PO-CH/N40148
PART A

Part A.

SECRET

(Circulate under cover and notify REGISTRY of movement)

Begins: 9/7/87.
Ends: 8/9/87.

PO -CH /NL/0148

PART A

Chancellor's (Lawson) Papers:

SHORT TERM PROSPECTS FOR THE GROSS DOMESTIC PRODUCT DEFLATOR 1987

Disposal Directions: 25 Years

25/8/95

PO -CH /NL/0148
PART A

(for 11 AM meeting if you have time to glance at it)

[Doesn't get us v. far]

FROM: P F L ALLUM

DATE: 9 July 1987

CHANCELLOR OF THE EXCHEQUER

cc: Chief Secretary
Sir P Middleton
Sir Terence Burns
Mr F E R Butler
Mr Anson
Mr Monck
Mr Sedgwick
Mr Culpin
Mr Bottrill
Mr S J Davies o/r
Mr Gieve
Mr Brooks o/r
Mr Cropper
Mr Tyrie

Ch
Terry must have asked his chaps for this.
AA

JUNE FORECAST FOR THE GDP DEFLATOR

This note provides further explanation of why the increase in the GDP deflator has been revised upwards and why its forecast growth is above RPI inflation.

2. Forecasts for the GDP deflator at market prices and the RPI made during the course of 1987 are set out below.

(percentage change on year earlier)

	January 1987 forecast		1987 FSBR forecast		June 1987 forecast	
	GDP deflator	RPI	GDP deflator	RPI	GDP deflator	RPI
1986-87	3.0	3.2	3.2	3.2	3.0	3.2
1987-88	4.4	4.6	4.4	4.1	5.0	4.1
1988-89	5.1	4.9	4.0	3.0	5.7	4.8

3. The following factors can be identified as accounting for the main changes in the inflation forecast since the FSBR:

- a higher exchange rate assumption implies slightly better terms of trade (ie sterling import prices are reduced by more than sterling export prices). This will raise the GDP deflator other things being equal;

ALLUM TO CH/EX 9/7

- a higher oil price total assumption than in the FSBR for 1987-88 and later years raises UK company profits, increasing the level of the GDP deflator through the forecast period;

- a higher construction price forecast;

- a forecast small pick up in pay settlements in the latter part of this year.

4. Because the RPI and the GDP deflator measure the prices of different types of goods and services these forecast changes have different effects on each measure of inflation. Specifically, the GDP deflator is a measure of the price of all domestically produced goods and services, whereas the RPI measures the price of goods and services bought by UK consumers, including imported consumer goods. The following paragraphs provide more details on the changes to the inflation forecast and how the GDP deflator and RPI have been individually affected.

(i) <u>Exchange rate assumption</u>

5. The following figures summarise the FSBR and June forecasts for the exchange rate, import and export prices.

	Effective exchange rate		**Deflator for imports of goods and services** (percentage change on year earlier)		**Deflator for exports of goods and services**	
	FSBR 1987	**June 1987**	**FSBR 1987**	**June 1987**	**FSBR 1987**	**June 1987**
1986-87	71	72	-1.2	-1.4	-5.7	-5.9
1987-88	70	72	3.9	3.0	4.5	3.9
1988-89	68	72	3.1	1.8	3.4	3.1

The higher exchange rate assumption has reduced the forecast for sterling import prices. Over the short run, domestic producers who purchase imported goods will tend to take part of this cost reduction as higher profits rather than passing it on in lower output prices. This increases the GDP deflator which measures the cost (labour and profits) associated with producing domestic output. This effect is partly offset by the fall in profits earned by exporters who have to reduce their sterling prices in order to remain competitive at a higher exchange rate. But the downward revision to the forecast for export prices is less than for import prices (the terms of trade are forecast to be better) so that the net effect on the forecast for the GDP deflator is to raise it.

6. The RPI is largely unaffected by the lower increase in sterling export prices while benefiting from a lower rise in sterling import prices - both directly as the price of imported consumer goods fall and indirectly as domestically produced consumer goods with a higher import content are reduced in price. The higher exchange rate assumption and improved terms of trade thus tends to reduce inflation as measured by the RPI while increasing, over the short run, inflation as measured by the GDP deflator.

(ii) Oil prices

7. The table below summarises the oil price assumption and the total and 'non-oil' GDP deflator embodied in the FSBR and June forecasts.

	Brent oil prices ($ barrel)		**Total and non-oil GDP deflator (percentage changes on a year earlier)**			
			FSBR		**June**	
	FSBR	**June**	**Total**	**non-oil**	**Total**	**non-oil**
1987-88	15.0	18.4	4.5	4.2	5.0	4.3
1988-89	15.9	19.2	4.0	3.7	5.7	5.6

The higher oil price assumption boosts oil company profits. The GDP deflator, which reflects total UK profits,is directly affected by this increase, while the RPI is only affected to the extent that higher oil prices feed through directly as higher petrol prices, or indirectly as the costs of producing domestic or imported consumer goods rise.

