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PART A

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ECONOMIC FORECASTS AND
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PART A

3696/8

COPY NO. 1

Thanks.
2. I'd be grateful for a note on X.
3. NB effect of RPI drop for Sept 1988, which affects soc sec spending in 1989-90. Is 5.4% assumption desirable [illegible]?
Smaller?

FROM: COLIN MOWL
DATE: 9 October 1987

MOWL TO CH/EX 9/10

CHANCELLOR

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
PCC members
Mr Sedgwick
Mr Hawtin
Mr Moore
Mr Odling-Smee
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Mr Cropper
Mr Tyrie
Mr Call

TREASURY ECONOMIC FORECAST, OCTOBER 1987: PUBLIC FINANCES

I attach a copy of the report on the outlook for Public Sector Finances.

2. The report is a little shorter than previous ones as we have dropped the first two sections (the summary and discussion of the borrowing aggregates and fiscal adjustment) which largely duplicated the public finances section of the main forecast report. This report takes the latter as read and is mainly intended to provide more detailed explanation of the forecasts of expenditure and receipts. The public finances section of the main report is however attached at the beginning of this report for those who have not already seen it and at the end as an annex for others (to facilitate cross reference).

Colin Mowl

COLIN MOWL

3696/11

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TREASURY ECONOMIC FORECAST

REPORT ON PUBLIC FINANCES

OCTOBER 1987

CONTENTS

TREASURY ECONOMIC FORECAST: PUBLIC SECTOR FINANCES

I PUBLIC EXPENDITURE

1. The forecast of expenditure relative to the plans in the 1987 PEWP is set out in table 32 of the main forecast report (see Annex to this report). The forecast for 1987-88 shows an underspend of the PEWP planning total excluding privatisation proceeds of £1.0 billion. By contrast currently published plans are forecast to be exceeded by substantial amounts in the following two years, by some £4 billion in 1988-89 and nearly £10 billion in 1989-90.

The Economic Background

2. The overspends should be interpreted in the light of the difference between the general economic prospect in this forecast and the economic assumptions used in the PEWP. Inflation is forecast to be higher than assumed in the PEWP throughout the forecast period and growth is projected to be higher than in the PEWP in 1987-88 and 1988-89. While higher than assumed inflation could be mainly reflected in a lower real level of public expenditure within year, it is likely to come through in large part as higher cash spending in future years and the effect will be bigger the further ahead one looks. A substantial proportion of spending is demand sensitive and therefore inversely related to the general level of economic activity. This is not only the case for about two-thirds of social security expenditure but also for central government subsidies, employment grants, regional assistance and some capital grants. Altogether, about a quarter of central government expenditure is likely to be significantly affected by the level of activity. Against this a buoyant economy may significantly increase the pressures for higher expenditure on non-demand sensitive elements, such as defence and health.

3. Table I compares the forecast with the economic assumptions used in the PEWP and FSBR.

TABLE I: GDP GROWTH AND INFLATION

	1986-87	1987-88	1988-89	1989-90
GDP growth				
PEWP 1987	2½	3¼	2½	2½
FSBR 1987	3	3	2½	2½
October Forecast	3¼	4	2¾	2½
GDP deflator				
PEWP 1987	3	3¾	3½	3
FSBR 1987	3	4½	4	3½
October Forecast	3	4½	5½	5¼

4. The following paragraphs consider each broad category of expenditure in turn, focusing attention on 1988-89 and 1989-90. The forecast is constructed in terms of economic categories rather than departmental programmes.

Central Government Pay

5. As in previous forecasts central government employment is assumed to remain broadly stable. The forecast of average earnings is built up from assumptions about each of the main groups (see table II). In the absence of complications introduced by staging, the outcome of the pay round beginning the previous September is the main determinant of earnings growth in each financial year. Central government earnings growth is assumed to be less than the private sector average in financial year 1988-89 and much the same in 1989-90; the civil service and non-Review Body groups are expected to do badly relative to the private sector in the 1987-88 pay round.

TABLE II: CENTRAL GOVERNMENT AVERAGE EARNINGS GROWTH

		Pay Rounds			Financial Years	
	(Weights)	1987-88	1988-89	1989-90	1988-89	1989-90
Review Body Groups (Nurses, Doctors, Armed Forces)	(51)	7½	8	7½	7½	8
Civil Service	(28)	6	8	7½	6	8
NHS non-Review Body	(17)	7	8	7½	7	8
Average CG	(100)	7	8	7½	7	8
Average Private Sector		8*	8½*	~~8½*~~ 7½	8	7¾

* Underlying earnings growth

Other Central Government Current Expenditure on Goods and Services

6. This category comprises current expenditure on goods and services (CEGs) excluding pay: it includes MOD procurement. It accounts for nearly a fifth of the central government component of the planning total.

7. As table III shows, the forecast growth of other CEGS in real terms over the period to 1989-90 is somewhat below the average of the last five years. This is mainly because of a projected slowdown in the growth of real defence spending which is not, however, as marked as planned in the PEWP. The forecast for spending on both defence and health in 1988-89 and more particularly 1989-90 in real terms has been revised up since June in the light of the healthy outlook for public finances and the economy in general.

