing by £1.1 billion.

First estimates and projections suggest that the current account surplus was of the order of £1 billion in the first five months of 1986. In May visible trade is estimated to have been in deficit by £0.7 billion, following a deficit of £0.3 billion in April. Following a decline since mid-1985, the trend in the volume of non-oil exports has been flat in the last few months. The underlying level of non-oil import volume has shown little change in recent months.

Unfavourable market reactions to the money supply figures have forestalled any renewed pressure for further interest rate falls. Stock markets have recovered from the short term decline experienced in the first part of May. Sterling's ERI has remained at around 76.

RECENT RATES OF CHANGE AND ASSESSMENT OF CURRENT TREND FOR SOME KEY ECONOMIC INDICATORS

In the following notes, the figures for current trend represent our best assessment of the current underlying rate of increase after making allowance for temporary distorting factors such as strikes, unseasonal weather effects, etc. The figures show how the series are moving currently and may be different from the comparisons over the latest published twelve months.

GDP (average measure) in the first quarter of 1986 was $2\frac{1}{2}$ per cent higher than in the same period a year ago or $1\frac{1}{2}$ per cent after discounting the effects of the coal strike. This figure does not take account of past experience which shows that revisions to growth rates for the initial published estimates of GDP were, on average, upwards, though not uniformly so. The assessment of current underlying trend for the second quarter of 1986 is that the rate of increase lies in the range $\frac{1}{2}$–$2\frac{1}{2}$ per cent per annum.

Industrial production in the three months to April was 2 per cent higher than in the same period a year ago, but was unchanged after allowing for the effects of the coal strike and other disputes, notably those in the motor vehicles industry. On the same basis, respective figures for manufacturing were $-\frac{1}{2}$ per cent in both cases. The assessment of underlying trend for industrial production is that the rate of change currently lies in the range $+\frac{1}{2}$ to $-1\frac{1}{2}$ per cent per annum. The trend in manufacturing output is in the range $-\frac{1}{2}$ to $-2\frac{1}{2}$ per cent per annum.

Retail prices rose by a little under 3 per cent in the twelve months to May 1986. It is only possible to provide a useful indicator of trend for about 70 per cent of the RPI, mainly that covering private sector prices and excluding mortgage rates, local authority rates, seasonal food, nationalised industry prices and petrol. The current trend for this series is a little under 4 per cent per annum. In the twelve months to May 1986 this series rose by 4 per cent (not published).

Producer input prices declined in seasonally adjusted terms in each of the months from March last year to April this year, and remained unchanged in May. Some further small decline is expected in June, bringing the index to about $12\frac{1}{2}$ per cent below its peak in February last year.

Average earnings (underlying) in the twelve months to April rose by $7\frac{1}{2}$ per cent. The current trend is estimated to be in the range 7–$7\frac{1}{2}$ per cent per annum.

Unit wage costs in manufacturing in the three months to April rose by $7\frac{1}{2}$ per cent compared with the same period a year ago. The current underlying trend is estimated to be in the range 7–9 per cent per annum.

Unemployment (excluding school leavers) in the twelve months to May has been rising on average by 7 thousand per month and by 16 thousand per month in the latest six months. Discounting the effects of employment and training measures as far as possible, the current underlying trend appears to be an increase in the region of 15–20 thousand per month.

Movements over the latest published 12 months include any revisions that may have occurred since last publication (in general any such differences only occur in the GDP series).

CHART 1

Changes in output and expenditure

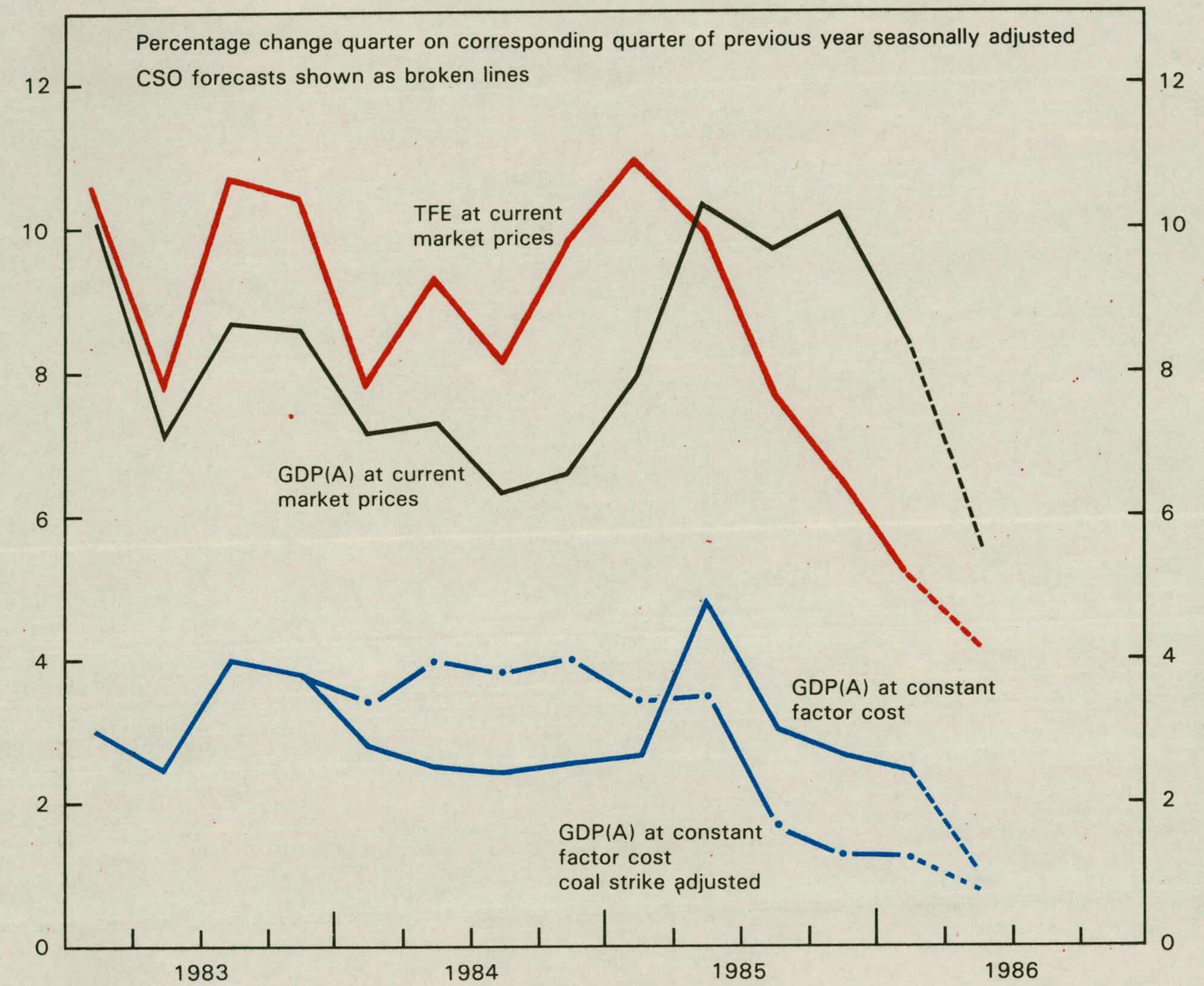
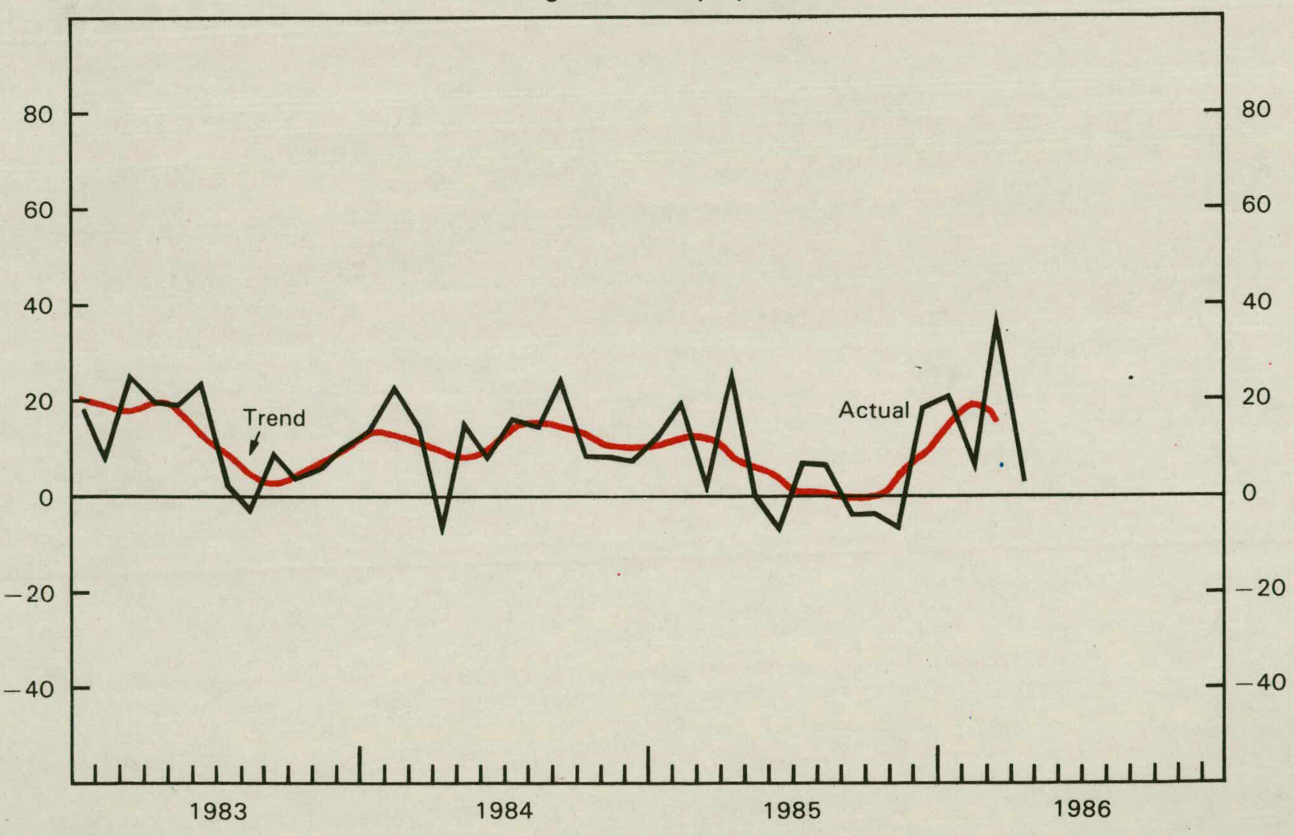


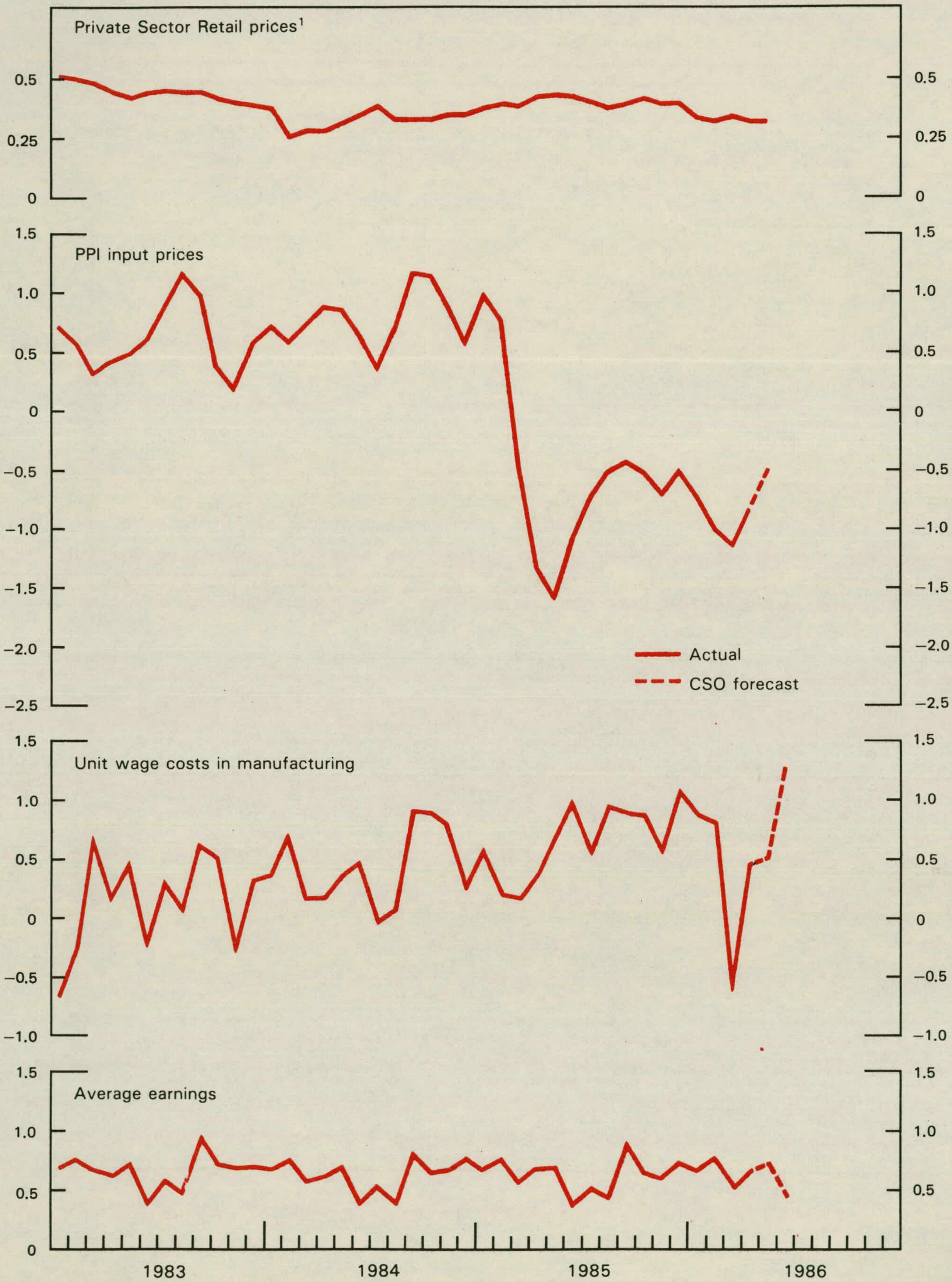
CHART 2

Changes in unemployment



Rate of increase in average earnings, unit wage cost in manufacturing PPI input prices and Private sector retail prices

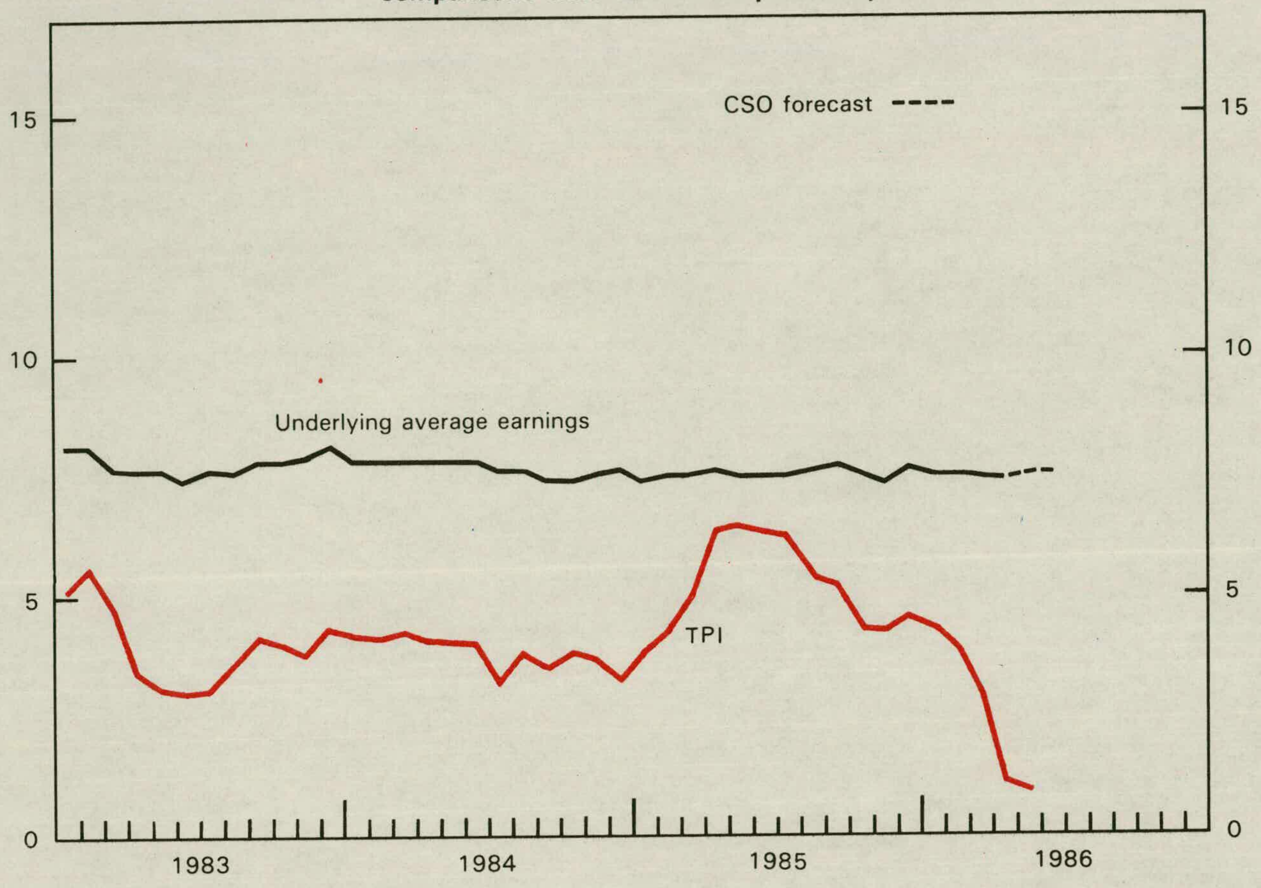
Month to month percentage changes, smoothed and adjusted for distorting factors where appropriate



1. Excludes seasonal food, mortgage interest, rent, rates and water charges, motor vehicle licences, products produced by Nationalised industries and petrol.