8. The figures above show that a considerable part of the upward revision to the GDP deflator for 1987-88 is accounted for by higher oil prices. For 1988-89 the increase in oil prices is broadly unchanged from that assumed in the FSBR, and the increase in the GDP deflator relative to the FSBR is entirely accounted for by changes other than to the oil price assumption.

(iii) Construction prices

9. Output growth during 1987 now look likely to turn out significantly above what we expected at Budget time, with the construction sector likely, in particular, to show strong growth. (Current estimates for construction activity in the first quarter of 1987 already show an increase of 12 per cent on a year earlier.) Although total output growth is then forecast to decelerate in 1988, activity in the construction industry is likely to remain buoyant with continued growth in industrial and housing investment. Examination of the relationship between construction prices and costs show that the ratio increases during periods of strong demand growth (Chart 1), and we have thus made a modest allowance for this over the forecast period.

10. Construction prices have only a minimal effect on the RPI but through their influence on the deflator for domestic fixed investment do affect the overall GDP deflator.

(iv) Earnings

11. The figures below show forecasts made this year for private sector average earnings and private sector unit labour costs.

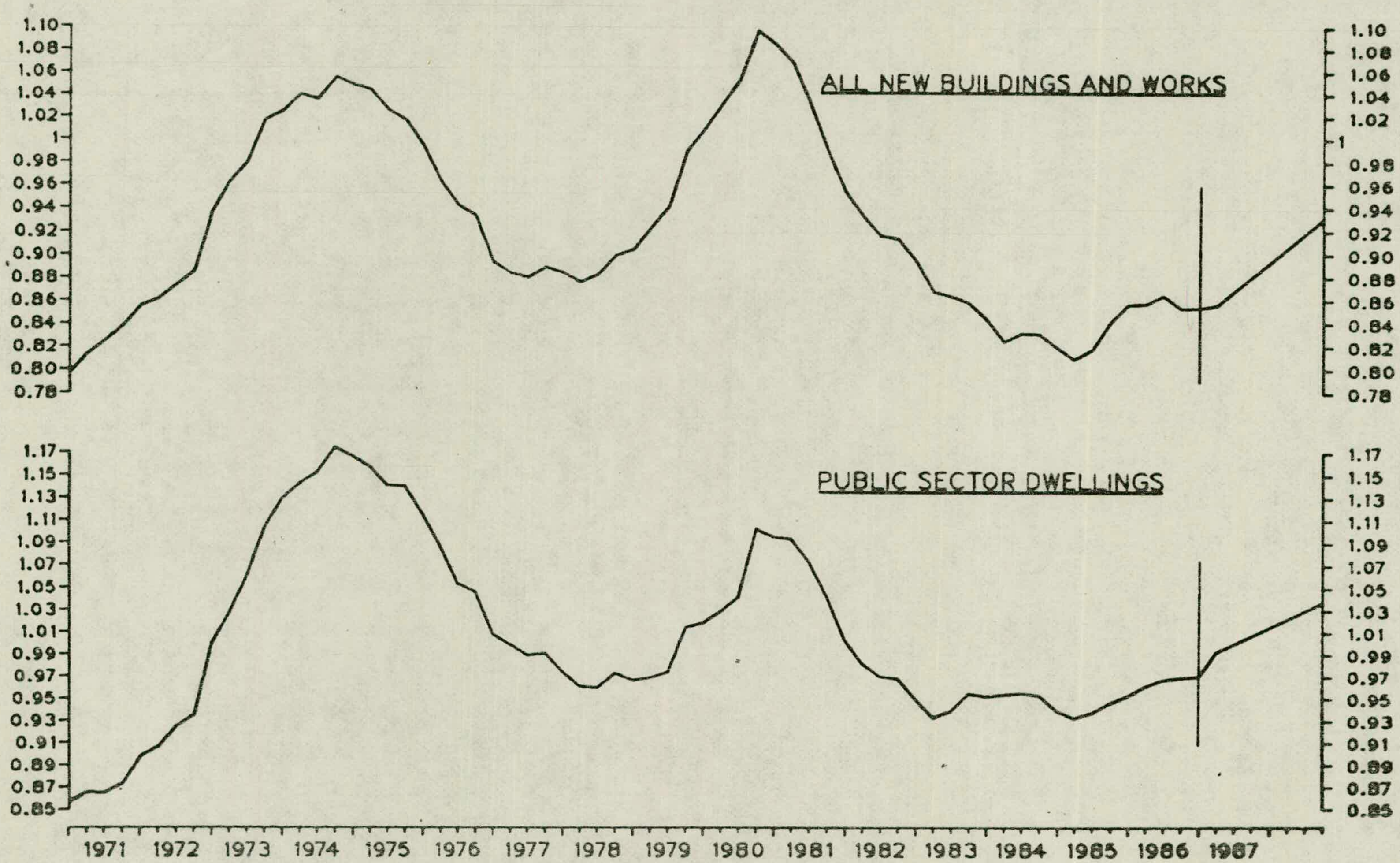
	Private sector average earnings			**Private sector unit labour costs**		
	Jan 1987	**FSBR 1987**	**June 1987**	**Jan 1987**	**FSBR 1987**	**June 1987**
1986-87	7.1	7.6	8.0	3.3	4.1	4.1
1987-88	7.0	6.8	7.3	4.0	3.8	4.0
1988-89	6.9	5.8	7.4	4.3	2.5	5.7