TABLE III: OTHER CENTRAL GOVERNMENT EXPENDITURE ON GOODS AND SERVICES (REAL TERMS, % GROWTH)

	Weight in 1986-87	Outturn Average 1981-82 to 1986-87	Forecast 1987-88	1988-89	1989-90
MOD	46	3¼	2¼	-	½
DHSS Health	28	3¼	5	2	3
Other	26	2¾	4¼	2	3
Total	100	3	3½	1	2

Social Security Expenditure

8. The forecast of social security expenditure for 1987-88 is in line with the figure produced in September by CYMS, the DHSS in-year monitoring system. The forecast of unemployment does not significantly diverge from the Treasury assumption used by DHSS.

9. There is some uncertainty over the CYMS forecast for 1987-88 in the light of recent low outturn data for certain types of benefit, mainly Unemployment and Supplementary Benefits. Currently DHSS have not allowed these outturns to exert their full influence on the CYMS forecast as the causes are still unclear and such outturn data would otherwise produce a large reduction in the in-year forecast. CYMS does not have a

X

sufficiently long track record to assess its performance adequately. The forecast has accepted the CYMS total for this year: there is however a downside risk.

10. For 1988-89 onwards, the PEWP plans have been adjusted for differences between the forecast for unemployment and upratings, and the corresponding assumptions underlying the PEWP. In addition upward adjustments were made to produce what is on the basis of past experience considered a central 'underlying' growth rate (ie the growth after allowing for the effects of upratings, changes in unemployment, changes in policy, demographic factors etc). This underlying growth can be seen as representing increases in benefit take-up or in the average levels of benefit payment.

11. Table IV shows the adjustments made to the plans in respect of changes to economic assumptions and the adoption of a higher underlying growth rate. The underlying growth rate is estimated to have risen from 3¼ per cent in 1986-87 to 4½ per cent in 1987-88, though the latter is still largely forecast. Uncertainty over the future path of underlying growth is exacerbated by the background of more buoyant economic activity than experienced in recent years, and the reforms due next April. The former could dampen underlying growth, the effect of the latter is uncertain. The forecast has discounted some of the projected increase in underlying growth in 1987-88 and put in lower figures for future years. Nevertheless large overspends of existing plans are forecast.

TABLE IV: EFFECTS OF ECONOMIC AND OTHER FACTORS ON THE SOCIAL SECURITY FORECAST

£ billion

	1987-88	1988-89	1989-90
Forecast overspend*	0.5	2.2	4.1
Due to:			
(a) Economic Assumptions:			
(i) Unemployment	- 0.7	- 1.2	- 1.3
(ii) Upratings	-	0.2	0.8
(b) More realistic underlying growth	1.2	3.3	4.6
MEMO:			
Underlying Growth Rate (%)	4.6	3.7	2.7

* relative to PEWP 1987 for 1987-88 and relative to PES baseline thereafter

12. Table V shows the economic assumptions used in the forecast and those underlying the PEWP. Unemployment is now forecast to be significantly lower than assumed in the PEWP whilst upratings are forecast to be higher. However the effects of these, partially offsetting, changes are smaller than the adjustment made to raise underlying growth.

TABLE V: ECONOMIC ASSUMPTIONS UNDERLYING THE FORECAST OF SOCIAL SECURITY EXPENDITURE

	1987-88	1988-89	1989-90
1. Unemployment (GB, million)			
PEWP 1987	3.05	3.05	3.05
October Forecast	2.7	2.5	2.5
2. Upratings (% pa)			
(i) RPI			
PEWP 1987	2.1	3.75	3.5
October Forecast	2.1	4.2	5.4 ?
(ii) ROSSI*			
PEWP 1987	2.0	3.0	3.25
October Forecast	2.0	~~3.6~~ 3.2	4.4

* RPI less housing costs

The National Insurance Fund

13. Forecast earnings growth in the economy continues to drive National Insurance Contributions (NICs) up at a faster rate than benefit expenditure, producing flow surpluses on the National Insurance Fund (GB).

14. Given the prospect of large surpluses, the forecast assumes that the Treasury Supplement will be reduced by 2 percentage points per annum, the maximum reduction possible without primary legislation. Were the Treasury Supplement to be maintained at 7 per cent the flow surpluses would be £¾ billion and £1½ billion higher than forecast in 1988-89 and 1989-90 respectively. Table VI shows the surpluses and the Treasury Supplement.

TABLE VI: NATIONAL INSURANCE FUND (GB) SURPLUSES - £ billion

	1986-87	1987-88	1988-89	1989-90
Surplus: flow	0.4	1.0	2.1	1.5
: level end-year	5.7	6.7	8.8	10.3
Treasury Supplement	2.4	2.1	1.7	1.1
(rate %)	(9)	(7)	(5)	(3)

Net EC Contributions

15. Table VII shows the forecast of total net payments to EC institutions. It assumes an increase in the VAT ceiling for EC own resources from 1.4 to 1.6 per cent with effect from 1 January 1988.

TABLE VII: NET EC CONTRIBUTIONS (£bn)

	1987-88	1988-89	1989-90
PEWP 1987	0.9	0.4	1.1
Forecast	1.3	1.3 (1.0)	1.6 (1.9)

16. The projected overspend in 1987-88 compared with the PEWP is largely the result of the supplementary budget agreed in July. A large part of the forecast overspend in 1988-89 and 1989-90 is due to the assumed increase in the VAT ceiling. Higher than expected receipts of customs duties and agricultural levies this year have also led to an upward revision of our share of traditional own resources in 1987 and all forward years. In addition, the recent buoyancy of VAT receipts coupled with the strengthening of sterling against the ecu have led to an upward revision of our share of Community VAT contributions.