CHART 4

Movements in underlying average earnings and the tax and price index comparisons with 12 months previously



Interest rates

CHART 5

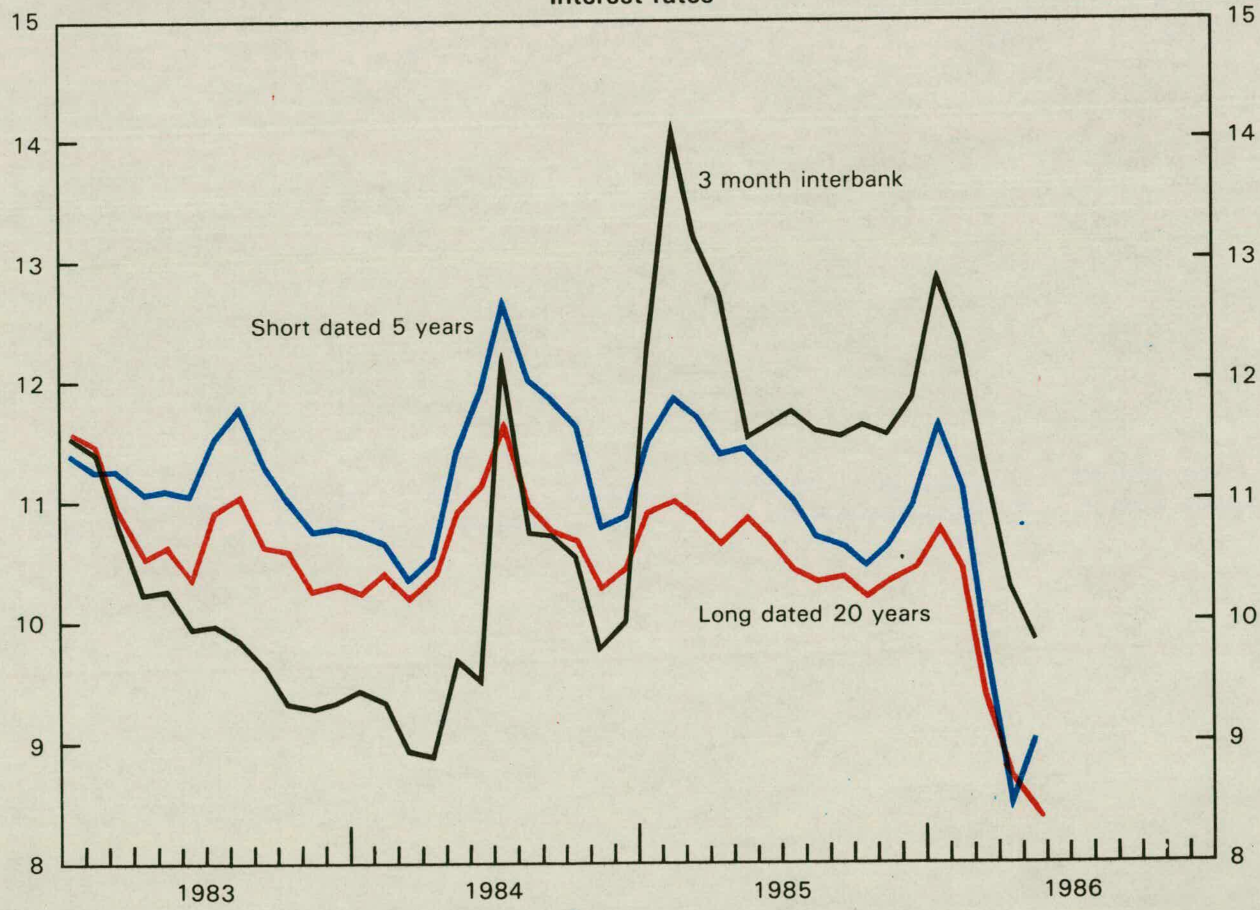
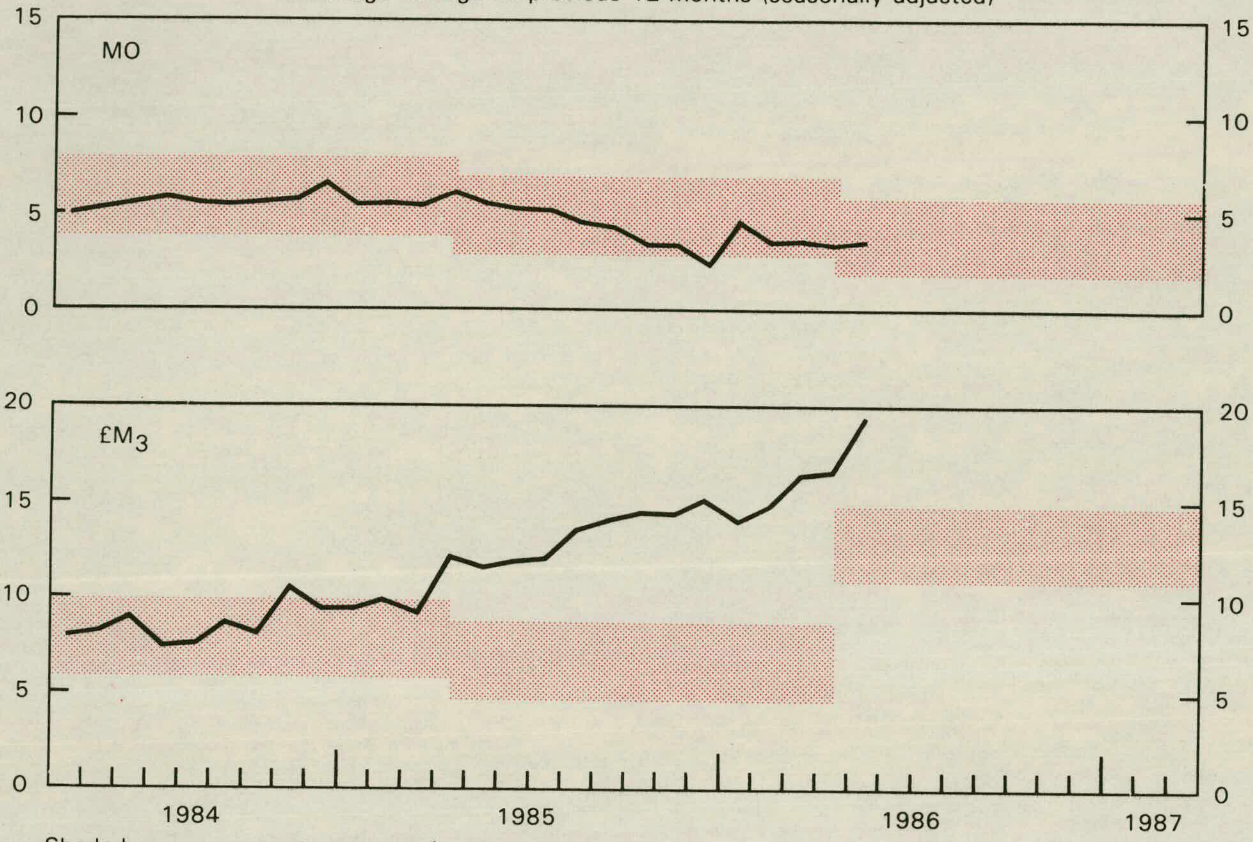


CHART 6

Monetary aggregates

Percentage change on previous 12 months (seasonally adjusted)

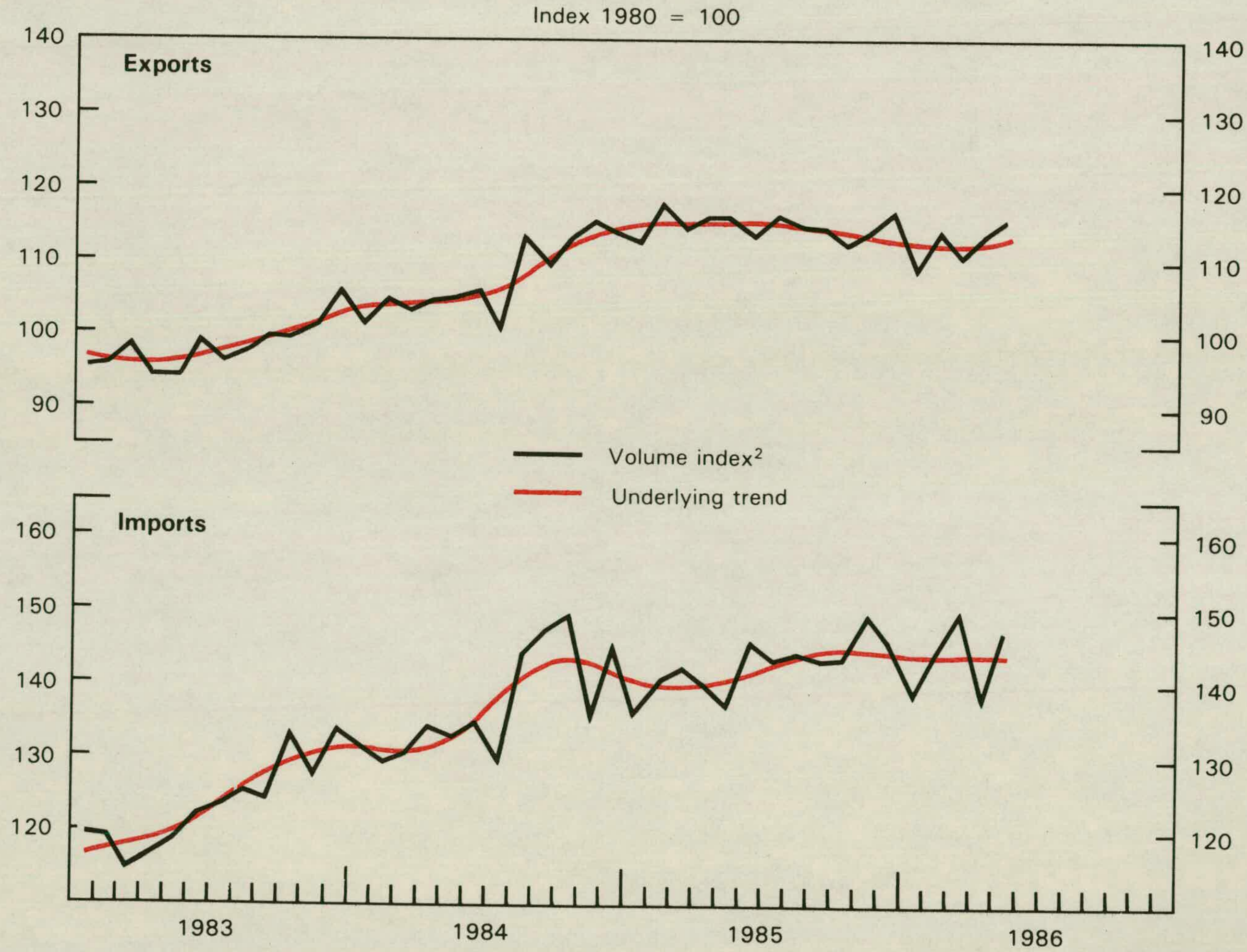


Shaded areas represent announced target ranges

CHART 7

Exports and Imports (excluding oil and erratics[1])

Index 1980 = 100



1. Ships, North Sea Installations, Aircraft, Precious Stones and Silver
2. Seasonally adjusted data, Balance of Payments basis

2932/87

FROM: MRS K S MEASON
DATE: 1 July 1986

pwf

MR PERETZ

cc: Chancellor
Chief Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Evans
Mr Sedgwick
Mr Culpin
Mr Walsh
Miss O'Mara
Mr Mathews
Mr Richardson
Ms Goodman
Mr Ross Goobey
Mr Hosker, T/Sol

RPI ADVISORY COMMITTEE: IMPLICATIONS FOR INDEX-LINKED GILTS AND SAVINGS CERTIFICATES

The Economic Secretary has read your minute of 30 June, and is content.

KS Meason

MRS K S MEASON

DM/78

CONFIDENTIAL

* DRAFT REPLY BY 8/7/86 PLEASE

CH/EXCHEQUER
REC. 03 JUL 1986
ACTION MR H EVANS
COPIES TO CST, FST, EST, MST, SIR P MIDDLETON, SIR T BURNS, MR BYATT, MR CASSELL, MR KEMP, MR ODLING-SMEE, MR PERETZ, MR SCHOLAR, MR CULPIN, MISS O'MARA, MR TYRIE, MR ROSS-GOOBEY

3/7

SECRETARY OF STATE FOR EMPLOYMENT

Caxton House Tothill Street London SW1H 9NF

Telephone Direct Line 01-213 6460
Switchboard 01-213 3000 GTN Code 213
Facsimile 01-213 5465 Telex 915564

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
Parliament Street
LONDON SW1

3 July 1986

Dear Nigel,

RETAIL PRICES INDEX ADVISORY COMMITTEE

I have now received this Committee's report and we agreed in correspondence arrangements for its handling. I have announced that I intend - as I must - to publish it as soon as possible and that decisions on its recommendations are in prospect. We are, I think, agreed that early publication with the simultaneous announcement of our decisions is most desirable to avoid any unwelcome speculation either about the report's contents or our intentions. Printing arrangements have been put in hand which would allow publication, as a White Paper, in the week beginning 14 July. The announcement of decisions would be by written answers in both Houses with attendant publicity.

... I am enclosing a copy of the report; a summary of its recommendations is given in paras 9 and 10. Importantly, it records the Committee's unanimous view that the retail prices index fully merits public acceptability and, with the changes recommended, will continue to do so.

As you know, the Committee was re-convened by my predecessor in September 1984, primarily to re-examine the treatment of housing costs (as recommended by the previous Committee when establishing the present practice), to consider the possibility of rebasing the index and to consider other, more detailed points, concerning the index's coverage and construction. In the event, the Committee ranged wider in considering many aspects of the index, although most of its recommendations are largely technical or presentational in character.

The most significant of the recommendations are that the index should be re-referenced from January 1987 (ie so that January 1987 = 100); on the treatment of subsidies and discounts with the objective of ensuring that the index measures prices charged and not changes to subventions on income; and that mortgage interest payments should continue to be the proxy for the housing costs of owner-occupiers.

The first of these is little more than a technical change with no material effect on the percentage changes shown by the index. Presentation of such a change would nevertheless be important and on this the report has suggestions. The second seeks to establish a surer principle, particularly for the treatment of means-tested benefits. Its adoption would insulate the index from changes in such benefits; they would be viewed as income transfers rather than as changes bearing directly on prices. Thus, for example, an increase/reduction in the provision of free school meals or in provision to meet NHS prescription charges would no longer be treated as price falls/rises for meals or medicines.

As for the housing costs of owner-occupiers, the report examines at some length the objections to and difficulties in including mortgage interest rates in the index as a proxy for them. It nevertheless concludes that this practice should continue, the Committee being unable to agree any other more acceptable and practical measure of these costs or to accept that they should not be covered by the index.

As to the likely effects of the recommendations on the course of the index, much depends upon future events including policy decisions taken by Government. Over the past 10 years the effect would have been small and, although it is not possible to be certain, this is likely to be so in the future. There may well be interest in the media as to the likely scale of the effects, either now or some time in the future when, for example, a policy decision is taken on welfare payments. My Department will be ready to follow the strong advice given by the Committee in para 22 of the report and resist all requests to make such assessments.

All previous reports of this independent Committee (there have been nine reports since 1946) have been accepted. This has provided an essential confidence in the index and a ready defence against the possibility of criticism of it. For my part, I am not minded to reject or modify any of the recommendations and my preliminary view is that all of them should be accepted.

SECRETARY OF STATE FOR EMPLOYMENT

With early publication of the report as a White Paper in prospect and the need for an early announcement of decisions, I would welcome any comments you, Norman Fowler, Nicholas Ridley and Michael Jopling (all of whom had officials on the Committee) may have, if at all possible by 9 July.

I am also copying this letter and the report to the Prime Minister, Willie Whitelaw, Norman Tebbit and to the Director of the Central Statistical Office.

Yours,

David

4-6a

CONFIDENTIAL

FROM: M C SCHOLAR
DATE: 4 JULY 1986

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Sir Peter Middleton
Sir Terence Burns
Mr F E R Butler
Mr Kemp
Mr H P Evans
Mr Peretz
Mr Turnbull
Mr Pratt
Mr Cropper
Mr Ross Goobey

CABINET ON 17 JULY: ECONOMIC PROSPECTS PAPER

... Following yesterday's discussion on the forecast I attach a first shot at your Cabinet paper on the economic prospects.

MCS

M C SCHOLAR

4-6

CONFIDENTIAL

ECONOMIC PROSPECTS

Memorandum by the Chancellor of the Exchequer

1. Since the budget forecast was prepared it has become clear that the fall in the oil price has coincided with a period of weak activity worldwide. But inflation has also been lower than expected. And the signs are for a resumption, probably later on this year, of more vigorous growth abroad and at home, with the gains from lower oil prices steadily outpacing the losses.

2. At home there are two main threats to this generally encouraging prospect: the continual pressure for ever higher public spending, and the failure of pay negotiators to respond to the sharply changed environment on inflation, with the serious consequences for unemployment and competitiveness which another year of excessive pay increases will entail.

World economy

3. Growth in the world economy was generally sluggish in the first quarter of 1986. There was a small fall in manufacturing output in Japan and much of Europe, and in the United States growth has been modest. Demand from outside the industrialised countries has also been weak, with lower commodity prices and a substantial reduction in imports by oil-producing countries.

Explain why (what effect) fall in oil prices may have been contractionary

4. With the fall in oil prices and the continuing effect of the counter-inflationary policies pursued in recent years there has been a further sharp fall in inflation: consumer prices in the major industrialised countries have risen on average by only 2 per cent over the past year. The consequent increases in real incomes, together with lower interest rates and strong equity and bond prices, suggest a resumption of stronger growth from the second half of 1986 onwards, with world trade growth in 1987 of up to 5 per cent or so.

The British economy

5. At home, the pattern has been broadly similar. Following its strong performance in the three years up to early 1985, output, adjusted for the recovery from the coal strike, has since grown more slowly, and is now forecast to grow at about 2½ per cent in 1986, instead of 3 per cent as forecast at Budget time. But with buoyant consumers' expenditure, and world trade and exports recovering during the rest of the year, growth in activity overall should move up to around 3 per cent in 1987 instead of 2½ per cent as forecast at Budget time.

Surely not?

6. The UK has also seen in recent months a decisive move to a lower inflation path. The RPI is currently down to 2½ per cent. I expect it to remain low throughout 1987, although perhaps a little above the very low end-1986 level.

?

?

7. But this fall in inflation has been matched and often surpassed in other industrialised countries. Germany and Japan are now enjoying a period of virtually stable prices. There are clear signs in our competitor countries that the slowdown in price increases is being reflected in lower earnings growth. In the UK, on the other hand, there has been no response to the new inflation environment, and earnings are continuing to grow at around 7½ per cent a year.