The June forecast shows higher earnings for both the current and the next year. Although drift during the pay round starting this summer is forecast to fall compared to that in the pay round just coming to a close, this is offset by a slight pickup in settlements which is sustained through the following pay round. The reduction in earnings growth relative to 1986-87 is thus modest. The feedthrough from earnings to unit labour costs is held down this year by cyclical improvements in productivity, but with deceleration in output growth next year unit labour costs pick up.

12. Higher earnings figures tend to raise inflation as measured by both the GDP deflator and the RPI. But higher domestic costs and prices influence only a proportion of those goods covered by the RPI - because it also covers imported goods. Thus higher earnings, other things being equal, tend to raise inflation measured by the GDP deflator more than the RPI.

P F L ALLUM

CHART I– CONSTRUCTION PRICES RELATIVE TO COSTS



005/4202

SECRET

NOTE OF A MEETING HELD IN THE CHANCELLOR'S ROOM

H M TREASURY AT 9.00AM ON THURSDAY, 9 JULY

NOTE OF MEETING 9/7

Present:

Chancellor
Chief Secretary
Sir Peter Middleton
Sir Terence Burns
Mr F E R Butler
Mr Anson
Mr Monck
Mr Sedgwick
Mr Turnbull
Mr Culpin
Mr Gieve
Mr Cropper
Mr Tyrie

PUBLIC EXPENDITURE: SURVEY TACTICS AND PRESENTATION

Papers:

Mr F E R Butler of 30 June
Mr Turnbull of 8 July
Mr Culpin of 8 July

The Chancellor said that the first issue to be considered was how to handle the later years - this subject had not been considered at the previous meeting on 7 July. There was a choice offered in Mr F E R Butler's paper of setting a tight but realistic figure which would give a large enough increase to enable the Treasury to hold the cash plans next year; or putting in the lowest figure negotiable with departments - that would create less alarm outside, but would mean that we were faced with a similar decision on increasing the planning totals this time next year.

2 Mr F E R Butler said that his preference would be for a realistic figure which the Government could hold. But he felt that would be difficult to reconcile with the MTFS path. He

therefore thought the Government would be forced into publishing a lower figure, thereby necessitating an increase next year. Sir Peter Middleton said that he felt that in the medium term it was right to plan public expenditure on the basis of a declining share of GDP. His concern was about using the ratio as a short-term control mechanism. He was therefore attracted to the second approach. Moreover, he would be very reluctant to put in a higher figures that the lowest negotiable unless we were absolutely clear that the higher figure was inevitable. Sir Terence Burns pointed out that the Treasury were in a better position if they erred on the side of caution, rather than put in a central estimate. The Chancellor thought that this issue could be fudged by being tough on programmes but having a higher reserve than normal, though that carried a slight danger that colleagues would see the higher reserve and assume that there could be higher additions to programmes.

3 Mr Anson said that his preference would be for a tough and realistic number. But that would require very high reserves - 4/8/12 rather than the present profile of 3½/5½/7½. But it was difficult to believe colleagues to sign up on sticking irrevocably to the cash figures for year 2. He therefore saw no real alternative to more normative figures. Mr Culpin agreed. He thought it would be difficult to convince the outside world that having gone through two Surveys in which the planning totals had been raised, the figures for next year were genuinely to be held. He saw attractions in the "dragging anchor" approach. But it had to be recognised that would inevitably mean that more of the cash planning rhetoric would have to be jettisoned. The planning total would then achieve intermediate status as a way of delivering the Government's ultimate objective of having GGE declining as a proportion of GDP.