17. The forecast of the net EC contribution is however particularly uncertain. In view of this, and the possible distortion to public expenditure totals, the overall fiscal position, and the current account from the dip in the net contribution in 1988-89 and rebound in 1989-90, which has been a feature of most recent forecasts, including that in the PEWP, the path of the net contribution in this forecast was partially smoothed. The figures in brackets show what the forecast would have looked like had there been no smoothing - the 1988-89 dip is largely the result of the expected path of VAT abatements.

Other Central Government Expenditure

18. The most important components of this category are capital expenditure, current grants other than social security (including employment grants and overseas aid) and subsidies. Overspends totalling £1.4 billion and £1.9 billion are forecast for 1988-89 and 1989-90 respectively. The composition of this overspend is given in table VIII.

TABLE VIII: OVERSPENDS ON OTHER CG EXPENDITURE £ billion

	1987-88	1988-89	1989-90
GDFCF	0	0.1	0.2
Capital grants	0.2	0.3	0.4
Current grants other than social security and grants abroad	0.2	0.3	0.7
Subsidies	0.3	0.3	0.3
Other	0.2	0	0
TOTAL	0.8	1.0	1.5

19. The major contribution to the overspends comes from assuming that higher inflation than in the plans leads to additional cash spending. The growth of this category of expenditure in total is in real terms close to that implicit in the PEWP.

Local Authorities

20. Table IX summarises the forecast of local authorities finances.

TABLE IX: LOCAL AUTHORITY SUMMARY

	1986-87	1987-88	1988-89	1989-90
Total Current Expenditure (% increase)	8.4	10.0	7.9	9.3
LA Average Earnings (% increase)	8.7	9.1	8.2	9.0
LA Manpower (% increase)	2.2	1.1	1.1	1.1
Grant percentage (GB, accruals-% level)	46.3	45.8	44.9	44.6
Rate Poundage (% increase)	12.0	6.8	10.8	10.2
Gross Capital Spending In Real Terms (% increase)	1.3	- 1.4	0.6	1.1
Total Capital Receipts (£ billion)	2.6	3.5	3.7	3.9
LABR (£bn)	0.3	0.3	0.4	0.8

The forecast of current expenditure in 1987-88 is based on the authorities' budgets. Although authorities have spent slightly less than anticipated in their budgets in recent years, the forecast assumes that expenditure will turn out close to budgets in 1987-88 because the authorities appear to have made unduly low provision for pay increases.

21. The forecast for later years results from judgements about average earnings, manpower and levels of procurement. The forecasts for the growth of procurement volume and manpower are based on the averages of recent years, while the earnings forecast is built up from detailed assumptions about settlements in each group. Table X gives details of the earnings forecast.

TABLE X: LOCAL AUTHORITY AVERAGE EARNINGS GROWTH %

	Pay Rounds*	**Financial Years****
1986-87	8 (7½)	8¾ (8¼)
1987-88	9½ (9)	9 (8)
1988-89	9 (8½)	8¼ (8)
1989-90	8½ (7¾)	9 (7¾)

* settlements in brackets
** private sector in brackets

High settlements for teachers, manual workers and construction workers are responsible for the generally positive differential with private sector earnings.

22. Table XI indicates that the forecast excess over provision for total local authority relevant public expenditure, which makes up about 95 per cent of total current expenditure, is not out of line with recent experience.

TABLE XI: LA RELEVANT PUBLIC EXPENDITURE

	% change	**Overspend on provision***	
		£bn	**%**
1985-86	3.3	1.5	6
1986-87	8.2	2.6	9½
1987-88	9.8	1.2	4
1988-89	9.1	1.8	5½
1989-90	9.3		

* Baseline is PEWP provision in current year for years to 1987-88, and RSG provision for 1988-89.

23. The forecast indicates a much larger increase in rates in 1988-89 than in 1987-88, but a smaller increase than in 1986-87. This is partly due to larger grant underclaim in 1988-89 than in 1987-88 (reflected in the reduction in grant percentage) and partly due to the expectation that local authorities will

build up balances; Scottish local authorities are preparing for the community charge and local elections in England next year are confined to a few district councils.

24. A sharp rise in local authority capital receipts is forecast for 1987-88 (see table IX). This partly reflects an increase in the gross proceeds of council house sales, but is also due to, first, an increasing tendency for these sales to be financed by private sector as opposed to local authority mortgages and, secondly, the repayment of local authority mortgages taken out on council house sales in 1981 and 1982 - tenants who bought then are now free to sell and keep all the capital gain. Local authorities may also be raising more from sales of non-housing assets. The forecast assumes that authorities will have the scope and incentive to maintain in real terms the projected 1987-88 level of capital receipts.

25. Gross capital spending is expected to fall slightly in real terms in 1987-88. In 1988-89 and 1989-90 small real increases are forecast, implying substantial overspends in those years of £1-1½ billion on 1987 PEWP provision. But the higher forecast level of receipts results in only tiny overspends on net capital spending.

[illegible]

26. The local authority borrowing requirement (LABR) in the first five months of 1987-88 was much the same as in the equivalent period last year and the forecast assumes that this will also be true of the annual totals. The latest forecasts of local authority income and expenditure are broadly consistent with this pattern. The LABR forecast has not changed much since June but then the LA accounts could only be squared by assuming implausibly high unidentified receipts. The upward revision to capital receipts in this forecast - and a corresponding downward revision to unidentified receipts - makes the whole picture internally consistent and more plausible.