8. These increases in earnings are taking place during a period when, as the tax and price index shows, less than a 1 per cent increase is necessary for those in work to maintain living standards. They are forcing increases in our unit costs and the erosion of our competitiveness. Our current performance here is in stark contrast [both to the successes we achieved on unit costs in 1983 and 1984 and] to the current performance of our competitors, whose unit cost increases are negligible or negative. ??

nor reqd. What's changed is productivity or pay. Pay surge to here further

9. The consequences of this excessive earnings growth are clear. The current account of the balance of payments, after the strong surpluses of recent years, now looks set to move towards broad balance or even deficit. Unemployment, despite considerable help

[illegible]

from all the measures we have taken, continues to increase at an average of 10,000-15,000 a month. With a faster expansion of employment as output growth picks up, and declining labour force growth, the prospect is still of some improvement in the unemployment position next year. But high earnings growth is losing us potential jobs.

10. The financial markets have been steady since the Budget. The exchange rate has held firm - more so than some expected, given the size of the fall in oil prices. Since the budget base rates have fallen by 2½ per cent, and long-term rates have fallen to their lowest level since the early 1970s. But the major changes taking place in financial markets have made the task of interpreting monetary conditions very difficult, for markets and authorities alike. Although narrow money is towards the bottom of its target range, bank lending is expanding rapidly and broad money continues to grow well beyond expectations. House prices have also been rising rapidly. In these circumstances, with no clear single guideline for the markets and authorities to look at, it is inevitable that we should err on the side of caution about further falls in interest rates.

Remain high, well above [illegible] & expectations [of] inflation

?

11. The markets, too, are watching, as ever, keenly for evidence of lack of resolution on the public sector finances; and the fiscal prospect is looking rather more difficult than at the time of the Budget. Oil prices have fluctuated between $10 and $15 a barrel since March. They may strengthen somewhat into the winter but the average for 1986-87 may well be below the Budget figure of $15. As the Chief Secretary's paper shows, the pressures for higher public spending are intense and relentless. It will require great determination to maintain the firm control of public expenditure which is central to our economic strategy and essential if we are to avoid increases in the tax burden.

help [illegible] [illegible] [illegible]

12. A summary of the most recent Treasury forecast is shown in the attached table.

...

Conclusion

13. The economy has been experiencing a pause in the remarkable growth it has experienced since the trough of the recession in 1981. That pause, which is also occurring in the rest of the industrialised world and has coincided with the collapse of oil prices, is affecting short-term employment prospects. But inflation has been lower than expected; and all the evidence points to a resumption of a more vigorous rate of growth, at home and abroad, later this year.

14. The UK's relative performance is, however, threatened by the prospect of yet another year of high earnings growth, and by the hazards which will follow from the failure of earnings to respond to the decisive change in the inflation path.

15. We must not add to these hazards by relaxing our grip on public spending. The burden of taxation and national insurance contributions is still substantially higher than it was in 1978-79. We cannot afford to put at risk the progress we have made in recent years in reducing this burden. We must therefore, as the Chief Secretary proposes, maintain tight control of public expenditure.

16. I urge my colleagues to agree to the Chief Secretary's proposals.

CONFIDENTIAL

NB these figures will be shown as fractions not decimals.
MCS

MAJOR ECONOMIC INDICATORS

	United Kingdom 1983	1984	1985	1986(1)	Summit 7 (exc. UK) ~~OECD~~(2) 1986
A Demand and activity (per cent change on previous year)					
GDP	3.5	2.5	3.5	2.5	3
Domestic Demand	4.5	2.5	2	3	3.5
of which: consumer spending	4	2	3	4	3.5
fixed investment	5	8	1	4	4.5
Exports of goods and services	2.5	7	6.5	1	1.5
Imports of goods and services	6	9.5	3	2	6.5
B Inflation (per cent changes on a year earlier)					
Retail prices, fourth quarter	5	4.75	5.5	2.25	0.5
Average earnings, fourth quarter	8	6.5	7.5	7.5	3.5(4)
C Other indicators (levels)					
Current balance (£ billion)	3	1.5	4	3	-6
Unemployment level (per cent, narrow definition)	12	12	12.5	13	7.5
Interest rates (3 month inter-bank, per cent)	10	10	12	10(3)	6.5(3)
Sterling Index, 1980=100	83	78.5	78	76(3)	-
Oil Prices, $ North Sea	30	29.5	27.5	10(5)	-

(1) Figures consistent with Treasury summer forecast: figures quoted are CONFIDENTIAL
(2) Major 6 countries only: US, Japan, Germany, France, Italy and Canada (Treasury forecasts)
(3) Current level
(4) Manufacturing earnings only
(5) Brent price for delivery in July, as of 3rd July

Ch.

No surprises in RPAC's report.

The immediate action is the reply to Ld Young, which is straightforward & ready to go off tomorrow.

You may like longer to reflect on the suggestion that we should publish – an important & weighty Treasury working paper on the treatment of owner occupier housing costs.

It is not immediately obvious as to what this would be for.

It would simply look like some

grapes to the hacks – insofar as they notice it – & have been through this, whatever we say, we don't accept this Report. And it is either too late or too early to influence serious academic opinion, with a view to producing a different outcome from this Committee.

(Judging by the authors, the WP would be pretty agnostic, saying this is all very difficult, there are different solutions, none satisfactory, so perhaps you ought to pay attention to the RPI less than overhauling it altogether – the

CHANCELLOR OF THE EXCHEQUER

HONI SOIT QUI MAL Y PENSE

personal arrangements, separately, for the understandable on his EPR).

But you may want to canvass others' views on this viz Terry, Peter, Robert.

RL

9/7.

RESTRICTED

FROM: H P EVANS

DATE: 8 July 1986

CHANCELLOR

cc: Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Mr F E R Butler
Mr Byatt
Mr Cassell
Mr Kemp
Mr Monger
Mr Odling-Smee
Mr Peretz
Mr Sedgwick
Mr Scholar
Mr Watson
Mr Culpin
Mr Davies
Miss O'Mara
Miss Noble
Mr Brooks
Dr Rowlatt
Mr Ross Goobey

Draft letter to LY. Stress firm. But I regret I can see no point in the work — Japan: the RPI is our line of last [illegible]

RETAIL PRICES INDEX ADVISORY COMMITTEE

We have now received the final report of the Advisory Committee, attached to Lord Young's letter to you of 3 July. The report was submitted to Lord Young on 1 July and PQs answered in both Houses. This minute:

(1) sets out and explains the report's summary and recommendations;

(2) considers at greater length the issue of owner-occupied housing costs on which the Committee rejected the Treasury line;

(3) attaches a draft reply for you to send to Lord Young.

Procedure

3. DE are aiming to publish the report and at the same time government decisions (by Press Notice and answer to PQ) in the week beginning July 14. You have been asked to comment by 9 July. We have seen earlier versions of the report and there are no last minute surprises. As sellers of index-linked securities we have some interest in minimising the delay between receipt of report and publication and we need to make sure there is no delay in announcing a decision once it is taken. It does not seem necessary to convene a meeting of Ministers. We probably ought to see the Press Notice and PQ in draft.

4. Mr Peretz' minute of 30 June to the Economic Secretary set out the implications of the Committee's recommendations for index-linked gilts and savings certificates. Not surprisingly, the Bank sees no problems in the very modest recommendations for changes recommended by the Committee.

The Committee's recommendations: substance

5. I attach at A a list of the main recommendations, taken from the report, together with comments explaining or justifying what is being proposed. In virtually all cases the recommendations are very minor, and will have little effect on the index movements in the future.

6. Recommendation (g), on the treatment of subsidies and discounts, is of some importance and represents a change from the existing method. It affects mainly **housing benefit:** in future it is proposed to treat this as a form of income support, not as a price reduction. Hence all rents and rates will in future be measured gross of housing benefit, instead of the current practice of treating supplementary benefit recipients gross and others net. This change is in line with Treasury views. Its effect on the index will depend on whether housing benefit in future increases faster or slower than the RPI: if, as I understand it, the intention is to uprate housing benefit in line with some measure of inflation, there should be little or no effect of this proposal on future RPI changes.

7. Recommendation (h) says that **"mortgage interest payments should continue to be in the index** as a proxy for the housing costs of owner-occupiers". This is the most difficult and contentious part of the report. Section G, pages 40-55, together with Annexes 2 and 3 on pages 80-85 set out the Committee's views in some detail. Quite a number of Committee members were worried about the measurement of owner-occupiers' housing costs: the doubts are expressed in paragraphs 111 to 117. These paragraphs are attached at B. The main doubts concern the use of a measure of the cost of credit for housing, but not elsewhere in the index; the investment aspect of buying and maintaining a house; and the increasing looseness of the relationship between mortgage finance and acquisition of housing as rationing disappears.

8. You may well think that the way in which the majority of the Committee counter these doubts, eg in the second part of paragraph 113(b), are not particularly convincing.

9. The changes recommended by the Committee are designed to "standardise the proportion of the purchase value of owner-occupied housing which is being mortgaged at any one time". The change in weight would then reflect the change in the quantity of housing which is owner-occupied rather than the change in the amount of debt being serviced. The Committee accepted that the weight was being artificially increased by the increasing use of mortgage funds for non-housing purposes through equity withdrawal. The proposals mean that the weight for owner-occupiers' shelter costs in future will be based on mortgage interest payments calculated on the assumption of a fixed proportion being mortgaged of that part of the housing stock that changes hands. (The proportion is fixed at 40 per cent: this allows for about 60 per cent of owner-occupiers taking out a mortgage when they move; and for a proportionate advance of those buying with a mortgage of about 65 per cent.)

10. The effect on the RPI of the proposed changes to this section of the index will be to reduce a little the weight on mortgage interest payments: from a current weight of 54 per thousand to about 50 per thousand. The difference in future, depending on

the rate of growth of mortgages and of house prices, could be rather greater.

11. The recommendations by the Committee are very far from meeting most of the objections. However, the criticisms have been spelt out at length, the rebuttals are not very convincing, and there has been some move in the right direction. What is missing from the report is a systematic treatment of the subject (see paragraph 15 below).

Treasury's response

12. I attach at C a draft reply to Lord Young. The line suggested is to accept the report, but to continue to make clear our disagreement on owner-occupiers' housing costs. You are already on record both as to your disagreement and your view that the reports recommendations would be accepted. In reply to a question from the TCSC, on 25 March 1986, you said:

> "The RPI is not the most accurate reflection in any event because of the curiosity of the mortgage rate being in the RPI (which is not the case in most other major countries, Canada is the only one that has it), which creates a distorting effect."

In reply to an oral question on 27 June 1985, you said:

> "... we must await what that independent Committee recommends. As it is, only the United Kingdom and Canada retain the mortgage interest rate in their indices. However, we shall abide by what the independent Committee suggests."

13. It would hardly ring true if you now affected to be convinced by that part of the report that deals with this subject. You may therefore wish to continue the Treasury line. A high profile line is not recommended, since acceptance of the report would then look odd and there would be more headlines of "The Treasury defeated" variety.

14. Commentators might wonder whether Treasury disagreement on this matter is consistent with the view of the Committee expressed in its paragraph 7 that: "... we are of the unanimous view that the index fully merits [public acceptability] and, with the changes we recommend, will continue to do so." The answer is that that judgment by the Committee members is based on the index as a whole and cannot be taken to imply - as the report makes clear on a number of occasions - unanimity on every point. Moreover, there is a clear difference between public acceptability and the best possible treatment of individual items.

15. The report's discussion of owner-occupied housing costs, though extensive, fails to provide a systematic treatment. Such a treatment is needed. I suggest that a **Treasury working paper** would be a good way of getting all the arguments on the record, not least for the time when they are re-opened. It will also make clear why a view different from the Committee's could reasonably be taken, though I do not envisage that a working paper would come to a firm conclusion about a single best solution. I attach at D a part of such a working paper, written mainly by Dr Rowlatt, to give you a flavour of what it might be like.

16. Such a working paper might not prove popular with DE and I have not mentioned it to them. In any case I do not envisage publication until say August, well after the report and its recommendations have been accepted and published. We would show the paper in draft to DE and other interested departments.

<u>**Conclusions**</u>

17. If you are in favour in principle of a working paper on this subject, we will do some further work on a draft.

18. A briefing and line to take on the report will be provided before publication. Copies of the full report, or extracts from it can be obtained from my office.

19. Are you content with the line taken in the draft letter? Although DE have asked for comments by 9 July, one or two days' delay would not matter greatly.

HPE

H P EVANS

A

PRINCIPAL RECOMMENDATIONS AND TREASURY COMMENTS

(a) **The RPI should be re-referenced** to 100 and the compilation of regular time series on the present base discontinued once the index for January 1987 has been published. this would have no material effect upon the percentage changes shown by the index. (See Section A.)

Comment

Sensible, technical change: the level of the index, currently nearly 400, will be 100 from January 1987; no effect on percentage changes.

(b) **The definition of the "index households"** covered by the RPI should be adjusted so as to exclude those households with the highest incomes, as opposed to the present convention of excluding those whose heads of household have the highest incomes. The cut-off point should be set so as to continue to exclude about 4 per cent of households at the upper end of the income distribution. (See Section C.)

Comment

Weighting in index continues to exclude those on relatively high or low incomes. This recommendation involves a slight and sensible change to the way in which high incomes are defined. Practical effect: nil.

(c) **The special price indices for pensioner households** with low incomes should be continued and, where relevant, all the changes recommended for the general index should be applied to them. (See Section D.)

Comment

Because low income pensioner households have a significantly different pattern of expenditure from the average household, they have long been excluded from the RPI weights. There is therefore a case for continuing to provide a price index which reflects the expenditure patterns of low income pensioner households. No changes proposed.

(d) **The structure of published component indices** below the "all items" RPI should be recast in the way shown in Annex 1 of this report. (See Section E.)

Comment

This is a useful updating of the structure of the RPI in the light of changes in expenditure patterns over the last 20-30 years. No effect on the total index, but a substantial recasting of the subgroup. Details in section E and Annex 1 of the report.

(e) The general aim should be to publish indices for all **categories of expenditure** having a weight of 5 or more parts per thousand in the general index, and for any others which are of general interest, subject to their being of sufficient reliability. As regards indices for smaller categories which are not of general interest, the Department of Employment should be prepared to release these to particular users provided the reliability criterion is satisfied. (See Section E.)

Comment

Release of more information recommended.

(f) If the recommendations in this report are accepted the Department of Employment should publish at the time of implementation a **succinct and authoritative statement** of the principles and concepts underlying the construction of the RPI, as laid down by ourselves and our predecessors. (See Section E.)

Comment

Detailed description of RPI is needed and last one published nearly 20 years ago.

(g) **The RPI should be based on prices charged.** In establishing the prices charged subsidies and discounts should be deducted where they are funded by the seller, or where they are available to all purchasers, but not in the case of selective benefits funded by a third party. (See Section F.)

Comment

Important and sensible change in principle, mainly affecting rent and rate rebates. In future, all rents and rates will be measured gross of housing benefit, which is thus being treated as a form of income supplement, not as a price reduction. Change agreed with ST group.

(h) **Mortgage interest payments should continue to be in the index** as a proxy for the housing costs of owner-occupiers (other than rates, repairs etc which are separately covered). Changes in the weight attached to mortgage interest payments (in relation to other goods and services in the RPI) should reflect changes in house prices, interest rates and the extent of owner-occupation (as opposed to the actual amount of mortgage debt). Both the price indicator and the weight should be based on a standardised mortgage, so limiting the effect of changes in financial arrangements. (See Section G.)

Comment

Substance dealt with elsewhere. The changes to the **price indicator** are very minor (so that past house prices, reflecting the different dates on which mortgages were taken out, continue to be in the index). The changes to the **weight** are of more significance in theory and in practice. By discounting a little of the growth in mortgage debt as a reflection of equity withdrawal, the weight on mortgage interest payments should be a little lower in 1987.

The following recommendations are for implementation at a later date:

(m) **The RPI should be extended** to certain types of expenditure not currently included, notably holiday accommodation and package holidays, various fees and subscriptions paid by consumers, the prices of financial services (but not of credit as such) and some other small items. The objective should be to introduce appropriate price indicators for each of these, and for items which are currently covered only by somewhat unsatisfactory proxy measures (most notably new cars). (See Section B.)

<u>Comment</u>

Holidays and new cars should certainly be included, although there are measurement problems. So too should financial services, a growing part of the economy. The report makes clear that credit as such should not be included.

Recommendations (j) to (l) and (n) to (s), not listed here, are minor, sensible, proposals.

B

Extract from final report of RPIAC

Objections to the inclusion of mortgage interest payments

111 However, the alternative adopted in 1975 is not without its shortcomings. In the course of our meetings some members have questioned both the principle and practice of including mortgage interest payments in the RPI. They put it to us that, with the benefit of hindsight, the adoption of mortgage interest payments as a measure of the cost of housing could be seen as having been made without sufficient consideration of the rationale for doing so or of the consequences. There are two separate but overlapping objections: the first is that this is not (even in principle) an appropriate method, and the second is that, to the extent that it was an appropriate method over a decade ago, developments in housing finance since 1974 have been so far reaching as to change radically the connection between housing and mortgage finance. In the 1960s and early 1970s mortgage finance was generally hard to obtain, whereas in more recent years, with greatly increased competition among lending institutions, mortgages have become more readily available. Prior to 1975 new mortgage finance corresponded quite closely to new investment in housing but by the mid 1980s the amount of new mortgage finance had outstripped this expenditure.

112 Borrowing on mortgage security from building societies and banks can provide not only a relatively inexpensive means of financing costs associated with acquiring or moving between houses but also a way of financing other types of consumption and the acquisition of assets, including financial assets. The Bank of England[5] has described and quantified the amount of what has come to be known as "equity withdrawal", which occurs not only if more is borrowed than the difference in value

between the houses bought and sold but also when money is borrowed to [illegible] houses coming on to the market because owner-occupiers have died or become tenants. The tendency for purchasers to borrow more than they need for house purchase is one reason for objecting in principle to the use of mortgage interest payments as an indicator of the cost of housing: our detailed recommendations are designed to limit the extent to which further moves in this direction would bias the weighting of mortgage interest in the RPI.