4 Summing up this part of the discussion, the Chancellor said that he thought the approach was agreed. The Chief Secretary's objective in the bilaterals would be to negotiate

the lowest possible figures for programmes in the later years of the Survey. At the end of the process a reserve would be added, which would if possible be larger than in the past. The actual size would be a matter for judgment at the time; it would have to be consistent with the critical constraint that GGE as a proportion of GDP should conform to the pre-set path. Mr F E R Butler pointed to a problem with the figures for the later years where a new GDP forecast was not provided at the time of the Autumn Statement. The Chancellor noted that it had been a key point that the MTFS was only revised once a year. Nonetheless he would be grateful if Sir Terence Burns could produce a note considering the pros and cons of extending the forecast in the Autumn Statement to the later years.

5 Turning to the draft paper for Cabinet and Mr Culpin's press line , the Chancellor said he thought that the Cabinet paper was along broadly the right lines. But there were two questions which had to be addressed:

(a) what precisely did we mean by a declining proportion of GDP, and

(b) why had the planning totals been increased?

6 On the first point, it was imperative to make clear that we were talking about the gradient in the PEWP. To let colleagues have the impression that the Treasury would be satisfied by anything that could be rationalised as a decline in the proportion of GDP taken by public spending would give them far too much scope for bids. Mr Turnbull's paper referred in his paragraph 5 to the decline "as envisaged in the PEWP". However this was not strong enough - it should be redrafted "as set out in the PEWP" and should be picked up in the conclusions which Cabinet were invited to endorse.

7 Mr Turnbull agreed. He pointed out that allowing all the bids for 1990-91 would still allow GGE to be the same proportion as in 1987-88. That indicated the margin. He asked whether

the starting point for the decline would be 1987-88 or 1986-87. It was likely that the revised figures would show a much steeper decline in 1987-88 than had been set out in the 1987 PEWP. Did that mean that the whole path was revised down from that starting point, or did it give leeway for a slower decline to meet the same GDP share at the end of the period? He pointed out that insofar as the upward revision in GDP money growth could be attributed to items in the GDP deflator which did not directly have a major impact on public expenditure, or higher real growth the upward revision did not imply that the public expenditure stance was any tighter. The RPI, which was growing at a slower rate than the GDP deflator, was much more significant for many - though not all - public expenditure programmes. The Chancellor thought that for present purposes at least we should assume that the starting point was 1987-88; it would be wrong to concede a slacker starting point now.

8 Turning to Mr Culpin's paper, the Chancellor said that we were faced with the same choice that we had had at the time of the 1986 Autumn Statement. There were two possible presentations. One was to deplore the increase, pointing to profligacy of local government etc. The alternative was to present the increase as a positive advantage flowing from the strength of the economy which enabled more resources to be devoted to public expenditure in key policy areas. Mr Culpin thought that it was important to differentiate between the line taken when the increases were actually announced i.e. at the time of the Autumn Statement when the positive line was possible; and a more cautious line in July when the Government would have to say that it was considering futher appropriate levels of public expenditure. Mr F E R Butler said that the Government would inevitably be in a weak position in the aftermath of the July Cabinet. As the Chancellor pointed out, it would be clear from the line Mr Ingham took that the Government was not sticking

to its planning totals. The arguments in Mr Culpin's paper would cut little ice in justifying why we did not know how much extra public expenditure the economy could afford. That was the question we were unable to answer.

9 It was pointed out that whatever the line to take after the July Cabinet the markets and outside commentators would take their immediate signal from the announcement of the Rate Support Grant settlement, which on present assumptions would be that afternoon.

10 The Chancellor said that these issues, including the interaction with the RSG announcement, would need to be discussed further.

Jill Rutter

JILL RUTTER
Private Secretary

Distribution:

Those present
Mr Scholar

CONFIDENTIAL

From: J ODLING-SMEE
29th July 1987

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Sir Peter Middleton
Sir Terence Burns
Mr F E R Butler
Mr Anson
Mr Cassell
Mr Scholar
Mr Sedgwick
Mr Turnbull
Mr Gieve
Mr Riley
Mr Franklin
Mr Cropper
Mr Tyrie

paper please

JOS TO CH/EX 29/7

REVISIONS TO MTFS ASSUMPTIONS IN THE AUTUMN

At the meeting you held on 9th July to discuss the public expenditure survey, you asked Sir Terence Burns to produce a note about revising the MTFS assumptions in the Autumn Statement. The note, which has been discussed and agreed with Sir Terence Burns, is attached.

JOS

J ODLING-SMEE

REVISIONS TO MTFS ASSUMPTIONS IN THE AUTUMN

This note discusses revisions to the MTFS assumptions for money GDP and the GDP deflator in the autumn. The first section summarises past practice, and the second section discusses the case for doing something different this year.

2. The first section shows that the MTFS assumptions for the growth of money GDP and the GDP deflator for the years beyond the first two years of the MTFS period have never been revised in the Autumn Statement. The figures for the first two years are normally revised to bring them into line with the short-term forecast.