27. With capital receipts constant in real terms and some increase in gross capital spending in real terms, the LABR is forecast to rise gently in cash terms in 1988-89 and 1989-90.

Nationalised Industries and Other Public Corporations

28. Nationalised industries' output growth in 1987-88 is forecast to be higher than in any year since 1974-75 (in which year coal output rose strongly following the end of the 1973-74 strike). Indeed output growth in 1987-88 could be the highest ever achieved by the non-privatised industries (after adjusting for coal strike effects). British Steel output, in particular, is expected to increase rapidly this year, in response to increases in both manufacturing output and investment. Table XII shows some of the key features of the forecast.

TABLE XII: NATIONALISED INDUSTRY TRADING PERFORMANCE AND INVESTMENT*

? RPI years

	1984-85	1985-86	1986-87	1987-88	1988-89	1989-90
Output (%)	0.7	3.4	0.9	3.6	1.6	1.4
Employment (%)	- 8.7	- 5.6	- 3.7	- 3.3	- 3.0	- 2.4
Productivity (%)	10.3	9.5	4.8	7.1	4.7	3.9
Real Prices (%)	- 0.7	- 1.8	- 1.1	- 1.2	- 0.6	- 0.1
Profits** (%)	32.0	16.0	21.0	26.0	8.5	10.1
Real Investment (%)	- 2.8	- 2.9	- 0.7	1.7	3.0	6.0

* The figures relate to the current composition of the NI Sector and adjust for coal strike effects.

** after stock appreciation

29. Buoyant output, together with continued high productivity growth, should produce healthy growth of profits in 1987-88 despite further real price falls. Some reduction in productivity growth is assumed in later years - the average for 1987-88 to 1989-90 is 5¼% compared with 7¼% in the period 1980-81 to 1986-87 - and output growth decelerates with that of the economy generally. But profits are forecast to rise in 1988-89 and 1989-90 at least as fast as money GDP, partly because the real prices are expected to fall less in 1988-89 and 1989-90 than the average of recent years (see table XIII for details).

TABLE XIII: NATIONALISED INDUSTRY PRICES IN REAL TERMS*
PERCENTAGE CHANGE IN FINANCIAL YEAR AVERAGE PRICES

	1984-85	1985-86	1986-87	1987-88	1988-89	1989-90
British Coal	0.0	- 1.9	- 3.1	- 4.5	- 2.9	- 2.4
Electricity (E&W)	- 2.0	- 2.2	- 1.9	- 3.9	2.9	0.0
Water	1.0	4.7	4.4	1.7	1.4	2.0
British Rail	0.4	0.0	2.8	1.2	- 0.2	- 0.9
LRT	3.2	1.5	2.2	2.1	4.4	4.1
Post Office	- 1.5	- 4.2	- 2.0	- 0.8	- 0.4	- 1.0
British Steel	1.1	- 4.6	- 1.8	- 1.6	- 2.3	- 1.7
Average, All NIs	- 0.7	- 1.8	- 1.1	- 2.3	- 0.6	- 0.1
Memo: RPI	5.1	5.9	3.2	4.1	5.1	4.4

* Average of prices charged in both industrial and domestic markets. (Prices are relative to RPI).

30. The forecast for growth in real investment is somewhat higher than in recent forecasts. Weight has been given to previous experience which suggests that rapid increases in nationalised industry output tend to be accompanied by increases in their real investment. The forecast includes some large real investment increases for electricity, British Steel, LRT, British Rail, Water and the Post Office, offset by falls for Coal and British Shipbuilders.

31. Table XIV shows the forecast of external finance and the PCBR.

TABLE XIV: EXTERNAL FINANCE AND THE PCBR (£bn)

	1986-87	1987-88	1988-89	1989-90
External Finance				
PEWP Plans	0.3	0.7	0.3	- 0.1
Budget Forecast	0.4	0.8	*	*
October Forecast	0.4	0.6	0.7	0.6
PCBR				
Budget Forecast	- 1.4	- 0.9	*	*
October Forecast	- 1.4	- 1.1	- 1.2	- 1.2

* The Budget forecast is shown for 1986-87 and 1987-88 only - later years were constrained to plan figures and cannot therefore be considered genuine forecasts.

32. The forecast for 1987-88 shows a small undershoot on the external finance limit in the PEWP. In large part this is due to a buoyant profits outlook. The forecast is for external finance overshoots of £½ billion to £¾ billion in 1988-89 and 1989-90. These overshoots, which are somewhat lower than in previous forecasts, arise because fixed investment is higher and profits lower than those underlying the PEWP plans.

Debt Interest

33. Current projections of general government gross debt interest lie below those published in the PEWP and FSBR but slightly above those forecast in June for 1987-88 and 1988-89.

TABLE XV: GENERAL GOVERNMENT GROSS DEBT INTEREST PAYMENTS

		£ billion		
	1986-87	**1987-88**	**1988-89**	**1989-90**
PEWP	17.5	18.1	18.1	18.7
1987 FSBR	17.5	17.9	18.2	18.6
June Forecast	17.2	17.6	17.8	18.0
October Forecast	17.4	17.7	18.0	17.5

34. The single most important influence on this forecast is the significantly lower projections of government borrowing in all years. This is partially offset by higher interest rates. Compared to the FSBR higher inflation implies greater accrued interest on index-linked debt whilst the removal of presentational increases contained in the FSBR lowers gross payments.