113 There are three other main objections to the inclusion of mortgage interest in the RPI, as follows:

a) Mortgage interest payments can be seen as measuring the cost of credit whereas no other type of credit charge is included and we believe that none should be. Most of us do not see this as giving rise to a serious inconsistency. In the first place mortgage interest payments represent such a long-term commitment as to be regarded as quite distinct from hire purchase, charge card and other forms of consumer credit payment, which are essentially short-term. Secondly, a mortgage arrangement is in practical terms the only way in which most households can possibly acquire their accommodation, and we consider it right to regard the servicing of that arrangement as a legitimate proxy for owner-occupiers' housing costs.

b) Mortgage interest payments involve a major element of investment. Generally borrowers in this country during the last 40 years have not only obtained the benefit of shelter while making mortgage payments but have also owned capital assets at the end of the mortgage term whose current value (because of inflation) far exceeded the sum of the principal repayments which had been made (and which alone are excluded from the RPI weighting). Some of us felt this was a serious objection and would have liked to take some account of capital appreciation in the construction of the index to the extent that it occurs (though we recognise that the gain in question cannot be relied upon, movements in house prices having varied across the country). However, most of us do not believe that any such allowance can be made in a satisfactory way within the framework of a conventional price index. One method which we considered involved the use of what are known as "real interest rates", deducting from the nominal interest rate the observed or anticipated change in prices (perhaps house prices) but we think these would be inappropriate in the context of the RPI, both conceptually and in view of the difficulty of measuring them in a generally acceptable way. A further practical problem that might arise is that some measures of real interest rates could lead (and

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[6] "The Housing Finance Market: Recent Growth in Perspective", *Bank of England Quarterly Bulletin*, March 1985, pages 80-91

in several recent years would have led) to the incorporation in the RPI of negative expenditures for owner-occupiers. The authors of the recent report published by the Institute for Fiscal Studies (*see* paragraph 54 above) proposed a way of largely overcoming this problem by offsetting capital gains on mortgaged housing not just against owner-occupiers' mortgage payments but against the total expenditure of all households on all goods and services. However, we do not regard this as being consistent with the fundamental concept of a price index with a fixed "quantum".

c) A third objection to the inclusion of mortgage interest payments in the RPI is that, while many households make mortgage payments each month, many of these also receive income from building society accounts, and for households as a whole the receipts roughly balance the payments. It has been suggested that this is a sufficient reason for excluding mortgage interest payments from the price index but in our view the income received in this way is not relevant to the RPI, which measures prices. Incomes, including for some purposes interest receipts, are measured separately. Nevertheless the volume of borrowing and lending in the economy, strongly affected by institutional changes in the mortgage market, can vary a great deal over time, partly in ways that are not relevant to the weighting of the RPI. As we have said, our proposals for changing the treatment of mortgage interest payments are designed to limit the extent to which it may be influenced by future changes in institutional arrangements.

114 A radical alternative to the use of mortgage interest payments, which was suggested to us at an early stage, was that the purchase of a house might be treated in the same way as that of most other items in the RPI, the whole of the cost being taken into the index at the time of acquisition, without regard to the way the purchase was being financed. The weight for owner-occupiers' housing costs would then reflect the net expenditure of index households on the purchase of houses in the course of the latest year, net of sales proceeds, but including nothing explicitly in respect of those households making no transactions. This would have the merit of simplicity but there are objections to it. If index households were ever to be net sellers of houses to private sector landlords the weight attached to house prices would be negative. More generally, changes in house prices would be taken to affect all owner-occupiers at the same time - not just those buying houses - whereas most of us think that, to be regarded as a realistic reflection of consumers' experience, the index must recognise the fact that expenditure on owner-occupied housing is typically spread over a long period of time, conventionally by means of a mortgage arrangement.

General view on mortgage interest payments

115 Having looked at the alternatives, our general view is that mortgage interest payments, though by no means ideal for the purpose,

continue to be the most suitable means by which to take account of owner-occupiers' housing costs in the RPI. They represent tangible expenditure which most owner-occupying households need to make at some time. The households concerned think of mortgage payments as an integral part of their regular expenditure, akin to rates, gas and electricity bills, and we have evidence from a survey of consumer opinion (undertaken for our benefit by the National Federation of Consumer Groups and the Consumers' Association) that over 80 per cent of consumers favour its inclusion in the RPI. We see the payments not as servicing a debt in the usual sense but as the alternative to paying rent: financing the acquisition of a house by the normal method. The payments are therefore suitable for inclusion in a consumer price measure. However, it is appropriate to include mortgage interest payments only to the extent that they represent the necessary cost of *housing*, and we would not want the index to be affected by alterations in financial arrangements which are not associated with any change in the amount of housing owned and occupied by index households.

116 The fact that owner-occupiers' housing costs are measured by the value of mortgage interest payments need not be taken to imply that only those owner-occupiers who have mortgages are covered by the RPI. It is possible to regard the payments in question as a proxy for the shelter costs of *all* owner-occupiers, though in calculating the average expenditure it should be recognised that at any one time some of them will not actually need to be making payments. Under this interpretation all owner-occupied housing is valued as if it were mortgaged to the same extent, but this amount is an average embracing those households which actually have mortgages and those which do not (generally because they have been paid off). We think that the index *should* be designed to cover all owner-occupier households, and this belief is reflected in our later recommendations about the way that changes in the 'weight' for mortgage interest should be determined.

117 While recommending that mortgage interest payments should continue to provide the means of measuring owner-occupiers' housing costs, and thereby rejecting a number of alternatives which have been suggested, we still think these alternatives deserve a full exposition. This should help to clarify the differences between the chosen measure and those which have been or might be adopted elsewhere, and provide a justification for such differences. These matters are dealt with in Annex 3.

DRAFT

PM agree ✓

C

Letter from Chancellor to Lord Young

RPI ADVISORY COMMITTEE

Thank you for your letter of 3 July

I agree that the report of this Committee should be accepted in full. The need to ensure public acceptability of the index leaves us with no alternative.

I do, however, continue to have one serious reservation, on owner-occupied housing costs. The report rightly spells out the problems of measurement in this area; it records the difficulties the Committee had in coming to a conclusion; it sets out - none too convincingly, in my view - the Committee's response to the problems; and it lists the solutions adopted by other countries, mostly at variance with the approach in the UK.

The minor modifications recommended by the Committee represent a slight improvement. But I shall continue to draw attention to the RPI less mortgage interest payments, as a measure of inflation that is less volatile than the RPI in the short term.

The early timetable you propose for publication is right. As you know, we need to publish as soon as a decision is made. I suggest that officials discuss the wording of the press notice and the answer to the PQs.

I have two points on future developments. The first is that when the Committee is reconvened, and the report suggests there should be more frequent meetings, your officials should consult with mine over the membership of the Committee.

The second is that in implementing the Committee's recommendations, and in devising methods of extending the coverage of the RPI and making other improvements, your department should seek to do this in as cost-effective a way as possible, bearing in mind that the RPI already costs about £1 million a year.

I am copying this letter to the Prime Minister, Willie Whitelaw, Norman Tebbit and to the head of the Central Statistical Office.

DRAFT: OUTLINE OF POSSIBLE WORKING PAPER

D

OWNER-OCCUPIERS' HOUSING COSTS

INTRODUCTION

1. The problem of measuring the cost to an owner-occupier of the "shelter" services received from his dwelling is among the most difficult and important problems encountered in the construction of consumer price indices. The choice has a significant effect on the path of the price index. The problem is to determine what is the appropriate measure of the cost of owner occupation. The object of this paper is to examine and evaluate the main alternatives that are available. Against this background we look at the system that has been used in the UK since 1975 and examine the changes recommended by the RPI Advisory Committee [and accepted by the Government].

2. The paper is organised in the following way. The first section sets out the problem. The second examines the principles involved in measuring shelter costs. In the third section the practical solutions that have been suggested are listed. These are then taken in turn, spelt out in more detail and the problems associated with them are noted. These include the method currently used in the UK and the changes recommended by the Committee. The final section summarises the findings, assesses the alternatives and contains conclusions. One annex surveys the methods used in other countries. A second annex shows the paths of the various price indicators considered, their weights and the effect on the RPI of substituting each of them for the present approach.

SECTION 1: THE NATURE OF THE PROBLEM

3. The following general principles are used in the construction of the RPI and are relevant to the discussion that follows.

(i) The prices included in the RPI are those that are commonly charged for a good or service.

(ii) The RPI covers expenditure on consumption. Expenditure on investment or saving is considered to be out of scope.

(iii) The cost of consumer credit is not included in the RPI. Goods bought on credit are treated as if they were acquired outright at the time of the sale.

(iv) Generally there is a clear distinction between expenditure and income. Expenditure is represented in the RPI: income is not taken into account.

4. Some aspects of owner-occupiers' housing costs are easy to measure. These include rates, water charges, insurance, repairs and maintenance, materials used for repair and decorations etc. In this paper we are concerned with the element that corresponds to rent for a tenant - for the purposes of this paper we call this "shelter". The problem is that **there is no current expenditure by owner-occupiers' on this aspect of housing**. Indeed it is in the nature of owner-occupation that this is so.

5. There is current expenditure associated with owner-occupation: owner-occupiers with mortgages have current expenditure on interest payments as well as making regular capital repayments of the loan secured on the value of the house. However, these involve the cost of credit, the cost of financial intermediation and saving, not the cost of shelter. In principle it should be the current cost of the shelter provided that is included in the RPI. For owner-occupiers without mortgages there is no current expenditure which is associated with the shelter services consumed.

SECTION 2: PRINCIPLES - THE COST OF SHELTER

6. There are three ways of paying for shelter services consumed. The accommodation can be bought outright, it can be bought with a mortgage or it can be rented. A clear difference between these

lies in the degree of front end loading of the payments made. To each of these there corresponds a method of representing shelter costs in the RPI which can be assessed in the context of the above guidelines. This section sets out the payments which are actually made in each case, describes how different ways of including them in the RPI might be justified and notes where these run counter to the guidelines. The analysis is presented in terms of the acquisition of accommodation but it could equally be applied to any other consumer durable.

(a) The housing is bought outright

7. The cost of acquisition of a house can be treated in the following ways.

(i) It can be treated as consumption expenditure. This has the implication that the services rendered are consumed at the time of the acquisition of the property. This is the approach that is taken with other consumer durables in the RPI.

(ii) If it is viewed as being expenditure on investment/saving it should be deemed to be out of scope for RPI purposes. In this case there would be no component in the RPI to represent these payments made for owner occupiers' shelter.

(iii) However this expenditure (or part of it) can be interpreted as being investment/saving which is specifically related to future consumption of shelter services and a case could be made for its inclusion for that reason.

(iv) This expenditure can be viewed as investment/saving in the sense that it involves the forgoing of an income stream that would have paid a rent for the services consumed.

(b) The housing is bought with a mortgage

8. An acquisition involving credit can be regarded as the sum of the following components:-

(i) a down payment

(ii) nominal interest payments which can be split into

- real interest payments (including the cost of financial intermediation)

- inflation adjustments to the value of the debt outstanding

(iii) repayments of principal.

The costs associated with depreciation (repairs) are omitted from this since they are covered by the repairs and maintenance component of the index.

9. Typically, the down payment and the repayments are ruled out of scope of the RPI, because they represent savings/investment. This leaves nominal interest payments.

10. It is possible to take this argument a step further. The inflation element in nominal interest payments can also be regarded as savings/investment. Its exclusion leaves only real interest payments as the relevant concept for the RPI. There are indeed a few index-linked mortgages in existence: this approach suggests we treat all mortgages as if they were index-linked.

11. However the arguments listed in paragraph 7 for including the whole of the cost of acquisition of the housing in the RPI, apply to this investment/saving expenditure which is spread

over time in mortgage payments. Its inclusion could be justified on the grounds that it might be treated as:

- expenditure on consumption, or

- expenditure on investment/savings designed to offset future expenditure on consumption, or

- expenditure on investment/savings which involves an income forgone and this income would have been used to pay rent in the future.

(c) The housing is rented

12. If the housing were actually rented, the cost would be met in the period in which housing services were consumed. Payments for housing would continue indefinitely at a rate given by the (real) rate of return on rented property (eg 5 per cent a year) multiplied by the current value of the property.

Conclusion

13. Solutions to the problem of measuring owner occupiers' shelter costs therefore fall into three categories which correspond to the three ways of paying for accommodation. These can be distinguished by the extent of front end loading. In the first the payment for shelter services for all time is treated as being made on acquisition of the property; thereafter the services provided are treated as having no cost. This is known as the **acquisitions approach.** The second takes the payments that are made for the duration of a standard mortgage (eg 25 years).* This is known as the **current expenditure approach.** The third approach treats the payments as extending over all time in a manner similar to that of rent payments. This is known as the **flow of services approach** and can be treated from the **user cost** or the **rent equivalent** point of view.

*The current expenditure approach can also include the down payment and the repayments. Both the others cover the <u>entire</u> cost of the housing.

DIAGRAM - PRINCIPAL METHODS OF REPRESENTING OWNER OCCUPIERS' SHELTER COSTS IN A PRICE INDEX

Timing of Inclusion	At Time of Acquisition			Spread over period of a standard mortgage		Spread over all time	
Name of Approach	(1) <u>**Acquisitions Approach**</u>			(2) <u>**Current Expenditure Approach**</u>		(3) <u>**Flow of Services Approach**</u>	
				A	**B**	**A** <u>**User Cost**</u>	**B** <u>**Rent Equivalent**</u>
Expenditure covered	New houses	<u>plus</u> Council houses bought by private sector	<u>plus</u> Home improvements	Nominal interest payments	Real interest payments	Income forgone on capital invested in house	Imputed expenditure on rent
Price Index indicators	New house price	Second-hand house price	Labour and material costs in construction sector	Mortgage rates; past house prices	"Real" Mortgage rates; past house prices	Real interest rate less tax at standard rate	Domestic rents or commercial rents
Weight	Indicated by expenditure in base period measured in consumers' expenditure survey			Expenditure on mortgage interest payments in base period	Expenditure on "real" mortgage interest payments in base period	Imputed expenditure in base period	Estimated "rentable value" of owner occupied housing

Notes

The acquisitions approach treats all owner occupied housing as if it were bought outright.

The current expenditure approach treats all owner occupied housing as if it were paid for with a standard mortgage. The variants listed here omit the possibility of including the down-payment and the monthly repayments.

The flow of services approach treats all owner occupied housing as if it were rented.

SECTION 3: PRACTICE - THE COST OF SHELTER

14. A number of possible solutions to this problem have been tried in practice but there is no consensus about the best. This problem has been examined in some depth and no easy solution found. Annex 1 lists the various solutions that have been adopted by a number of other countries.

15. The diagram provides a summary of the alternatives. These are described briefly in the following list. For each proposal an appropriate <u>price</u> index needs to be found. The share of total household expenditure on RPI goods and services that is attributable to the relevant measures then indicates the <u>weight</u> that this price index would pick up in the RPI.

(1) Acquisitions approach - net expenditure on housing stock owned and occupied by RPI households. In the main this would comprise the net acquisition of dwellings by RPI households (purchases from public sector, investment in new houses and flats) as well as expenditure on improvements to existing dwellings etc, and transactions costs.

(2) Current expenditure approach - expenditure on financing the ownership of dwellings. The most familiar example of this is (A) mortgage interest payments. But **(B)**, the use of real interest payments, is also possible.

(3) Flow of services approach. There are two quite different approaches that can be taken. **(A) User cost** - income forgone on capital invested in housing plus expenditure on financing acquisition of remainder. A measure of the income that might have been generated had the capital invested in the non-mortgaged portion been invested elsewhere would be included in this measure. **(B) Rent equivalent** - the rent which owner occupiers as landlords would charge to owner-occupiers as tenants. This involves making an estimate of the appropriate private sector rent on housing comparable to that which is owner-occupied.

[Sections on each approach in more detail]

SECTION 4: SUMMARY, ASSESSMENT AND CONCLUSIONS

53. In this paper we have demonstrated how the principles on which the RPI is constructed could be used to rule out every method of measuring the cost to the house-owner of his shelter. The RPI is constructed from prices actually charged and paid in the market. The only payments made for accommodation by the owner-occupier are either the cost of acquisition - and expenditure on investment is out of scope of the RPI, or expenditure on the cost of credit - and credit is not covered by the RPI. In order to include a cost of owner occupiers' shelter we have to do one of the following:

- include investment expenditure (acquisitions approach)
- include expenditure on credit (current expenditure approach)
- impute an income forgone (user cost approach)
- impute a rent (rental equivalent approach)

But each of these contravenes one or more of the RPI guidelines.

54. The chosen methodology in the UK since 1975 has been the current expenditure approach. The problem that has arisen in recent years is that by including actual expenditure on credit secured on housing this item has increasingly come to cover credit associated with expenditure on goods and services not associated with housing as mortgages have been used for other purposes.

55. As a result the revised RPI methodology that is recommended by the Committee is an imputed current expenditure approach. It imputes a stream of expenditure on credit to every home owner by assuming that they finance the acquisition of their house in a standard manner, taking out a standard mortgage.

56. Of the three general approaches, the acquisitions one is perhaps the least convincing, since it ignores the long life of houses.

57. Of the two current expenditure approaches, **A** has the merit of being closest to most people's perception of housing costs, in spite the use of nominal interest rates (i.e. the neglect of capital gains) and the growing looseness of the relation between finance and housing.

58. The current expenditure approach **2B** loses the intuitive appeal of **2A;** and introduces concepts of real interest rates without the benefit of the more comprehensive approach of **3A** or **3B.**

59. The third approach, the flow of services, has much to recommend it from a theoretical point of view. However, the use in **3A** of proxies (private or commercial rents) is unlikely to be convincing, because both will be subject to major influences (such as the supply and demand for offices) irrelevant to the owner-occupier. More promising is the measure in **3B** of income forgone on the capital invested in the house. This is relatively straightforward in concept and explicable in practice - at least to economists. But it is debatable whether the path of such an indicator would correspond to the common perception of housing costs [see charts in Annex 2].

60. Finally, the difficulties in each of the approaches, and the fact that no approach satisfies the usual RPI criteria, makes omission of owner-occupiers' shelter costs from the index a serious alternative.

ANNEX 1: Methods used in other countries

ANNEX 2: Paths of the various price indicators considered, together with weights.

ANNEX 1: OWNER-OCCUPIERS' HOUSING COSTS - PRACTICE IN SOME OTHER COUNTRIES

1. This annex summarises the methodology that has been chosen for the representation of owner-occupiers' shelter costs in the CPI by some other countries that have examined the question in depth - the US, Australia and Canada. A table attached lists the methods used in OECD countries.

United States

2. Before 1983 the US followed a hybrid methodology that compounded the **acquisitions approach** with the **current expenditure approach** in representing owner occupiers' shelter costs in its CPI. The total weight on this accounted for more that 25 per cent of the index (compared with about 5 per cent in the UK). It comprised:

- total value of net acquisition of owner-occupied housing (using an appropriate house price index with a weight derived from a consumer survey);

- transactions costs (indicated by the house price index included with weight derived from survey);

- amount of interest that those obtaining mortgages <u>in the base period</u> promise to pay in the first half of the term of the loan (that is, it included <u>future</u> payments).

3. The new US index introduced in 1983 abandoned the old methodology and adopted a **flow of services** approach. The two varieties - user cost and rental equivalent - were considered and the latter was favoured. The Bureau of Labour Statistics concluded:

> "It has been demonstrated that estimated cost functions are subject to extreme volatility and that the direct use of rental market information is a far more promising approach".