3. Decisions about the figures to use for this year's Autumn Statement should not be made until the October forecast and the public expenditure survey are completed. The second section argues that, although there are public expenditure reasons for revising up the MTFS growth rates of money GDP and the deflator in the later years, there are objections to doing so quite apart from the break with precedent and our line that the MTFS is revised only once a year. In particular it would call into question the government's objectives for inflation and money GDP growth and it would require us to reconsider other aspects of the MTFS (eg the M0 ranges, the revenue projections, the PSBR).

?

Revisions in the Past

4. Table 1 shows which money GDP and GDP deflator figures have been revised in the FSBR, the Autumn Statement and the Public Expenditure White Paper. The general pattern is clear:

- the figures for money GDP and the GDP deflator for all years are revised in the FSBR every year

- the figures for money GDP and the GDP deflator for the current and next financial years are revised and published in the Autumn Statement. They are consistent with the short-term forecast

- figures for the GDP deflator for the two later years have been published in recent Autumn Statements, together with GGE/GDP ratios. The growth rates for the GDP deflator and the implicit money GDP series are the same as those used in the FSBR

- the figures in the Public Expenditure White Paper have always been the same as in the Autumn Statement. Again the deflators are shown explicitly while the money GDP figures are implicit in the GGE/GDP ratios

- figures for money GDP and the GDP deflator for years beyond the next financial year were not provided in either the Autumn Statement or the Public Expenditure White Paper before 1985.

5. Thus the MTFS assumptions for the growth of money GDP and the GDP deflator for the years beyond the first two years of the MTFS period have never been revised in between annual FSBRs (except for a minor revision to the final year figures in the 1985 PEWP). The publication of real terms expenditure figures for the later years together with the assumptions about the GDP deflator began in 1985 at the specific request of the TCSC. Publication of ratios of expenditure to GDP began at the same time.

6. The actual figures for money GDP and the GDP deflator are compared with those in the September or October internal forecasts in Table 2. The general picture for the later years is of lower projected growth rates, especially for the deflator, in the AS/PEWP than in the internal forecasts. Some downward revision of the internal forecasts for the first year after the current year was also a feature of 1984-85 and 1986-87.

This Year's Autumn Statement

7. If the October forecast this year turns out to be the same as the June forecast and a similar pattern of adjustments as last year is made to produce series for the Autumn Statement, inflation and

money GDP growth this year and next will be higher than the FSBR figures but those for the following year will be about the same. Decisions about the figures to use for the Autumn Statement cannot be made until we have seen the October forecast and know the outcome of the public expenditure survey. The main considerations can be summarised here.

8. On the public expenditure front it could be helpful to revise down the figure for the growth of the GDP deflator next year. This would reduce the risk of complaints from departments after the Autumn Statement that, having settled on the FSBR assumptions, they find that the real value of their programmes looks lower in the light of the new figures for the deflator. On the other hand, given the constraint of publishing a declining path for the GGE/GDP ratio, a lower projection for the GDP deflator would reduce the scope for showing Reserves that were sufficiently large to enable the cash planning totals to be held. More room for larger reserves could also be created by revising up the growth rates of money GDP and the deflator in the later years.

9. The money GDP and GDP deflator figures also have to be considered from the point of view of the signals they convey about the government's objectives and policy intentions. There is also a need to protect the government's forecasting reputation which is fairly good, especially of inflation. In the case of the MTFS projections for 1989-90 and later years, there are a number of objections to revising them up in the Autumn Statement:

- to do so would call into question the government's objectives for inflation and money GDP over the medium term, unless the output assumption alone was changed

- it would conflict with our line that the MTFS is revised only once a year because more frequent revisions would reduce the benefits from having a stable medium-term framework and are not required for operational purposes

- it would require us to reconsider other aspects of the MTFS such as the illustrative M0 ranges and PSBR figures, and the revenue projections

- it would be a break with precedent.

Table 1

Projections of Money GDP and GDP Deflator

	Present financial year	Next financial year	Later financial years
FSBR March 1982	Revised	Revised	Revised (MTFS)
AS Nov. 1982	Revised	Revised	Not provided
PEWP 1983	As in AS	As in AS	Not provided
FSBR March 1983	Revised	Revised	Revised (MTFS)
AS Nov. 1983	Revised	Revised	Not provided
PEWP Feb. 1984	As in AS	As in AS	Not provided(1)
FSBR March 1984	Revised	Revised	Revised (MTFS)
AS Nov. 1984	Revised	Revised	Not provided
PEWP Jan. 1985	As in AS	As in AS	Growth rates as in FSBR(2)
FSBR March 1985	Revised	Revised	Revised (MTFS)
AS Nov. 1985	Revised	Revised	Growth rates as in FSBR
PEWP Jan. 1986	As in AS	As in AS	As in AS
FSBR March 1986	Revised	Revised	Revised (MTFS)
AS Nov. 1986	Revised	Revised	Growth rates as in FSBR
PEWP Jan. 1987	As in AS	As in AS	As in AS
FSBR March 1987	Revised	Revised	Revised

(1) Figures for public expenditure in cost terms in the later years were published in a Written Answer on Budget Day (13th March), using the GDP deflators from the new FSBR.