II GENERAL GOVERNMENT RECEIPTS

35. Table XVI sets out details of the forecast of general government receipts in the format of FSBR Table 1.2. Comparisons are shown with the June Forecast and - for 1987-88 only - with the forecast published in the FSBR. All the figures in this section are before taking account of the fiscal adjustment.

36. In spite of the effect of the budget tax cuts general government receipts are forecast to rise by 8 per cent in 1987-88, only a little below the 9 per cent growth forecast for money GDP. Without the Budget tax cuts, growth of general government receipts would have been a little higher than money GDP. The forecast increase in taxes and royalties, at 10 per cent, is above GDP growth, despite the tax cuts. The main explanation is the exceptional buoyancy of a number of individual taxes - non-North Sea corporation tax, stamp duties and certain capital taxes - which boosted tax receipts last year, and which as yet shows no signs of abating. This buoyancy is now expected to continue into 1988-89; the forecast growth rates for general government receipts and taxes and royalties for that year, at 11 per cent and 12 per cent respectively, are substantially in excess of the 8½ per cent projected for money GDP. The forecast shows somewhat less tax buoyancy for 1989-90, with general government receipts growth, at 7½ per cent, just below that of money GDP and that of taxes and royalties slightly above it.

37. The forecast <u>tax burden</u> is summarised in paragraph 77 of the main report.

Income Tax

38. Income tax revenues are forecast to rise by only 5½ per cent this year, following the reduction of the basic rate in the Budget. This nevertheless represents an increase of £0.7 billion on the forecast made in June, nearly all of which is accounted for by PAYE. The upward revision to PAYE revenues is in line with the outturn to date, and for the most part reflects higher wages and salaries growth in the current forecast.

TABLE XVI

GENERAL GOVERNMENT RECEIPTS

£ billion (percentage changes on year earlier in brackets)

	Forecasts			Changes from June Forecast			Changes from FSBR
	1987-88	1988-89	1989-90	1987-88	1988-89	1989-90	1987-88
Income Tax	40.7 (+ 5½)	45.2 (+ 11)	49.4 (+ 9½)	+ 0.7	+ 1.1	+ 1.9	+ 0.7
Corporation Tax (excl. North Sea)	14.7 (+ 30½)	17.9 (+ 22)	19.0 (+ 6)	+ 0.6	+ 2.3	+ 1.3	+ 1.1
Capital Taxes	3.1 (+ 21)	4.2 (+ 34)	4.8 (+ 14)	- 0.1	- 0.1	- 0.3	- 0.1
Expenditure Taxes:							
VAT Receipts	23.8 (+ 10)	26.1 (+ 9½)	28.2 (+ 8)	+ 0.5	+ 0.4	+ 0.6	+ 0.5
Local Authority Rates	16.9 (+ 8½)	19.1 (+ 13)	21.2 (+ 11)	-	+ 0.7	+ 1.2	-
Stamp Duties	2.5 (+ 38½)	3.2 (+ 24)	3.7 (+ 17½)	+ 0.1	+ 0.2	+ 0.3	+ 0.4
Other	25.6 (+ 4½)	27.6 (+ 8)	29.7 (+ 7½)	- 0.3	+ 0.3	+ 0.8	+ 0.1
Total Expenditure Taxes	68.8 (+ 8½)	76.0 (+ 10½)	82.8 (+ 9)	+ 0.3	+ 1.6	+ 2.9	+ 1.1
North Sea Revenues	4.6 (- 4)	4.5 (- 2½)	4.5 (+ ½)	- 0.1	- 0.1	-	+ 0.7
Other Taxes	- 0.7	- 0.7	- 0.6	+ 0.1	-	-	+ 0.1
Total Taxes and Royalties	131.3 (+ 10)	147.1 (+ 12)	159.9 (+ 8½)	+ 1.4	+ 4.8	+ 6.1	+ 3.6
National Insurance and Other Contributions	29.1 (+ 9)	31.7 (+ 9)	34.3 (+ 8)	-	+ 0.3	+ 0.4	+ 0.6
Interest and Dividend Receipts	5.6 (- 8)	5.6 (+ 1)	5.4 (- 3½)	+ 0.2	+ 0.5	+ 0.5	- 0.1
Gross Trading Surplus and Rent	3.5	3.6	3.6	-	+ 0.1	+ 0.2	+ 0.2
Other Receipts	3.3	3.7	3.2	- 0.5	- 1.0	- 1.2	- 0.3
General Government Receipts	172.8 (+ 8)	191.7 (+ 11)	206.4 (+ 7½)	+ 1.1	+ 4.8	+ 5.8	+ 4.0

39. The forecasts for 1988-89 and 1989-90 assume annual indexation of allowances and thresholds in line with the RPI. With real incomes rising, the forecast shows real fiscal drag, with income tax revenues rising faster than incomes. Table XVII below, which sets out the forecast in terms of effective tax rates, illustrates this.