4. The US rent index has therefore been modified to make it appropriate for owner-occupiers as well as tenants. This has involved augmenting the sample to increase the proportion of rented homes with characteristics similar to owner-occupied ones and changing the sample to reflect the geographical distribution of owner-occupiers as well as tenants.

Australia

5. The Australian consumer price index currently uses the acquisitions approach, treating home acquisition in a similar manner to the acquisition of consumer goods for CPI purposes. The weight is based on the actual value of houses acquired in the base period corrected for the effect of the growth of the relevant population. The price indicator is a measure of the cost of construction of a specified house on a level site in the capital city - it excludes the cost of land - and is obtained from a representative sample of builders.

6. However, an independent body, the Standing Tripartite Commission, reviewed this treatment in 1981 and recommended a change. It proved impossible to resolve the practical problems in time for the 1982 revision of the index. The matter was still under discussion in 1984.

7. The Commission considered the entire set of approaches:

acquisitions approach

current expenditure approach

user cost

rental equivalent

8. They rejected the **user cost approach** on the grounds that:

- the validity of including notional items in a CPI is doubtful;

- users would be likely to find an index that included notional costs unacceptable;

- there were major practical problems associated with this approach.

9. They rejected the **rental equivalent approach** on the grounds that it is "... based on a premise that the housing services consumed by an owner-occupier are the same services as those purchased by a tenant when he pays rent ...", for they maintained:

- owner-occupied houses and tenanted houses differ in characteristics and location;

- market imperfections such as rent control distort the observed price;

- even if the houses were identical and there were no market distortions the rent may not reflect the value of the services consumed because there are intangible benefits to owner-occupation.

They also objected to including a hypothetical or imputed price in the index.

10. In the course of their discussions they came down against treating houses as investment goods. In their view:

> ".... most owner-occupiers regard their expenditure on houses as predominantly a means of purchasing shelter rather than as an investment ...."

11. The method recommended by the Commission was the **current expenditure approach** incorporating two components. Net current

the 25 year duration in the UK. The interest rates appropriate to the month the mortgage contract was entered have tended to be maintained throughout the life of the mortgage so the formula contains a distributed lag of interest rates as well as house prices.

expenditure on acquisitions - down payments and repayments of principal less value of sales - would be represented by a measure of the level of house prices. A separate component would be included to represent mortgage interest payments, similar in structure to that currently used in the UK but set up in such a way as to mirror the financial arrangements existing in Australia.

Canada

12. Canada has chosen a variant of **current expenditure approach** to represent owner occupiers' shelter costs in its CPI. It includes two components:

- replacement cost of owner-occupied dwellings "used up" in each period;

- mortgage interest payments.

13. The first component is a measure of the **depreciation of the housing stock** but can also be viewed as the net replacement or net acquisitions associated with the base period, fixed, level of the housing stock. The price indices used are the current values of the New Housing Price Indices in the major urban centres of Canada. These are contractors' selling prices for new dwellings, excluding land value. They are collected from large-scale builders in the relevant urban centres. The weight given to these in the index is proportional to the value of the housing stock in the base period using a depreciation rate of 2 per cent.

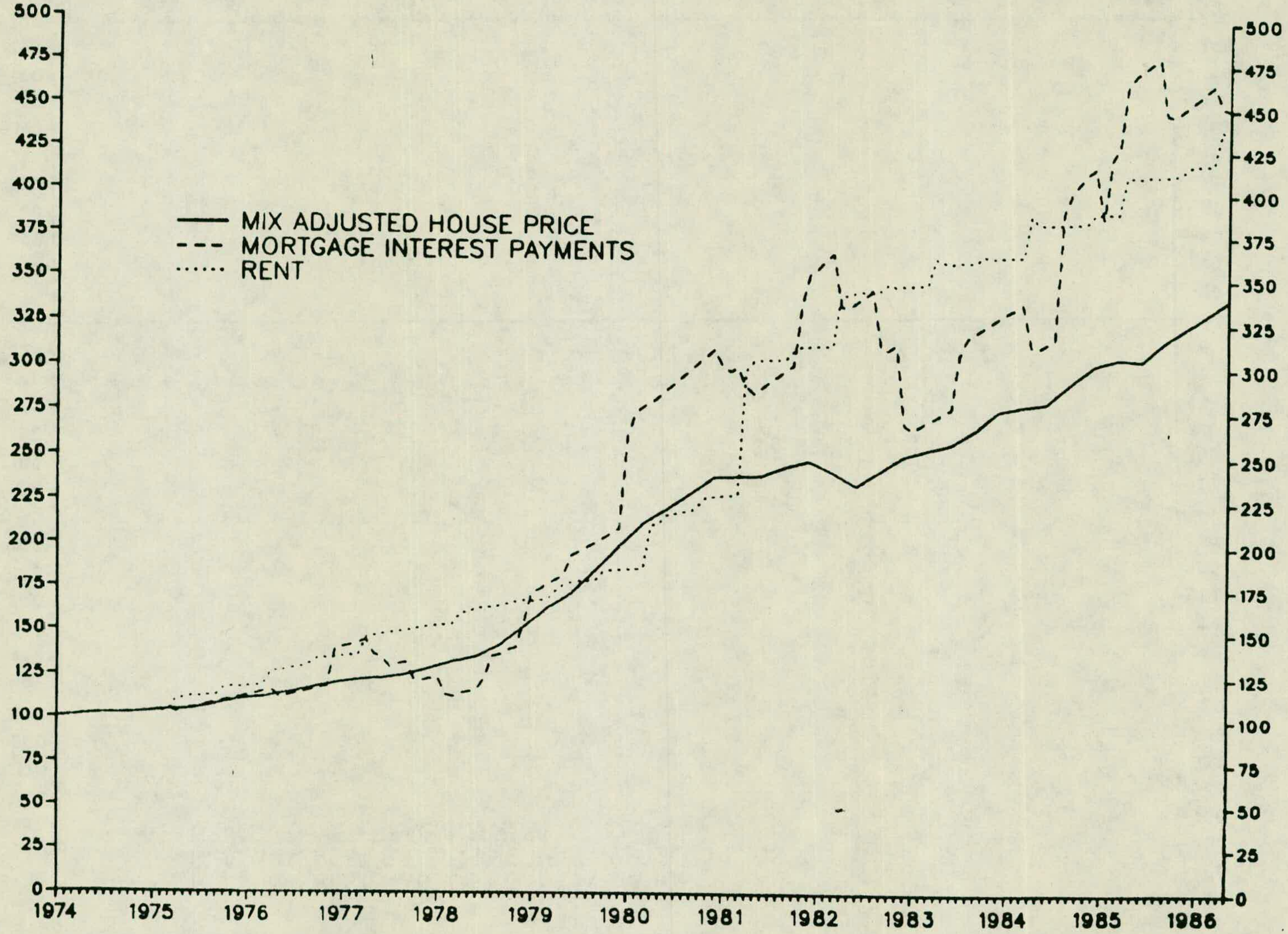
14. The second component is a measure of the value of **mortgage interest payments** very similar in principle to that used in the UK. It measures the change through time in the value of the mortgage interest payments required to finance a fixed stock of dwellings under given conditions of financing (eg down payment proportion and amortisation period). The weight is based on expenditure as reported in the Family Expenditure Surveys.

15. The Price index is based on a standard mortgage. This standard mortgage is of 5 years duration (60 months) instead of

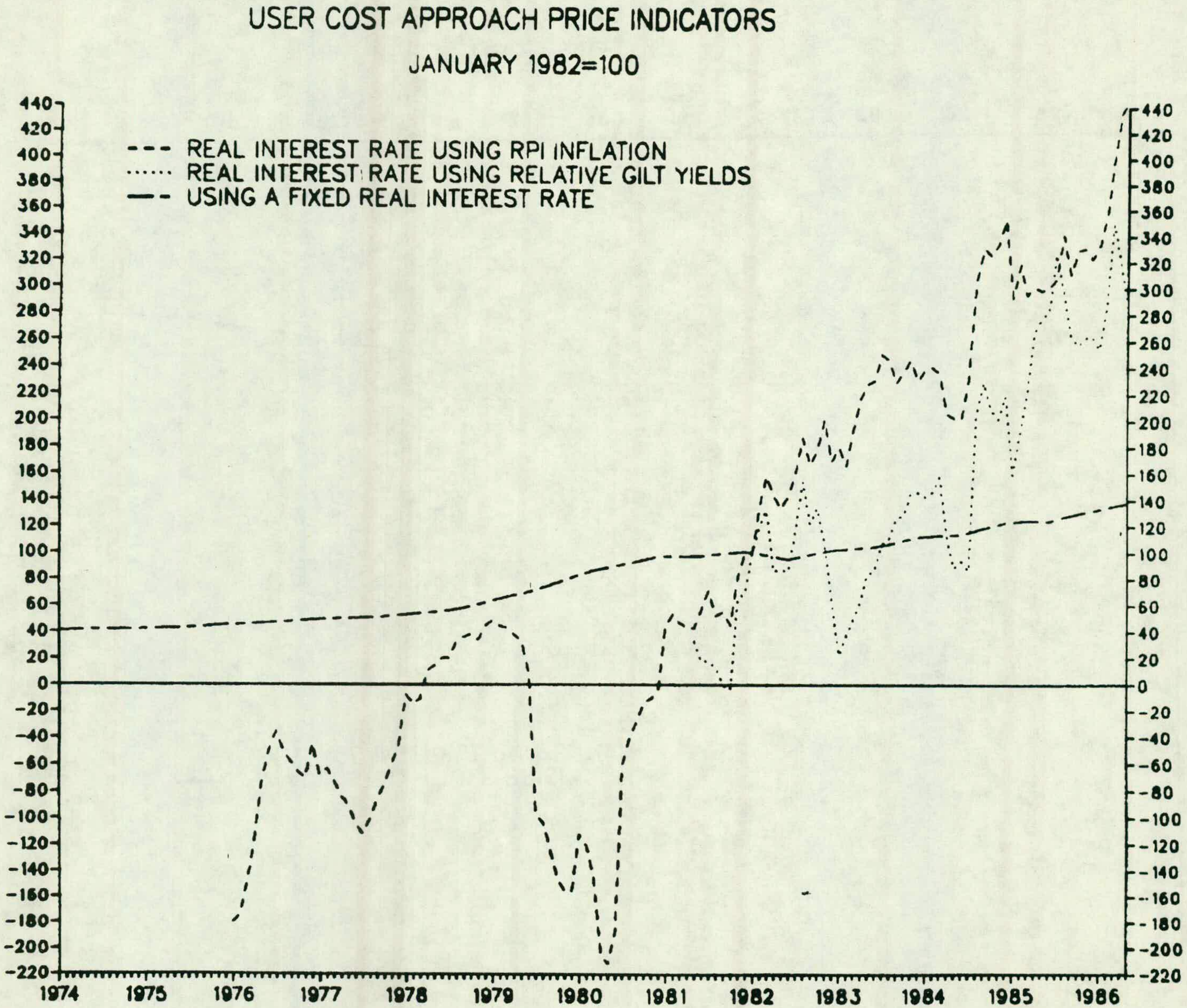
›

PRICE INDICATORS FOR OWNER OCCUPIERS SHELTER COSTS

JANUARY 1974 = 100



NB: data provisional



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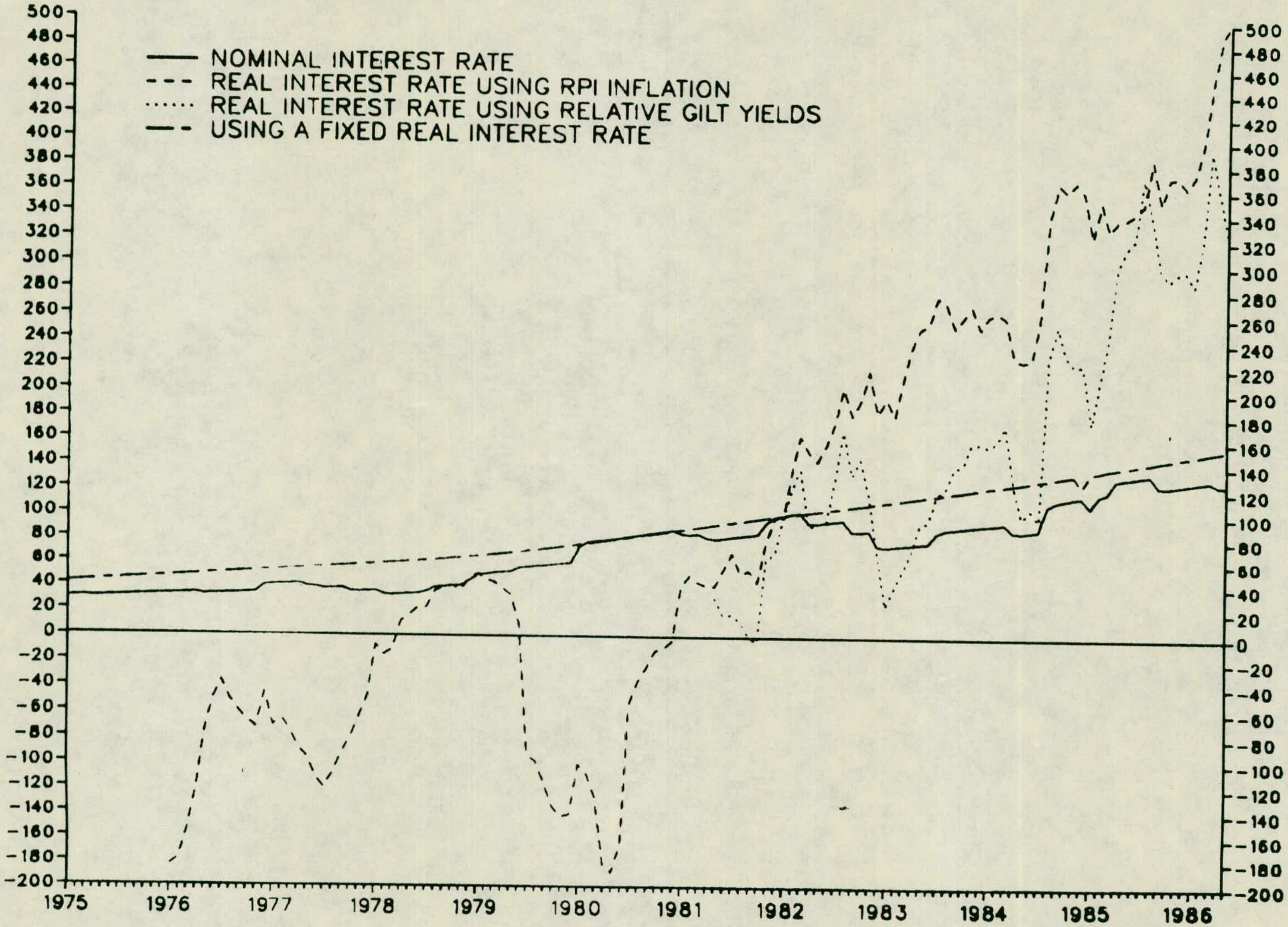
CURRENT EXPENDITURE APPROACH PRICE INDICATORS

JANUARY 1982=100



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cc CST
FST
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Sir P Middleton
Sir T Burns
Mr F E R Butler
Mr Byatt
Mr Cassell
Mr Kemp
Mr Monger
Mr Evans
Mr Odling-Smee
Mr Peretz
Mr Sedgwick
Mr Scholar
Mr Watson
Mr Culpin
Mr Davies
Miss O'Mara
Miss Noble
Mr Brooks
Dr Rowlatt
Mr Ross Goobey

p.f.

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

9 July 1986

The Rt. Hon. Lord Young of Graffham
Secretary of State for Employment

Dear David

RPI ADVISORY COMMITTEE

Thank you for your letter of 3 July.

I agree that the report of this Committee should be accepted in full. The need to ensure public acceptability of the index leaves us with no alternative.

I do, however, continue to have one serious reservation, on owner-occupied housing costs. The report rightly spells out the problems of measurement in this area; it records the difficulties the Committee had in coming to a conclusion; it sets out - none too convincingly, in my view - the Committee's response to the problems; and it lists the solutions adopted by other countries, mostly at variance with the approach in the UK.

The minor modifications recommended by the Committee represent a slight improvement. But I shall continue to draw attention to the RPI less mortgage interest payments, as a measure of inflation that is less volatile than the RPI in the short term.

The early timetable you propose for publication is right. As you know, we need to publish as soon as a decision is made. I suggest that officials discuss the wording of the press notice and the answer to the PQs.

I have two points on future developments. The first is that when the Committee is reconvened (and the report suggests there should be more frequent meetings) your officials should consult with mine over the membership of the Committee.

The second is that in implementing the Committee's recommendations, and in devising methods of extending the coverage of the RPI and making other improvements, your department should seek to do this in as cost-effective a way

CHANCELLOR OF THE EXCHEQUER

Ch.

A vastly improved version of the regular monthly note, due to a Burns initiative.

Some useful background here for Cabinet.

RL.

15/7.

CHANCELLOR OF THE EXCHEQUER

HONI SOIT QUI MAL Y PENSE

RL → Sir P.
14/7

The Changed World Economy: Peter Drucker

RGF 25/7

133/4

HM TREASURY

WORLD ECONOMIC DEVELOPMENTS

Summary

1. Real GNP in the G5 countries was virtually unchanged in the first quarter of 1986 with falls of 1½ per cent in Germany and ½ per cent in Japan. Industrial production in the G5 countries has been flat over the last 6 months.

2. G5 consumer price inflation, fell to 1½ per cent in May and is now at its lowest level for over 20 years.

3. There have been no reductions yet in world payments imbalances. The US trade deficit for the twelve months to May was a record $160 billion and the Japanese and German surpluses have also risen to record levels.

4. Interest rates have been little changed since the general discount rate cuts in March and April, though pressure on the Federal Reserve for a cut in US rates has increased in recent weeks.

5. In the US a budget resolution for the fiscal 1987 budget has been agreed by Congress. It is claimed that it will bring the deficit down to $143 billion (within the Gramm-Rudman target).

JONATHAN WEBB

9 July 1986

SECTION A: NOMINAL AND REAL GNP

1. Table 1 shows that nominal GNP in the G5 countries grew by only 3¼ per cent, at an annual rate, in the first quarter of 1986, bringing the year-on-year growth rate down to 5½ per cent. Real growth was a modest ¼ per cent in the first quarter, and inflation, as measured by the GNP deflator was 3 per cent. Thus, although the collapse of oil prices has brought sharp falls in consumer price inflation (see Section B), which includes the effects of lower import prices, the growth rate of the GNP deflator, which measures domestically generated inflation, has continued to fall only gradually.