(2) Except for a minor divergence in the final year.

Table 2

Public and Internal Projections of Money GDP and the Deflator

	Current year	Year 1	Year 2	Year 3
1984-85				
Money GDP (£bn and % increase)				
FSBR	328(8)	350(6¾)	371(6)	392(5½)
Sept. internal forecast	328(7)	356(8¾)	380(6½)	402(5¾)
AS/PEWP	327(7)	353(8)	374(6)	395(5½)
GDP deflator (% increase)				
FSBR	4.6	4.2	3.9	3.5
Sept. internal forecast	5.0	5.3	4.2	5.0
AS/PEWP	4¾	4½	4	3¼
1985-86				
Money GDP (£bn and % increase)				
FSBR	354(8½)	377(6½)	399(5¾)	419(5)
Oct. internal forecast	358(9)	383(7)	405(6)	430(6)
AS/PEWP	357(8¾)	383(7¼)	405(5¾)	425(5)
GDP deflator (% increase)				
FSBR	5	4½	3½	3
Oct. internal forecast	5.1	4.3	4.1	4.4
AS/PEWP	5	4½	3½	3
1986-87				
Money GDP (£bn and % increase)				
FSBR	382(6¾)	407(6½)	431(6)	455(5½)
Oct. internal forecast	380(5½)	408(7¼)	441(8)	476(8)
AS/PEWP	380(5½)	407(7)	431(6)	455(5½)
GDP deflator (% increase)				
FSBR	3¾	3¾	3½	3
Oct. internal forecast	2.9	4.2	5.0	5.9
AS/PEWP	3	3¾	3½	3
1987-88				
Money GDP (£bn and % increase)				
FSBR	411(7½)	437(6½)	464(6)	489(5½)
June internal forecast	416(8.8)	449(7.9)	481(7.1)	
GDP deflator (% increase)				
FSBR	4½	4	3½	3
June internal forecast	5.0	5.7	5.1	

NOTE: The growth rates are calculated from unrounded figures

MTFS

CONFIDENTIAL

PPS

FROM: F. E. R. BUTLER
30th July, 1987.

FERB TO CH/EX 30/7

CHANCELLOR OF THE EXCHEQUER

? Set 'realistic' cash plans without mention of GDP?

? Comment that we will have to raise plans total?

c.c. Chief Secretary
Sir Peter Middleton
Sir Terence Burns
Mr. Anson
Mr. Cassell
Mr. Odling-Smee
Mr. Scholar
Mr. Sedgwick
Mr. Turnbull
Mr. Gieve
Mr. Riley
Mr. Franklin
Mr. Cropper
Mr. Tyrie

REVISIONS TO MTFS ASSUMPTIONS IN THE AUTUMN

I have seen the note attached to Mr. Odling-Smee's minute of 29th July in which he sets out the objections to revising the MTFS in the autumn. I want to set out the public expenditure arguments for a change of practice.

2. As Mr. Odling-Smee points out, the Autumn Statement is accompanied by a revised forecast for the present year and the next financial year. It then reverts to the MTFS projection in the FSBR for the second forward year and subsequent years. These MTFS projections are not revised until the Budget.

3. For public expenditure, the second forward year is the crucial one because in the next Survey it will be the first forward year. Revision of the MTFS in the Budget comes too late for public expenditure because we need to take in the Autumn Statement as good a view as we can about the amount of cash expenditure we can afford for that year. ?

4. This issue has taken on a new significance since the Government's policy in relation to public expenditure has been expressed in terms of percentages of GDP. We do

not want it to be a result of that policy that cash planning of public expenditure is weakened. But, as we have found this year, an under-statement of GDP in the Autumn Statement for the second forward year constrain us in setting cash plans which can be held to in next Survey. More realistic projections for money GDP would allow either more realistic plans to be set for individual programmes or larger reserves to be carried. The current practice tends to lead to our having to increase the cash total of public expenditure for the year ahead in the subsequent Survey. We may still be able to say that the higher cash figure is within the prescribed proportion of GDP but the discipline of operating within cash totals is weakened every time we have to raise the planning totals in this way.

??

5. This is a heavy price to pay for insisting on amending the MTFS projection for the second forward year only in the Budget. An alternative solution, which would preserve the principle of only amending the MTFS in the Budget, would be to push forward the forecast published with the Autumn Statement so that it covered the second forward year. But one way or the other, it does not seem to me wise to allow insistence on our present procedures - which, as Mr. Odling-Smee notes, have been developing over the years - to undermine our forward planning of public expenditure in cash.