TABLE XVII: EFFECTIVE RATES OF INCOME TAX* (%)

	1985-86	1986-87	1987-88	1988-89	1989-90
PAYE	19.5	19.2	18.7	19.2	19.6
Total income tax	13.1	13.2	13.2	13.7	14.0

NB

(* before taking account of fiscal adjustment)

Corporation Tax

40. Non-North Sea mainstream corporation tax (MCT) receipts increased by over 50 per cent (£2.2 billion) between 1985-86 and 1986-87. We are now forecasting a further increase for 1987-88 which, at approaching 40 per cent, is a little lower than last year's in percentage terms, but larger (£2.7 billion) in terms of absolute magnitude. These very substantial rises reflect both rapid profits growth during 1985 and 1986 (MCT received in 1987-88 will be in respect of company incomes in 1986 and earlier years) and a rising effective tax rate. The latter in turn reflects both the effect of several years of healthy profits growth in reducing the extent of tax exhaustion, and the phasing in - following the 1984 Budget reforms - of a new system of capital allowances, which has the effect of producing a temporary 'dip' in the amounts of allowances against tax during the transition period. The current forecast of MCT in 1987-88 is over £0.6 billion higher than that made at Budget time and £0.4 billion higher than the forecast made in June; this upward revision mainly reflects revisions to profits data for 1986. It should be stressed that, unlike most other taxes, monthly figures on outturn to date for MCT give little or no indication as to the likely outturn for the year; the vast bulk of MCT is paid in the second half of the financial year, mostly in October and January. In addition receipts in the first half of the year relate to company incomes in earlier years than

the year which will generate most of the second half receipts. In present circumstances, therefore the forecast of MCT is particularly uncertain.

41. The forecasts for future years show a further substantial rise in MCT receipts for 1988-89, but a much smaller rise for 1989-90. Table XVIII shows some details of the CT forecast, including effective tax rates (calculated on the basis of tax accruals and profits in the previous calendar year). The slow-down in 1989-90 reflects the lower profits growth forecast for 1988. The effective rate is expected to show a further significant rise for 1987-88 but to fall back a little in the following years, as the reduction in tax exhaustion slows and capital allowances under the new system begin to build up. As compared with the forecast made in June, MCT receipts are now expected to be £1.7 billion higher in 1988-89. This upward revision reflects the forecast higher level of profits in 1987, resulting from both higher profits growth than in June and upward revisions to profits data for 1986 and earlier years.

TABLE XVIII: CORPORATION TAX EFFECTIVE TAX RATES

Percentage Growth Rates for:-

	Revenue		Tax determinants		Effective Rates (%)	
	MCT Receipts	ACT	Company Incomes (previous Calendar year)	Dividends (Calendar year)	MCT*	ACT
1985-86	+ 23	+ 21	+ 15	+ 24	11.0	59.3
1986-87	+ 55	+ 17	+ 26	+ 33	13.2	52.2
1987-88	+ 37	+ 17	+ 25	+ 28	15.2	47.7
1988-89	+ 21	+ 19	+ 19	+ 19	14.8	47.6
1989-90	+ 5	+ 11	+ 8	+ 10	14.5	47.8

[* numerator is tax accruals for previous year]

42. ACT receipts are now forecast to rise by 17 per cent (£0.7 billion) this year, despite the reduction in the income tax basic rate in the Budget, which has led to a reduction in the effective tax rate. This forecast has been revised upwards by £0.5 billion from Budget time, and by £0.2 billion since

June, in line with upward revisions to the forecast of dividends - which are now forecast to record a rise of nearly 30 per cent for the year, not much below last year's substantial increase. The forecast shows ACT receipts growing in line with dividends.

VAT

43. VAT receipts have been quite buoyant so far this year, but part of this buoyancy may be due to a further reduction in payment lags resulting from the Keith reforms to VAT collection procedures, and in particular to the default surcharge - introduced last October, but which only started to 'bite' (in the sense of penalties actually being levied on late-payers) in May. In the light of the evidence available so far - on penalties collected, and numbers of firms in arrears - we have tentatively revised our estimate of Keith effects for 1987-88 up from £0.2 billion to £0.4 billion.

44. The forecast for VAT is shown in Table XIX; the presentation here abstracts from 'special factors', such as Keith effects, in order to monitor 'underlying' VAT receipts. As compared with the forecast made in June, which was not significantly different from that in the FSBR, the forecast for 1987-88 has been revised upwards by £0.5 billion - nearly half of which is attributed to Keith effects. In the light of receipts to date, the forecast for 1987-88 as a whole could be termed cautious - even with our doubling our previous estimate of Keith effects. It nevertheless implies - on the basis of the present forecast of consumers' expenditure - a substantial rise in the effective tax rate, much larger than the rise which (following an upward revision to 1986 consumers expenditure data for this year's Blue Book) now appears to have taken place in 1986-87. It is quite possible therefore that - as happened last year - buoyant VAT receipts will turn out to be an indicator of higher than expected consumers' expenditure in total, rather than of a substantial shift in expenditure towards VATable goods and services.

TABLE XIX: VAT RECEIPTS FORECAST

	Percentage Growth Rates in:-			Forecast Levels (£bn)		
	VAT Receipts (Underlying)	Consumers Expenditure	Effective Tax Rate (Underlying)	Underlying Receipts	Special Factors*	Total Receipts
1985-86	13.7	9.1	9.09	19.4	+ 0.1	19.5
1986-87	10.0	9.6	9.13	21.4	+ 0.3	21.7
1987-88	9.1	7.6	9.25	23.3	+ 0.5	23.8
1988-89	10.1	9.4	9.32	25.7	+ 0.4	26.1
1989-90	8.4	8.0	9.36	27.8	+ 0.4	28.2

[* reduction of arrears from Keith report changes; 1987 Budget effects; repayment supplement resulting from strike earlier this year]

45. The forecasts for 1988-89 and 1989-90 assume some further growth in the effective tax rate. Real growth in consumers expenditure is forecast at 4½ per cent in 1988-89 and 3½ per cent in 1989-90.