Table 1: Nominal GNP growth in the G5 countries*

		Nominal GNP	Real GNP	GNP Deflator
Annual percentage change				
1980		9.3	0.8	8.5
1981		9.5	1.6	7.9
1982		5.5	-0.5	6.0
1983		7.2	2.8	4.1
1984		8.7	4.8	3.6
1985		6.2	2.7	3.4
Change from four quarters earlier (per cent)				
1984	Q1	9.7	5.7	3.7
	Q2	8.8	4.8	3.8
	Q3	8.6	4.8	3.6
	Q4	7.7	4.1	3.5
1985	Q1	6.1	2.5	3.4
	Q2	6.2	2.8	3.3
	Q3	6.4	2.9	3.4
	Q4	6.2	2.6	3.4
1986	Q1	5.5	2.2	3.2
Change from previous quarter (per cent, annual rate)				
1984	Q1	12.6	8.2	4.0
	Q2	5.6	2.3	3.2
	Q3	6.9	3.0	3.7
	Q4	5.7	2.8	3.0
1985	Q1	6.0	1.9	3.9
	Q2	6.2	3.3	2.7
	Q3	7.5	3.3	4.1
	Q4	5.0	1.9	3.1
1986	Q1	3.2	0.2	3.0

*G5 weighted averages are calculated using GNP in 1980 prices converted to a common currency using average 1980 exchange rates.

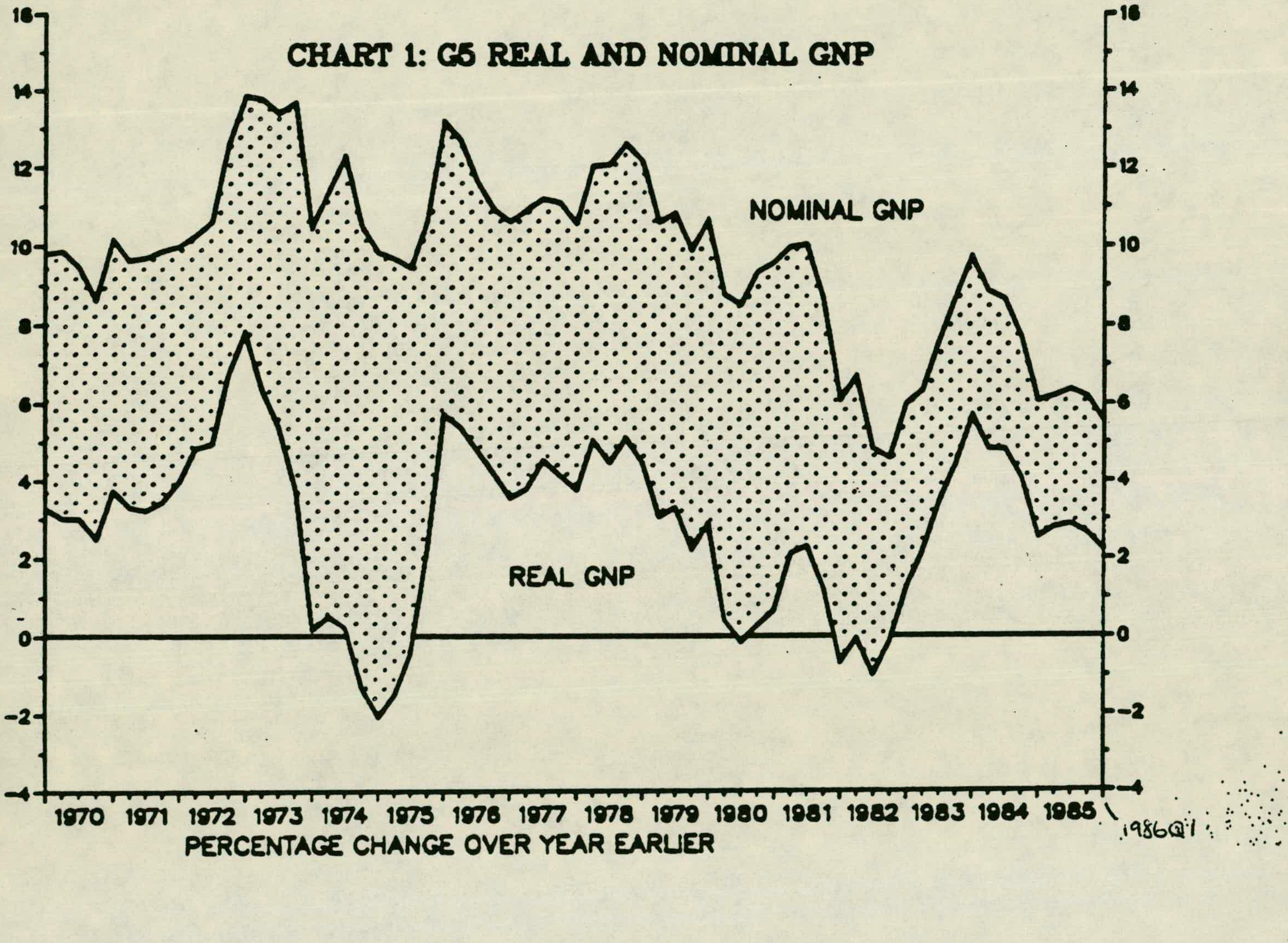
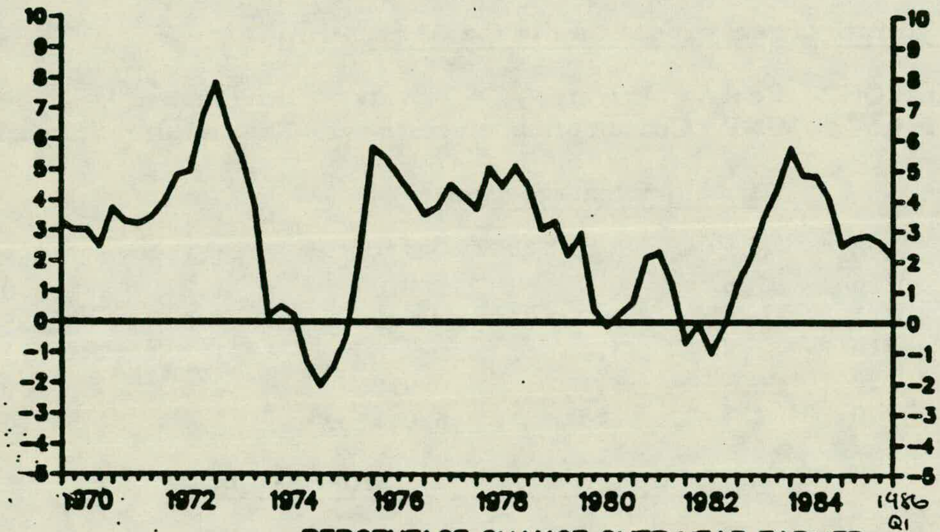


CHART 1: G5 REAL AND NOMINAL GNP
NOMINAL GNP
REAL GNP
16
14
12
10
8
6
4
2
0
-2
-4
1970 1971 1972 1973 1974 1975 1976 1977 1978 1979 1980 1981 1982 1983 1984 1985
1986Q1
PERCENTAGE CHANGE OVER YEAR EARLIER

2. Real GNP in the G5 grew by less then 0.1 per cent in the first quarter (0.2 per cent at an annual rate) with growth of ¾ per cent in the US and ¼ per cent in France offset by falls of 1½ per cent in Germany and ½ per cent in Japan (the first fall there for 11 years).

CHART 2: G5 GNP GROWTH



PERCENTAGE CHANGE OVER YEAR EARLIER

Table 2: GNP growth in individual countries

		US	Japan	Germany	France	UK	G5
Annual percentage changes							
1983		3.4	3.2	1.5	0.7	3.3	2.8
1984		6.6	5.0	3.0	1.5	2.6	4.8
1985		2.2	4.6	2.4	1.4	3.4	2.7
Change from previous quarter (per cent, at annual rate)							
1985	Q1	3.7	1.7	-3.3	-0.6	3.8	1.9
	Q2	1.1	5.8	6.8	3.3	6.4	3.3
	Q3	3.0	3.0	6.8	3.7	-1.1	3.3
	Q4	0.7	5.7	-0.2	2.2	1.8	1.9
1986	Q1	2.9	-2.1	-6.5	1.2	2.9	0.2

3. The modest growth in the G5 countries in the first quarter is attributable t[o] falls in private investment and export volumes; private consumption continues to grow at an annual rate of about 3 per cent and government expenditure has increased strongly in real terms in each of the last three quarters. Private investment growth has been slowing down for some time now, reflecting the maturity of the business cycle in the US, but in the first quarter of 1986 investment was particularly weak in Japan and Germany.

Table 3: Growth of real expenditure in the G5 countries

		Real GNP index*	Real GNP	Private Consumption	Private Investment	Government Expenditure	Exports
				Annual percentage change			
1980		100.0	0.8	0.5	-2.6	1.1	4.8
1981		101.6	1.6	0.9	0.0	1.2	2.0
1982		101.1	-0.5	1.7	-3.9	1.0	-4.5
1983		104.0	2.8	3.4	3.8	1.3	-1.3
1984		109.0	4.8	3.1	9.8	2.5	7.9
1985		112.0	2.7	2.8	6.5	2.4	3.4
				Change from four quarters earlier (per cent)			
1984	Q1	107.9	5.7	3.8	10.8	0.6	7.6
	Q2	108.6	4.8	3.5	11.4	2.6	6.4
	Q3	109.9	4.8	2.7	9.2	2.8	9.4
	Q4	110.1	4.1	2.3	8.2	4.2	8.2
1985	Q1	110.7	2.5	2.5	6.9	2.7	6.7
	Q2	111.6	2.8	2.4	6.4	0.7	6.4
	Q3	112.5	2.9	3.4	6.8	2.9	1.3
	Q4	113.0	2.6	3.0	6.1	3.5	-0.5
1986	Q1	113.2	2.3	3.0	5.1	2.4	-0.5
				Change from previous quarter (per cent, annual rate)			
1984	Q1		8.2	3.1	4.7	2.3	4.9
	Q2		2.3	3.4	11.6	8.8	-2.1
	Q3		3.0	0.4	6.2	2.6	21.1
	Q4		2.8	2.4	10.3	3.0	10.2
1985	Q1		1.9	3.8	0.0	-3.4	-0.7
	Q2		3.3	3.1	9.3	0.7	-3.2
	Q3		3.3	4.3	7.9	11.9	-0.7
	Q4		1.9	1.0	7.4	5.3	2.6
1986	Q1		0.2	3.6	-3.5	7.3	-0.6

* Level (1980 = 100)

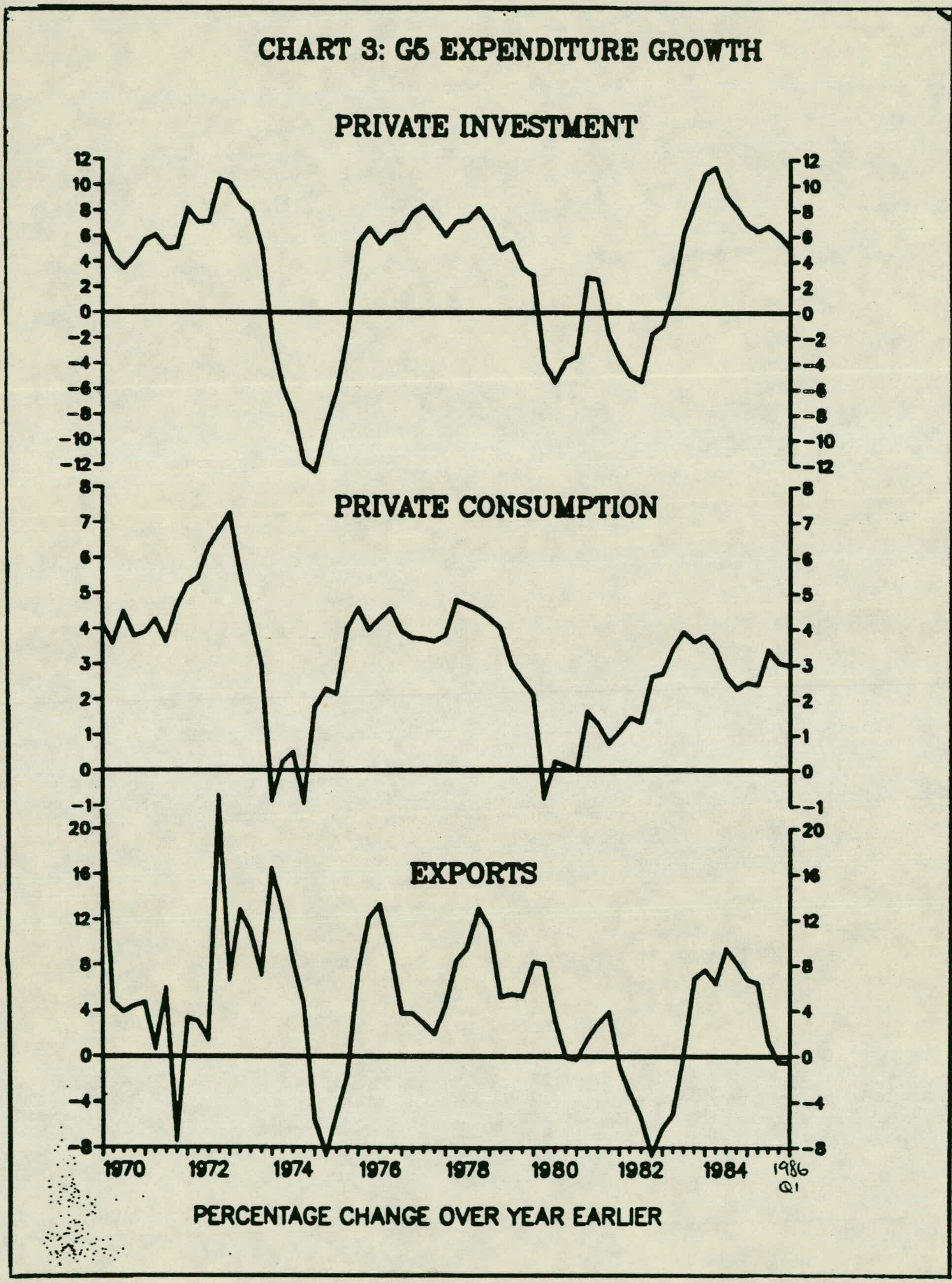


CHART 3: G5 EXPENDITURE GROWTH
PRIVATE INVESTMENT
12
10
8
6
4
2
0
-2
-4
-6
-8
-10
-12
PRIVATE CONSUMPTION
8
7
6
5
4
3
2
1
0
-1
EXPORTS
20
16
12
8
4
0
-4
-8
1970
1972
1974
1976
1978
1980
1982
1984
1986
Q1
PERCENTAGE CHANGE OVER YEAR EARLIER

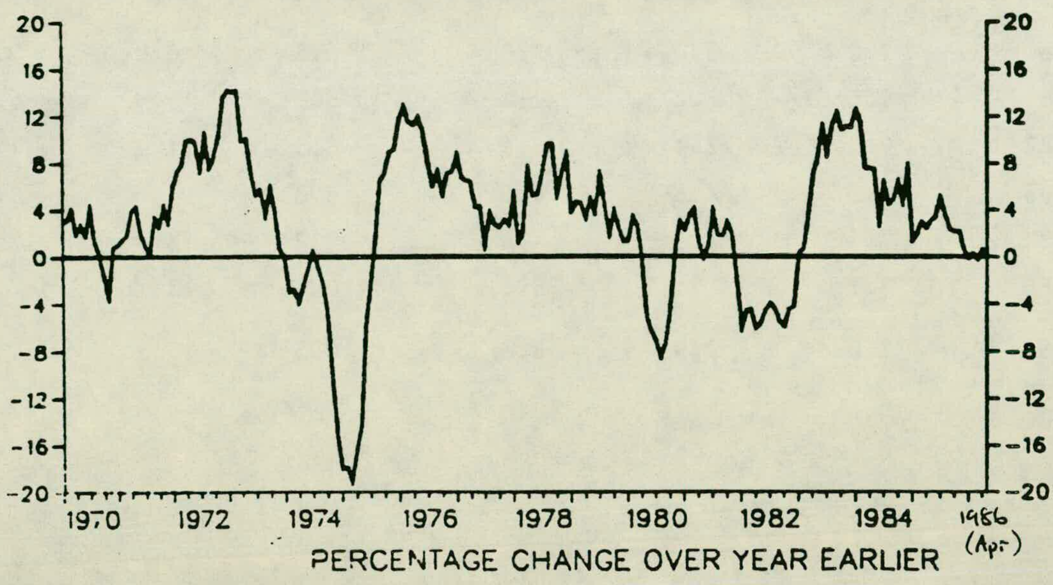
4. As Table 4 and Chart 4 show, industrial production in the G5 countries as a whole has been broadly flat over the last twelve months. None of the G5 have avoided a pause in output growth, and in the US, Japan and Germany production is now lower than in the fourth quarter of 1985.