F.E.R.B.

F. E. R. BUTLER

PEM
TO
CH/EX
31/7

CONFIDENTIAL

From: SIR PETER MIDDLETON

Date: 31 July 1987

CHANCELLOR

cc Chief Secretary
Sir T Burns
Mr F E R Butler
Mr Anson
Mr Cassell
Mr Odling-Smee
Mr Scholar
Mr Sedgwick
Mr Turnbull
Mr Gieve
Mr Riley
Mr Franklin
Mr Cropper
Mr Tyrie

REVISIONS TO MTFS ASSUMPTIONS

not till Sept

You will no doubt wish to have an early discussion to discuss the minutes on this subject submitted by Mr Butler and Mr Odling-Smee.

2. I see great difficulty in revising one extra year of the MTFS path for money GDP, in the autumn. First it may look as though we are raising the forecast to accommodate more expenditure; you cannot produce a much more alarming message than that. Second it would cast doubt on the whole strategy, removing credibility from the years which are left unchanged.

3. I think the origin of the problem in holding to cash plans in the second forward year does not lie in revision to the GDP deflator. Rather it lies in the level at which the expenditure figures are set in the first place. All the pressures are to publish figures as low - or lower - than we can manage. And I cannot see this changing, because it provides some insurance to the Treasury if inflation turns out to be lower than expected

- as it has more often than not since we embarked on the MTFS.

4. So I am still for waiting until the Budget when we can both give a complete explanation of our strategy and have more confidence in any revisions we do decide to make for year 2 and subsequent years.

PEM.

P E MIDDLETON

SECRET & PERSONAL

8/9/87. BIF 8/9

This reminds you of how the GGE/GDP ratios may appear in the Autumn Statement on the basis of our present assessment of the Survey outcome. The CST is also going to let you have on Monday an aide memoire for your talk with the Prime Minister.

FERB 4.9.

SCORECARD
Copy No 1 of 14 Copies

1. MR F E R ~~BUTLER~~
2. CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Mr Monck
Mr Sedgwick
Mr Turnbull
Miss Walker
Mr Tyrie

Thanks. Pse also let me have similar ratios for tax (inc NICs)/GDP.

Ch
Changing this – will try to get down before holidays

AA

PUBLIC EXPENDITURE RATIOS

As background for your meeting with the Prime Minister and your meeting next week on revisions to the MTFS assumptions, this minute sets out the implications for the GGE/GDP ratios of the latest Survey scorecard.

Cash totals

2. The cash figures are as follows:

£ billion

	1987-88	1988-89	1989-90	1990-91
Programme baselines (excl privatisation)	150.1	153.7	159.0	163.0
Forecast increase in programmes	3.5	+5.4	+7.2	+8.9
Level of reserves	-	4.0	7.0	10.0
Planning total excl privatisation (increase on White Paper)	153.6	163.1 (+3.9)	173.2 (+6.7)	181.9
Debt interest and other accounts adjustments (June Forecast)	+24.5	+25.6	+25.9	+25.4
Implied GGE totals (excl privatisation)	178.1	188.7	199.1	207.3

These figures take credit for the reduction in debt interest and other accounts adjustments in the June forecast. They allow for Reserves of £4 billion, £7 billion and £10 billion.

PUBLIC EXP RATIOS

169

Ratios

3. The White Paper path for GGE (excluding privatisation proceeds) as a proportion of GDP was:

	1987-88	1988-89	1989-90	1990-91
				%
A	44	42¾	42¼	-

On the basis of the MTFS projections of GDP the above totals would produce:

B	43¼	43¼	43	42½

However, latest indications are that the figures for GDP in 1986-87 will be revised upwards by ½ per cent; on that basis the ratios would be:

C	43	43	42¾	42¼

The June forecast pointed to a more rapid growth of GDP in 1987-88, 9 per cent (5 prices, 4 real) rather than 7½ per cent (4½ prices, 3 real). If, in addition to revision to 1986-87, the estimate of GDP in 1987-88 is revised up to reflect this the ratios would fall to

D	42½	42½	42¼	41½

If, in addition, the growth rate of money GDP in 1988-89 is revised upwards by ½ per cent the ratios would be

E	42½	42¼	42	41½

Finally, using the GDP growth rates in the June forecast for all years applied to the higher estimates for 1986-87, the ratios would be

F	42½	41¾	41¼	40¼

Conclusions

5. The figures are no more than illustrative but they suggest that if the path for money GDP were revised only to reflect

the latest outturn for 1986-87 and the forecast for 1987-88 (line D), the level in 1989-90 would be about the same as in the White Paper (42¼ per cent), but progress from 1987-88 would be negligible. To show a measurable decline it would be necessary to revise growth in money GDP in 1988-89 as well (line E). The tightness of this position makes it essential to do no worse than our current assessment; indeed we really need to do somewhat better.