North Sea Revenues

46. Government revenues from the North Sea in 1987-88 are projected at £4.6 billion, close to the June forecast but £0.7 billion above the FSBR forecast. Revenues have been boosted by a higher sterling oil price, reflecting a stronger dollar oil price only partly offset by a higher projected $/£ rate, and by the effect of lower than expected costs of drilling exploration and appraisal wells. Although total North Sea production in 1987 is turning out lower than expected at the time of the Budget, this has little effect on projected revenues because reductions are concentrated in non-PRT paying fields while production in some PRT paying fields has been revised up.

47. Despite the assumption of a constant $18 oil price in 1988 the sterling oil price is projected to weaken a little over the next year as a result of the projected depreciation of the dollar. With production also expected to fall, revenues are projected to decline slightly in 1988-89 but in 1989-90 the effect of a further decline in production is offset by the ending of APRT repayments.

TABLE XX: GOVERNMENT REVENUES FROM THE NORTH SEA

£ billion

	1986-87	1987-88	1988-89	1989-90
Current Forecast	4.8	4.6	4.5	4.5
FSBR Forecast	4.8	3.9	3.8	4.1
Change since FSBR	-	0.7	0.6	0.4
of which: $ oil price		0.7	0.9	0.6
exchange rate		- 0.2	- 0.2	- 0.2
production, expenditure etc		0.2	0.0	0.0

National Insurance Contributions

48. Table XXI sets out the forecast for National Insurance Contributions (NICs). The forecast has underlying NICs growing quite closely in line with wages and salaries, but with a slight fall in the effective rate for accruals in 1988-89 as a result of changes to the rate structure due to be introduced in 1988. One of these changes - the introduction of an 'incentive rebate' for those taking out personal pension plans - will not actually affect receipts until 1989-90; hence the rather different path projected for receipts, as compared with accruals.

TABLE XXI: EFFECTIVE RATES FOR NICs (%)

	Employees	Employers	Total Accruals	Total Receipts
1985-86	7.07	7.25	14.32	14.28
1986-87	7.04	7.28	14.32	14.25
1987-88	6.89	7.34	14.23	14.07
1988-89	6.68	7.51	14.19	14.25
1989-90	6.63	7.56	14.19	14.05

Changes since the FSBR

49. The current forecast for general government receipts in 1987-88 is £4 billion higher than that published in the FSBR; the upward revision is entirely explained by taxes and royalties, and NICs. Of this £4 billion, over £1 billion is non-North Sea corporation tax, and £¾ billion is North Sea revenues

Of the remaining £2¼ billion, a good part can be attributed to higher than forecast economic activity.

Changes since June Forecast

50. The forecast of taxes and royalties for 1987-88 has been raised by nearly £1½ billion since June. Most of this is accounted for by upward revisions to the forecasts for income tax and corporation tax. The increase since June to the 1987-88 forecast for General Government Receipts, at a little over £1 billion, is smaller than that for taxes and royalties. This is mainly because extra local authority unidentified receipts, which had been added into the June forecast in order to balance the forecast of the LABR with the then-current expenditure projections, have now been taken out. (The LABR forecast is little changed from June, but the previously unidentified receipts are now identified as higher capital receipts - which count as reducing general government expenditure, rather than increasing general government receipts).

51. For 1988-89 and 1989-90, taxes and royalties (before fiscal adjustment) are now forecast to be substantially higher than in June, by £5 billion for 1988-89, and £6 billion for 1989-90. This is partly attributable to higher forecast incomes and expenditure. However, corporation tax and rates account for around two-thirds of the upward revision to the 1988-89 forecast for total taxes and royalties, and for nearly a half of that to 1989-90; for neither of these taxes is there a strong link between tax revenues and current economic activity. The upward revisions to the forecast for 1988-89 and 1989-90 for general government receipts are identical to those for taxes and royalties. Among non-tax receipts, both NICs and interest and dividend receipts have been increased, but this has been offset by lower 'other receipts' - mainly reflecting a lower forecast of unidentified local authority receipts in each year as described in the previous paragraph.

ANNEX : EXTRACT FROM MAIN FORECAST REPORT

(8) PUBLIC FINANCES

64. Table 30 summarises the forecast and compares it with the numbers in the FSBR, and with the internal June forecast. The projections in the FSBR were on the basis of certain conventional assumptions and not a central forecast.

TABLE 30 : PUBLIC SECTOR EXPENDITURE, REVENUE, AND BORROWING
(£ billion)

	1986-87	1987-88			1988-89			1989-90		
	Outturn	FSBR	June Forecast	Oct. Forecast	FSBR	June Forecast	Oct. Forecast	FSBR	June Forecast	Oct Forecast
General Government Expenditure	165	174	173	**172½**	180	185	**184**	188	198	**197**
General Government receipts	160	169	172	**173**	178	187	**192**	187	201	**206**
Assumed cuts in personal taxes (cumulative)					3	3	**4**	5	5	**6**
GGBR	5	5	2	**-½**	5	2	**-3**	6	2	**-4**
Public corporations' overseas and market borrowing	-1½	-1	-1	**-½**	-1	-1	**-2**	-1	-1	**-2**
PSBR	3½	4	1	**-1**	4	1	**-5**	5	1	**-5**
(per cent of GDP) brackets)	(1)	(1)	(¼)	**(-¼)**	(1)	(¼)	**(-1)**	(1)	(¼)	**(-1)**

(a) 1987-88

65. The PSBR for 1987-88 is now forecast to be a surplus of £1b. The margins of error attached to PSBR forecasts made at this time of the year, whilst lower than those for the Budget forecast, are still very high. The average absolute error is around 0.8 per cent of GDP (£3b.).