Table 4: Industrial production and employment in the G5 countries*

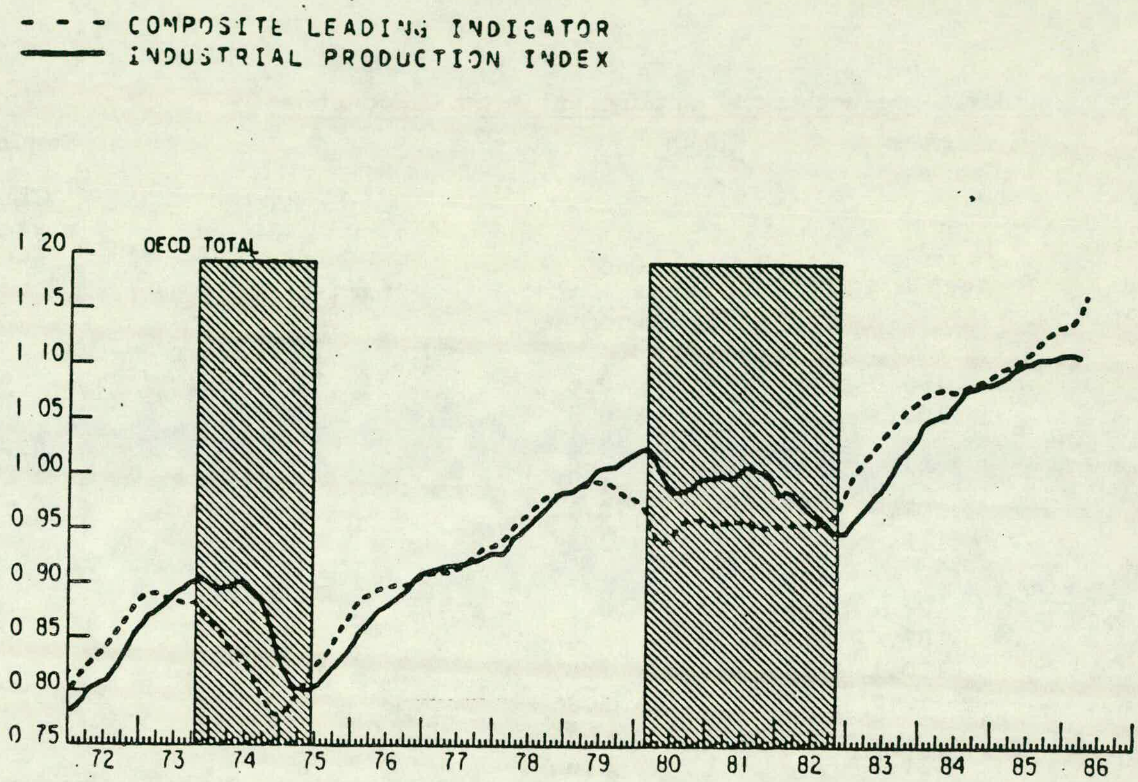
		Industrial Production			Employment
		Index (1980 = 100)	Change on a year earlier (per cent)	Change on 6 months earlier, per cent, a.r.)	Change on a year earlier (per cent)
1980		100.0	-0.6		0.5
1981		100.3	0.3		0.2
1982		96.8	-3.5		-0.6
1983		100.6	3.9		0.7
1984		108.9	8.1		2.1
1985		112.6	3.3		1.3
1984	Q1	107.1	10.6	10.5	2.1
	Q2	107.4	8.4	5.9	2.5
	Q3	110.1	7.8	5.2	2.0
	Q4	110.7	5.8	6.0	1.8
1985	Q1	111.3	3.6	2.1	1.8
	Q2	112.4	4.4	2.9	1.1
	Q3	113.3	2.8	3.6	1.1
	Q4	113.3	2.3	1.6	1.2
1986	Jan	113.5	2.3	-0.2	
	Feb	113.4	1.9	0.1	
	Mar	112.7	1.0	-0.5	
	Apr	113.6	1.3	0.6	

* Weights derived from 1980 gross domestic product originating in industry converted at average exchange rates for 1980.

CHART 4: G5 INDUSTRIAL PRODUCTION



5. The OECD's leading indicators, which are shown in the chart below, point to a recovery in the second half of 1986.



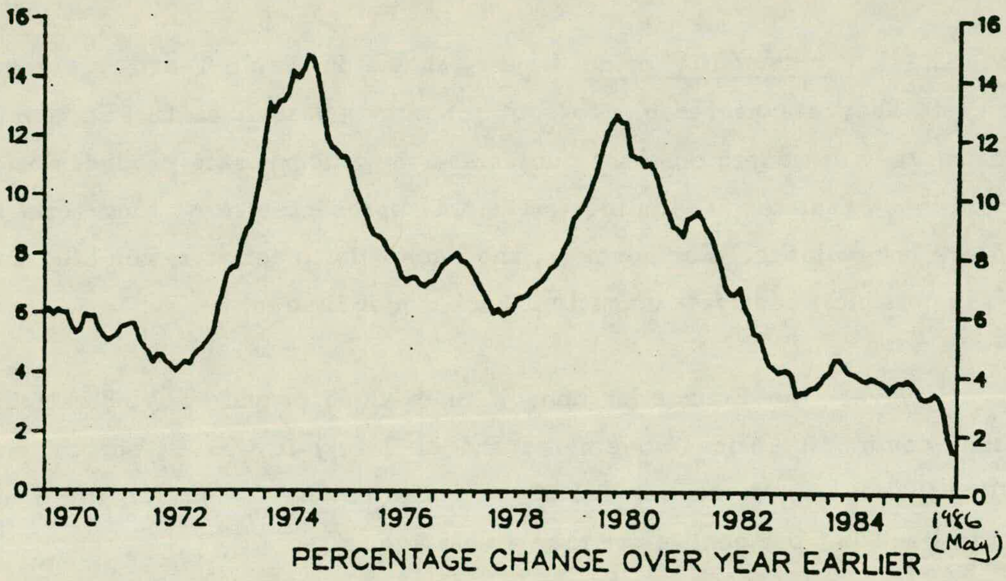
6. Unemployment has changed little in the G5 countries since the midde of 1984.

Table 5: OECD Standardized Unemployment rates (per cent of labour force)

	US	Japan	Germany	France	UK	G5
1980	7.0	2.0	3.0	6.3	6.6	5.4
1981	7.5	2.2	4.4	8.1	9.9	6.3
1982	9.5	2.4	6.1	8.3	11.4	7.7
1983	9.5	2.6	8.0	8.3	12.6	8.1
1984	7.4	2.7	8.5	9.7	13.0	7.4
1985	7.1	2.6	8.6	10.1	13.2	7.3
1986 Apr	7.0	2.9	8.3	10.3	13.3	7.3

SECTION B: PRICES AND WAGES

CHART 5: G5 CONSUMER PRICE INFLATION



7. G5 consumer price inflation is at its lowest level for over 20 years. In Japan and Germany prices have fallen since the beginning of 1986.

Table 6: Consumer prices (percentage change on a year earlier)

	US	Japan	Germany	France	UK	G5
1980	13.5	8.1	5.6	13.5	18.0	11.7
1983	3.3	1.9	3.3	9.5	4.6	3.9
1984	4.3	2.3	2.4	7.7	4.9	4.1
1985	3.5	2.0	2.2	5.8	6.1	3.7
1986 May	1.6	1.1	-0.2 (June)	2.3	2.8	1.4

8. Table 7 shows that unit labour costs (not cyclically adjusted) are rising much faster in the UK than in other G5 countries, reflecting strong earnings growth.

Table 7: Unit Labour costs (manufacturing, percentage change on year earlier)

	US	Japan	Germany	France	UK	G5
1983	-2.8	2.2	-0.4	7.6	0.3	-0.8
1984	-1.3	4.2	-0.9	3.5	3.0	-0.9
1985	1.6	0.4	0.3	2.3	5.5	1.6
1985 Q1	1.8	-0.9	-1.0	4.6	5.0	1.4
Q2	1.2	-0.6	-0.4	1.7	5.6	1.0
Q3	1.9	0.4	1.5	2.1	6.3	2.0
Q4	1.5	2.7	1.3	0.6	4.2	1.9

Source: IMF

9. Spot oil prices were generally weak in thin trading throughout June. The price of Brent blend, which stood at $12.90 on 2 june fell during the month to $9.75 on 8 July, with OPEC's aggregate output believed to have reached its highest level (19 mbd) for 2½ years.

10. The UN commodity price figures shown in Table 8 and 9 are unit value indices. They are preferable to spot price indices such as the Economist index, because they are based on more quotes and they incorporate producer prices. This should mean that the UN indices are more representative of long-term contracts and are less volatile. Furthermore, the Economist index is reweighted annually so it is impossible to derive a consistent back run of figures.

11. However, the Economist non-oil index does provide an indication of more recent commodity price movements and on 1 July it was 6½ per cent lower, in SDRs, than a month earlier (with the index having fallen for three successive months) and 11½ per cent lower than a year ago.

Table 8: Commodity Prices (In nominal SDRs, (1980 = 100)

		Food	Agricultural Non-Food	Non-Ferrous Metals	Metal Ores	Oil
1980		100.0	100.0	100.0	100.0	100.0
1981		97.7	101.5	96.6	98.7	123.6
1982		92.4	96.1	90.0	101.5	126.7
1983		94.0	106.0	94.4	103.3	116.2
1984		93.5	116.8	95.0	102.8	117.5
1985		85.3	101.9	89.8	100.9	113.5
1984	Q1	96.0	118.1	97.4	103.0	115.7
	Q2	96.3	121.5	97.0	103.7	116.0
	Q3	93.0	113.9	93.3	103.0	118.6
	Q4	88.9	113.6	92.2	101.6	119.5
1985	Q1	88.0	109.6	93.6	105.9	121.1
	Q2	85.5	107.3	93.5	106.0	116.7
	Q3	82.9	98.6	88.6	98.2	109.4
	Q4	84.7	92.2	83.5	93.7	107.0
1986	Q1 est*	85.4	89.0	81.2	89.0	81.2

Source: United Nations

* By Bank of England

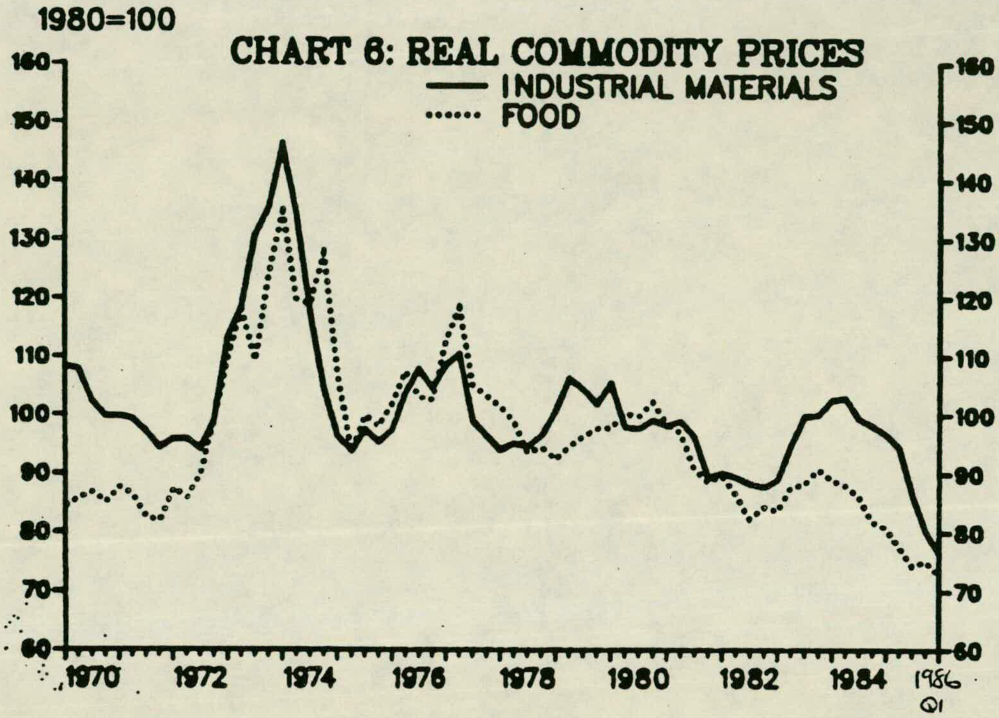


Table 9: Commodity Prices (In dollars, 1980 = 100)

		Nominal Dollars			Real Dollars*		
		Food	Industrial materials**	Oil	Food	Industrial materials**	Oil
1980		100.0	100.0	100.0	100.0	100.0	100.0
1981		88.7	90.5	111.9	93.7	95.7	118.4
1982		78.5	81.4	107.4	85.7	88.9	117.5
1983		77.2	84.5	95.5	87.5	95.9	108.2
1984		73.7	86.2	92.5	86.2	100.8	108.2
1985		66.6	77.2	88.5	76.8	89.4	102.3
1984	Q1	77.4	89.2	93.3	88.9	102.5	107.2
	Q2	77.4	90.6	93.3	87.9	102.9	106.0
	Q3	72.3	83.5	92.3	86.1	99.4	109.8
	Q4	67.9	81.5	91.3	81.8	98.2	110.0
1985	Q1	65.4	78.3	90.0	80.7	96.7	111.1
	Q2	65.2	79.3	89.0	77.6	94.5	105.9
	Q3	65.4	76.0	86.3	74.3	86.4	98.1
	Q4	70.2	75.1	88.6	74.7	79.9	94.3
1986	Q1 est	73.8	75.5	70.2	75.1	76.8	71.4

* deflated by the manufactures' unit value index.
** includes agricultural non-food, non-ferrous metals and metal ores shown in Table 8.

Source: United Nations

SECTION C: TRADE AND CURRENT BALANCES

12. The change in G5 export volume to various trade blocks is shown in Table 10. Thefigures are calculated by taking the value of exports from each of the G5 countries to the three trade groups and deflating this by the total export unit value index to produce estimates of exports at 1980 prices. (Export UVIs are not available for separate trade blocks.) The G5 export volumes index is derived by summing the five individual countries exports (and setting 1980 equal to 100). The volumes thus include intra-G5 trade. The table shows that exports to OECD countries appear to be on a continued upward trend although with marked seasonal variations. Exports to OPEC countries, on the other hand, have fallen steadily over the past three years and exports to other non-OECD countries appear to have fallen back a little at the end of 1985.

Table 10: G5 Export Volumes (1980 = 100, not seasonally adjusted)

			to		of which:	
		Total	OECD	non-OECD	OPEC	non-OPEC
1980		100	100	100	100	100
1981		103	97	110	118	105
1982		101	97	106	119	99
1983		102	102	103	100	104
1984		108	112	104	85	114
1985		111	119	102	75	116
1984	Q1	106	111	101	91	106
	Q2	107	110	103	84	113
	Q3	103	104	101	78	113
	Q4	117	121	112	87	125
1985	Q1	110	118	101	79	113
	Q2	113	121	104	77	118
	Q3	105	111	98	72	112
	Q4	116	125	105	74	122

13. The US trade deficit widened to $14.2 billion in May from an original estimate for April of $12.1 billion. The month was notable in that the US recorded a deficit in agricultural trade for the first time since the Department of Commerce started to collect the data by the current method twenty years ago. Japan's trade surplus in dollar terms rose to a further record of $8.3bn in May, nearly double the level a year earlier.

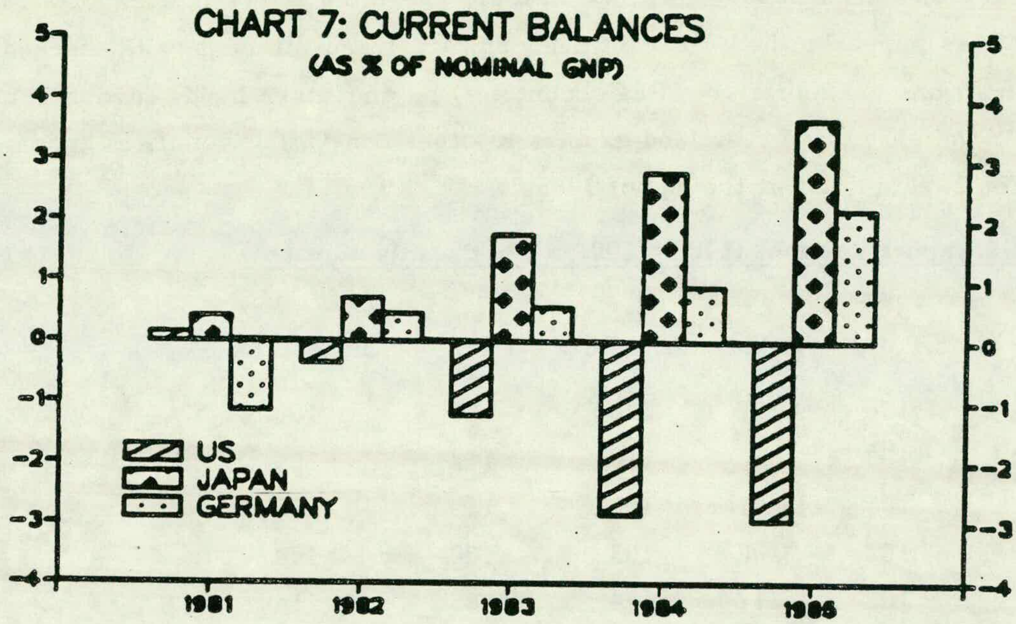


Table 11: Current balance ($bn)

	US	Japan	Germany	France	UK	G5
1982	-11	8	3	-12	7	-6
1983	-42	21	9	-4	5	-16
1984	-107	35	6	0	2	-64
1985	-118	49	14	0	5	-50
latest 12 months	-130 (Mar)	63 (May)	20 (Mar)	2 (Mar)	6 (Mar)	-39

Visible Trade balance

	US	Japan	Germany	France	UK	G5
1982	-36	8	21	-20	-3	-30
1983	-61	20	16	-9	-8	-42
1984	-114	34	19	-3	-11	-73
1985	-124	47	26	-3	-8	-63
latest 12 months	-159 (May)	69 (May)	34 (Apr)	-2 (May)	-3 (Apr)	-60

SECTION D: INTEREST RATES, MONEY SUPPLY AND EXCHANGE RATES

14. Following the general cuts in discount rates in March and April, interest rates have been broadly flat over the last two month. US short term (3 month interbank) rates are now around 6½ per cent, with long term (10 year Treasury bill) rates at 7¼ per cent.

Table 12: Interest rates in the G5 countries

		United States	Japan	Germany	France	United Kingdom	G5 average
Three-month interest rates							
1984	Q1	9½	6¾	6	12½	9¼	8¾
	Q2	11	6¼	6	12½	9¼	9½
	Q3	11½	6¼	6	11½	11	9¾
	Q4	9½	6¼	6	10¾	10¼	8½
1985	Q1	8¾	6¼	6¼	10½	13	8½
	Q2	8	6¼	5¾	10¼	12¾	8
	Q3	8	6¼	5	9¾	11¾	7¾
	Q4	7¾	7	4¾	9	11¾	7¾
1986	Q1	7¾	6¼	4½	8¾	12½	7½
	Q2	6¾	4¾	4½	7½	10¼	6½
8 July		6½	4½	4½	7¼	10	6¼
Long-term government bond yields							
1984	Q1	12	7¼	8¼	13	10¾	10½
	Q2	13¼	7¼	8¼	13	11½	11¼
	Q3	13	7½	8	12½	11¾	11
	Q4	11¾	6¾	7	11¼	11	10
1985	Q1	11½	6¾	7½	11¼	11½	10
	Q2	11¼	6¼	7½	11	11¼	9¾
	Q3	10¼	6¼	6¾	10¾	10¾	9
	Q4	9¾	6	6¾	10½	10¾	8¾
1986	Q1	8¾	5½	6½	9¾	10¾	8
	Q2	7½	4¾	6¼	8	9	7
8 July		7¼	5	6¼	7¾	9	7

15. In Germany the Central Bank Council of the Deutsche Bundesbank agreed on 3 July to maintain its CBM target of 3½ to 5½ per cent (86Q4 on 85Q4) even though CBM growth throughout the first half of 1986 was consistently above the target range. In the US M1 continues to grow well above target but M2 and M3 are within their target ranges. The Federal Reserve appear to be reconciled to rapid M1 growth, and the pressure on them is, if anything, to relax monetary policy in the face of continued weakness in the real economy.