JSt. Gieve

J GIEVE

3 questions

Sedgwick

CHANCELLOR OF THE EXCHEQUER

HONI SOIT QUI MAL Y PENSE

1. Can we set a firm cash fig for the 2nd forward yr?
2. If so, can we do it without issuing MGDP figure?
3. If so, what would be figs show, & does it matter?

C/

These papers are concerned with the problems caused to public expenditure control by only revising the path for money GDP in year and for the year ahead in the A.S.* FERB's minute of 30 July outlines the problems and argues in favour of changing current practice.

JOS in his minute of 29/7 sets out the case against.

PEM's views are set out in his minute of 31 July. See also Sedgewick's minute on top which gives latest view on money gdp.

CR 8/9

* See page 3 of the note of your meeting on 9/7

CONFIDENTIAL

FROM: **P N SEDGWICK**
DATE: 8 SEPTEMBER 1987

CHANCELLOR

cc Chief Secretary
Sir P Middleton
Sir T Burns
Mr F E R Butler
Mr Anson
Mr Cassell
Mr Odling-Smee
Mr Scholar
Mr Turnbull
Mr S Davies
Mr Gieve
Mr C M Kelly
Mr Cropper
Mr Tyrie

SHORT TERM PROSPECTS FOR MONEY GDP

You and those attending your meeting tomorrow on the MTFS assumptions might like to see the attached note by Stephen Davies which describes our latest view on the prospects for money GDP in the short term.

P.N.S

P N SEDGWICK

SEDGWICK TO CH/EX 8/9

CONFIDENTIAL

FROM: S J DAVIES
DATE: 8 SEPTEMBER 1987

MR SEDGWICK

FORECAST OF MONEY GDP

Figures for money GDP in the FSBR/MTFS and in the June Forecast are shown below (figures in brackets under the MTFS/FSBR column are the unrounded figures on our print out - the published figures were rounded):

Money GDP at market prices, percentage changes on previous year

	FSBR/MTFS	June forecast
1986-87	6 (6.1)	6.3
1987-88	7½ (7.5)	8.8
1988-89	6½ (6.4)	7.9

1986-87

2. Financial year figures consistent with the new Blue Book are not yet available, but the new calendar year figures suggest that the financial year increase will have been revised up, at least to 6½ per cent, and more probably to 6¾ per cent. The latest figures thus suggest that the 1986 FSBR money GDP path was not after all undershot in 1986-87. The level of GDP in calendar 1986 is now 0.6 per cent higher than previously estimated.

1987-88

3. We have really no substantial further information on the outlook for 1987-88 since the June forecast. The economy seems to have been very strong over the summer months, but this is what we had expected in June. We have as yet no indications about the trend of private sector pay settlements in the new pay round (though our worst fears about the local authorities' manual settlement have been confirmed).

29/9

4. The CSO will be publishing a figure for money GDP for 1987Q2 on [illegible] September. An internal CSO estimate made at the end of July gave growth in money GDP over the year to 1987Q2 some 1¼ percentage points less than we had in the June forecast. I expect that the figure they publish in two weeks time will be well above their July estimate, but it may still be below the June forecast. The habitual downward bias in early CSO estimates means that if the June forecast is to be proved correct in the longer run, it is likely to appear too high in the short run. Just as at the time of this year's Budget it appeared that money GDP had undershot the 1986 FSBR in 1986-87, but this no longer appears to have been the case; so at the time of the 1988 Budget, even if our June forecast is <u>ultimately</u> to be proved correct, we may well be faced <u>apparently</u> with a much smaller overshoot of the 1987 FSBR than the June forecast indicates.

1988-89

5. Mr Allum's minute to the Chancellor of 9 July set out an explanation of the large upward revision to the forecast of the GDP deflator in the June forecast shown below:

	FSBR/MTFS		June 1987 forecast	
	GDP deflator	RPI	GDP deflator	RPI
1987-88	4.4	4.1	5.0	4.1
1988-89	4.0	3.0	5.7	4.8

6. I must stress the uncertainty about this forecast - which, it is fair to say, is based on some difficult judgments about the effect of the present construction boom on construction prices. We certainly have no further evidence to support the judgments we made in June: if anything the housing market may have calmed down a little, and talk of shortages of construction materials seems to have receded. There is no sign yet of earnings in the construction industry taking off. It is therefore possible that we will during the current forecasting round mark down our 1988-89 GDP deflator forecast somewhat (and there might be some reason to mark down our 1987-88 GDP deflator forecast a little on this account, as well). Nevertheless, I would expect at this stage that the forecast for money GDP will come out somewhere in the 7½ - 8 per cent range.

S J DAVIES