Table 13: Narrow money growth (M1, percentage change on a year earlier)

		US	Japan	Germany	France*	UK	G5**	Germany CBM***	UK MO
1980		6.2	2.6	2.4	8.2	4.1	5.1	4.8	8.5
1981		7.1	3.3	1.1	12.2	11.7	6.5	4.4	4.6
1982		6.6	5.8	3.6	13.9	14.6	7.5	4.9	0.9
1983		11.2	3.7	10.2	10.0	13.0	9.7	7.3	5.7
1984		7.0	2.8	3.3	7.8	14.5	6.4	4.8	5.6
1985		9.1	5.1	4.4	8.7	16.7	8.2	4.6	4.6
1985	May	7.5	4.8	3.3	7.3	16.1	7.0	4.4	5.4
	Jun	8.2	4.8	4.2	8.9	18.5	7.9	4.3	5.2
	Jul	9.2	4.8	3.6	9.9	16.6	8.3	4.4	5.1
	Aug	10.5	5.1	4.2	10.3	18.7	9.2	4.3	4.5
	Sep	11.0	4.5	5.4	6.7	17.3	9.0	4.3	4.2
	Oct	11.8	4.4	6.4	7.5	18.3	9.7	4.5	3.4
	Nov	11.9	4.4	5.6	8.8	17.4	9.7	4.6	3.4
	Dec	12.2	4.7	6.6	6.0	18.0	9.8	4.2	2.4
1986	Jan	11.4	4.1	6.8	8.8	19.6	9.8	5.2	4.5
	Feb	10.9	4.2	7.7	8.4	20.1	9.7	5.2	3.5
	Mar	11.6	4.0	10.2	7.6	20.8	10.3	5.1	3.6
	Apr	12.2		10.8	6.5	20.0	10.7	6.0	3.2
	May	12.9						5.8	3.4
	June							5.9	3.2
1986	target	3-8						3½-5½	2-6
	latest over target base	12.8						6.5	3.2ø

* figures shown for 1980-84 are for M1R.

** weighted average of five M1 series shown using 1980 GNP weights

*** CBM is a constructed monetary aggregate not a true measure of narrow money. It comprises 100 per cent of current in circulation plus 16.6 per cent of sight deposits plus 12.4 per cent of time deposits plus 8.1 per cent of savings deposits currency in circulation.

ø percentage change on year earlier.

CHART 8: G5 MONEY SUPPLY

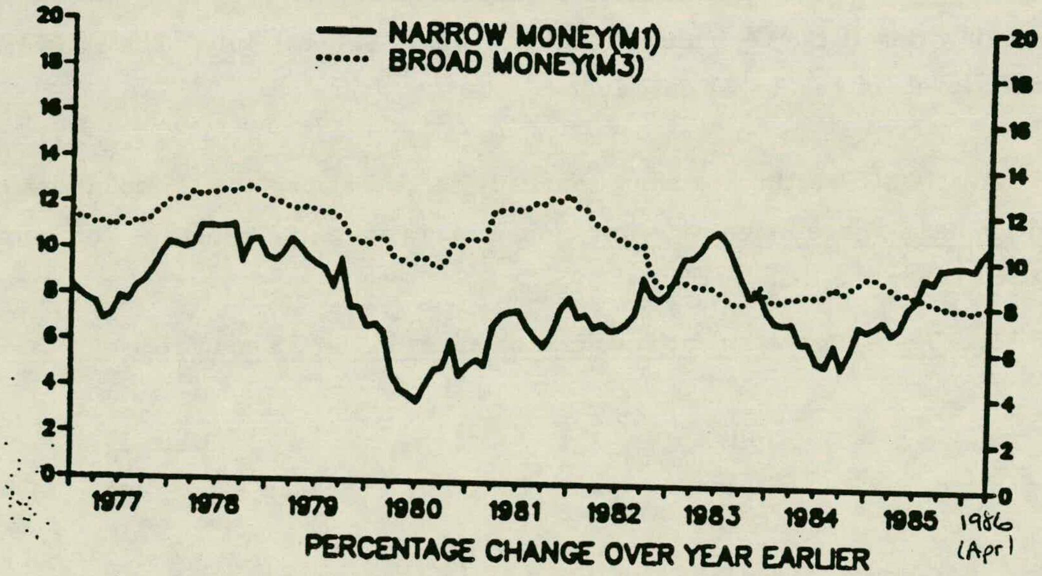


Table 14: **Broad money growth (percentage change on a year earlier)**

		US M3	Japan M2+CDs	Germany M2	France M3*	UK £M3	G5**
1980		9.2	2.6	9.4	11.1	15.0	9.9
1981		11.9	3.3	10.4	11.6	19.7	11.7
1982		10.9	5.8	6.8	11.7	20.1	10.8
1983		10.0	3.7	2.9	9.7	10.6	8.5
1984		10.0	2.8	3.4	8.5	9.1	8.4
1985		9.0	5.1	4.6	8.0	12.9	8.5
1985	May	9.1	8.4	4.8	8.1	12.1	8.5
	June	9.2	8.2	5.3	7.7	12.9	8.6
	Jul	8.8	8.3	4.6	7.9	12.7	8.3
	Aug	8.8	8.3	3.9	8.0	14.0	8.3
	Sep	8.6	8.2	3.2	6.9	14.7	8.1
	Oct	8.2	8.7	3.6	7.4	15.1	8.1
	Nov	7.6	9.0	3.4	7.7	14.8	7.9
	Dec	7.1	9.2	6.6	5.5	15.1	7.9
1986	Jan	6.9	9.0	7.6	6.1	14.0	7.9
	Feb	6.8	9.0	7.0	5.9	14.7	7.8
	Mar	7.0	8.9	7.3	5.5	16.3	8.0
	Apr	7.8	8.6	6.2	4.6	16.6	8.0
	May	7.7	8.4			19.5	
	June					18.2	
1986	target	6-9	8-9***		3-5	11-15	
	latest over target base	8	8.4ø		3.8	18.2 ø	

* figures shown for 1980-84 are for M3R. M3 is new target aggregate for 1986.

** weighted average of the series shown using 1980 GNP weights.

*** projection

ø percentage change on year earlier

17. The dollar effective fluctuated in the range of 114-119 during June but has fallen below this at the beginning of July. It was 113.8 on 8 July. The yen reached a record level of 158.9 = $1 on 7 July.

18. Latest OECD estimates show that only the US among the G5 countries has a larger general government deficit (expressed as a percentange of nominal GNP/GDP) than the UK.

Table 15: General government financial balances in the G5 countries

		United States	Japan	Germany	France	United Kingdom	G5
	1983	-3.8	-3.7	-2.5	-3.1	-3.7	-3.5
	1984	-2.9	-2.2	-1.9	-2.9	-3.9	-2.7
	1985	-3.5	-1.3	-1.1	-2.6	-3.1	-2.6
OECD forecast	1986	-3.4	-0.8	-0.8	-2.6	-3.2	-2.4
	1987	-2.5	-0.4	-0.4	-2.5	-3.1	-1.9

CHART 9: REAL AND NOMINAL EFFECTIVE EXCHANGE RATES

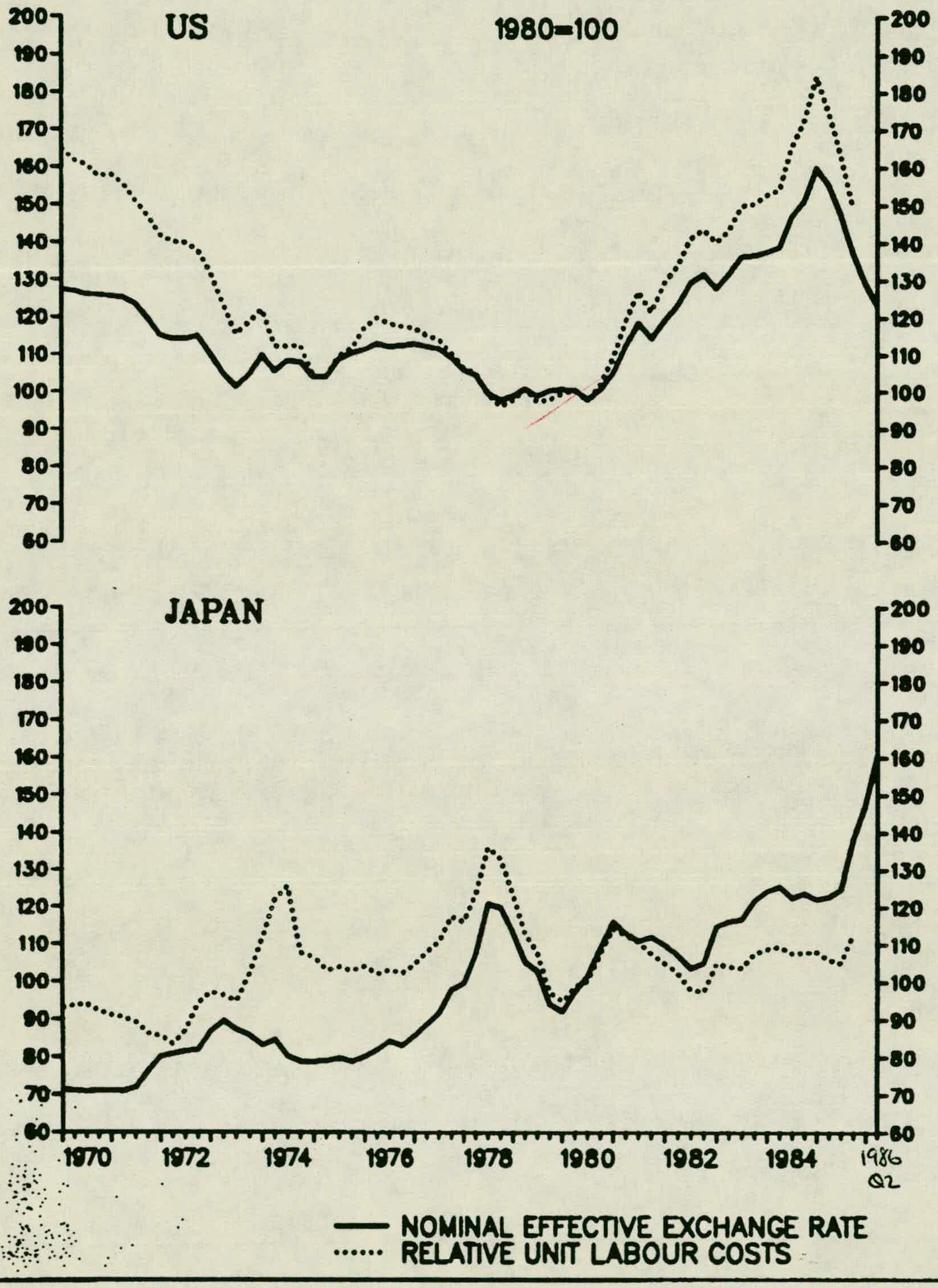
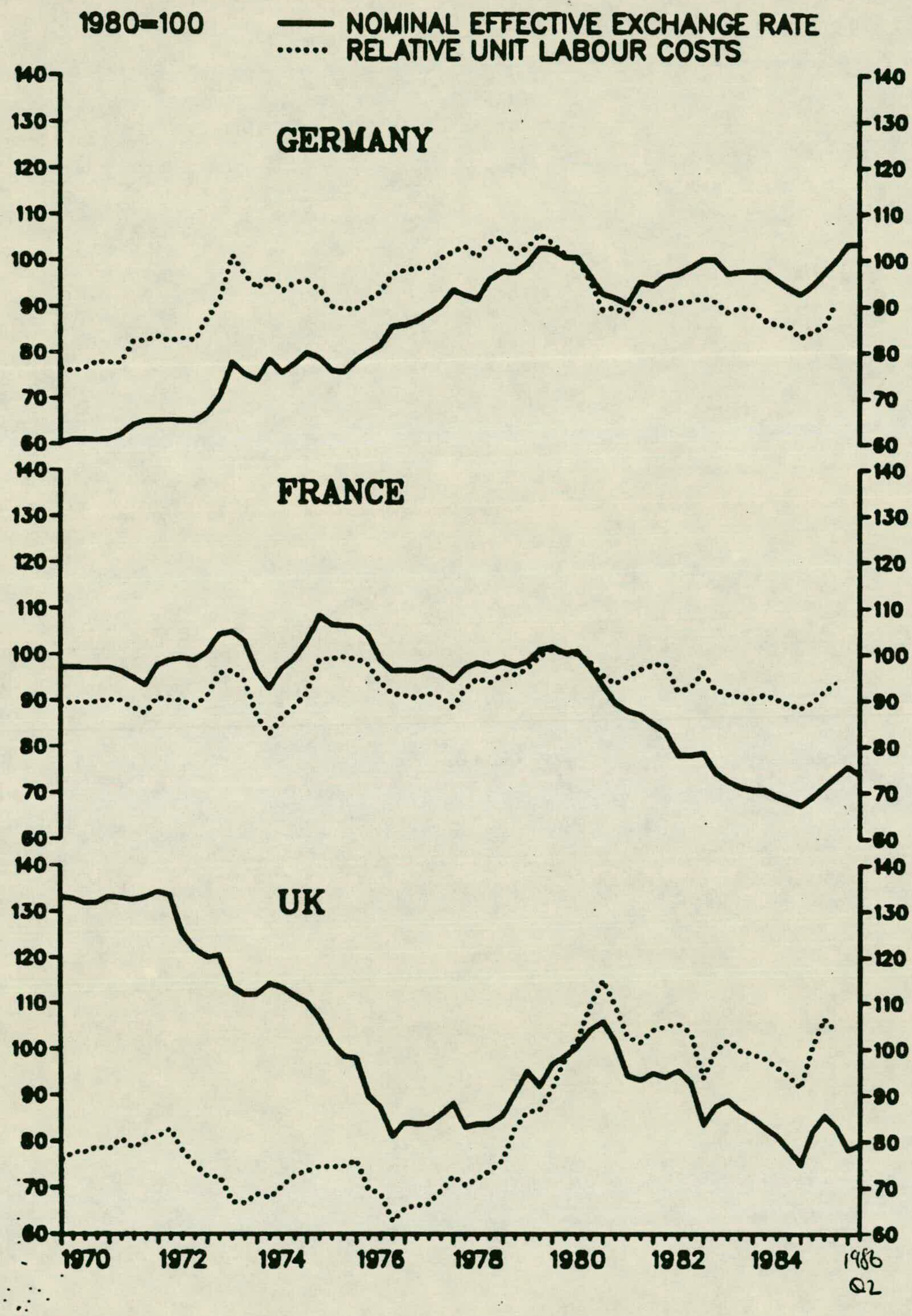


CHART 10:REAL AND NOMINAL EFFECTIVE EXCHANGE RATES



SECTION E: RECENT POLICY ANNOUNCEMENTS

US

19. Congres has agreed a budget resolution for fiscal 1987 that is intended to reduce the deficit to $143 billion (just below the target set by the Gramm Rudman deficit-reduction legislation). The budget sets defence appropriations at $292 billion (cf $320 billion in the President's proposals), but the reduction in planned defence outlays is much less. Other programmes to be cut include foreign aid and grants for urban development and rental housing. The budget increases funding for some programme such as education and health care. There are no new taxes, though an option is included that will allow incresed revenues which could be used partly to increase defence expenditure.

20. The Supreme Court has upheld a lower court decision which ruled a key section of the Gramm-Rudman legislation unconstitutional. The automatic mechanism for expenditure cuts is no longer available but a fall back provision was included in the legislation. Under this provision congressional budget committees will have to produce a budget resolution consistent with GR target deficits, but this will be subject to amendment by Congress (though they would still be under some pressure to meet the target).

21. The House and Senate have now both passed tax reform proposals. Both plans include a sharp cut in personal income tax rates; the present top rate is reduced from its present level of 50 per cent to 38 per cent in the House proposals and to only 27 per cent in the Senate's. Tax thresholds are also raised but many deductions, such as for non-mortgage interest are to be no longer allowed.

22. On the corporate side, both sets of proposals cut tax rates but many corporate deductions are removed. In particular, the investment tax credit is repealed under both plans. A minimum tax of 20 per cent is included in the Senate proposals and 25 per cent in those of the House. This was to ensure profitable companies such as General Electric and Boeing would no longer be able to avoid paying taxes.

23. Both sets of proposals are assumed to be revenue neutral, but with a significant shift in taxation from the personal to the corporate sector. This is estimated at around $100 billion over the next five years in the Senate plan, and $140 billion in the House proposals. The Senate and House will now go to Conference to reconcile the two bills.

Japan

24. The weakness of the Japanese economy in the first half of 1986 has led to calls for a relaxation of fiscal and/or monetary policy, but any government action has been delayed by the "double" General Election held on 6 July. The Governor of the Bank of Japan has denied that the discount rate (now 3½ per cent) will be cut further in the near future. However, there have been reports that a supplementary budget will be introduced in the Autumn to increase government expenditure by Yen 3 trillion (£12 billion).

Germany

25. On the 18 June the government ordered spending cuts by all government departments totalling DM1 billion to bring expenditure back within budget following a forecast shortfall in tax revenues and unexpectedly large payments to farmers. This decision was taken despite the present weakness in the Germany economy (where GNP fell by 1½ per cent in the first quarter of 1986) and pressure from the US for Germany to expand.

26. The German draft budget for fiscal 1987 was agreed by Cabinet on 1 July. This shows a continuation of the government's tight fiscal stance. The deficit is expected to rise slightly in 1987 to DM24 billion, partly because of the sharp fall in the Bundesbank profits (following the appreciation of the DM and lower interest rates) which are expected to fall from DM12½ billion to DM7 billion next year. Revenue of DM3 billion is to be raised by privatisation. Expenditure is expected to increase by 3 per cent next year, with the draft financial plan aiming to maintain this rate of growth up to 1990. This plan expects the deficit to fall to DM20 billion by 1990.

France

27. Finance Minister Balladur has announced that quantitative credit controls will be abolished on 1 January 1987 provided inflation, the exchange rate and money supply growth are satisfactory. Credit would then be controlled through open market operations. Exchange controls have been further relaxed.

Other countries

28. The Italian cabinet agreed to introduce a new lira worth 1000 times the present unit of currency. In Australia the continued, weakness in its external accounts, (caused by weak commodity prices) has led the government to propose measures to reduce current deficit including less than full indexation of wages and cuts in government spending. In Norway the fall in oil prices has led to a change in

government, as the centre-right coalition collapsed when it tried to pass austerity proposals necessary because of a prospective 10 per cent fall in government revenues (the Progress Party, with only two seats, held the balance of power and voted against the government). The new Labour government has since passed a similar package of measures.