66. The latest forecast represents an undershoot on the FSBR forecast of £5b., and a reduction of £2b. from the June forecast. Table 31 shows the main components of the £5b. reduction in the PSBR forecast since the Budget. Over three-quarters of the predicted undershoot of the FSBR forecast is accounted for by lower central government own account borrowing, with most of the remainder due to lower local authorities' borrowing. The forecast of public corporations' market and overseas borrowing is little changed. Looked at another way three-quarters of the downward revision to the forecast has been on general government receipts, and one-third to general government expenditure.

TABLE 31 : CONTRIBUTION TO THE CHANGE IN THE 1987 PSBR FORECAST SINCE JUNE AND THE FSBR

	£ billion Changes since	
	FSBR	June
- higher North Sea revenues from a higher North Sea oil price;	-¾	-
- higher non-North Sea corporation tax reflecting upward revisions to 1986 profits data and higher dividend payments (generating ACT) in 1987;	-1	-½
- higher income tax, in line with experience to date and mainly reflecting higher money incomes;	-¾	-¾
- higher national insurance contributions, reflecting higher money incomes;	-	-½
- higher VAT, in line with outturn to date, and reflecting buoyant expenditure and - we think - a larger than expected reduction in arrears as a result of the Keith reforms;	-½	-½
- higher stamp duty as a result of the buoyant housing and stock markets;	-	-½
- higher privatisation proceeds;	-¼	-¼
- a lower public expenditure planning total (excluding privatisation proceeds);	-1	-1¼
- offsetting increases, mainly lower 'other' receipts and higher national accounts adjustments	+¼	+1¼
TOTAL CHANGE IN PSBR FORECAST	-5	-2

67. Lower expenditure and higher receipts have contributed roughly equally to the £2b. reduction in the PSBR since June. The main upward revisions on the receipts side have been to income tax, non-North Sea corporation tax and VAT. On the expenditure side the main reduction is lower local authority net capital spending, reflecting higher capital receipts, but the forecasts of social security spending and nationalised industries' EFLs have also been reduced.

(b) Fiscal adjustment and PSBR in 1988-89 and 1989-90

68. The MTFS assumption of PSBRs of one per cent of GDP would, on present projections, imply a massive fiscal adjustment in 1988-89 of around £13½b., with a further annual fiscal adjustment of £3b. in 1989-90. The forecast makes the stylised assumption that higher than previously planned privatisation proceeds are used to reduce the PSBR and that one third of the remaining available fiscal adjustment for 1988-89, calculated on this

basis, reduces personal taxes, with the remaining two thirds reducing the PSBR to a surplus equivalent to about 1 per cent of GDP. The assumed cut in taxes is a little larger than in the June forecast. In 1989-90 the PSBR is maintained at the arbitrary surplus of 1 per cent of GDP, and there is scope for a further cut in personal taxes of £2b.

(c) Public expenditure

69. The forecast of the planning total excluding privatisation proceeds in 1987-88 has been revised down since June, and instead of a small overspend of the 1987 PEWP plans, a £1b. undershoot is now forecast. Substantial overspends of the PEWP totals are forecast for 1988-89 and 1989-90, only a little less than those forecast in June. The forecast for these years takes account both of the differences between the economic assumptions used in the PEWP and of the economic prospects in the forecast, together with other pressures on programmes which past experience suggests are likely. The forecast is in effect attempting to anticipate not only the final outcome of the current survey (and in the case of 1989-90 the next survey as well), but also any eventual over or underspend on the finally agreed planning totals. The forecast incorporates some modest additions to expenditure in 1989-90 following the buoyant performance of the economy in general and public finances in particular in 1987 and 1988. Privatisation proceeds of £5¼b. are assumed for 1987-88, in line with PE's latest assessment. Proceeds of £6b. a year are assumed for 1988-89 and 1989-90.

70. Table 32 sets out forecast increases in actual programme spending compared with the 1987 PEWP in terms of economic rather than departmental categories. About half the projected excess above current programme plans is accounted for by social security and local authority current expenditure. These are areas over which the Government has limited direct control.

TABLE 32 : FORECAST ADDITIONS TO PROGRAMME BASELINES

£ billion

	1987-88		1988-89		1989-90	
	PEWP 1987	Forecast Claims on Reserve	PES 1987 Base-line	Forecast additions to baseline	PES 1987 Base-line	Forecast additions to baseline
Allocated to programmes						
1. Social Security (including HB)	44.7	0.5	46.1	2.2	48.0	4.1
2. LA current (excluding HB)	32.5	1.1	33.7	2.9	34.6	5.2
3. CG pay	24.8	0.5	25.8	1.5	26.6	2.9
4. CG procurement	24.6	0.1	25.0	1.4	25.9	2.3
5. LA capital	4.3	-0.7	4.0	-0.2	4.1	0.0
6. EC	0.9	0.4	0.4	0.9	1.1	0.6
7. Nationalised industries	0.7	-0.1	0.3	0.3	-0.1	0.7
8. Other	17.8	0.6	18.3	0.9	18.8	1.5
9. Total programmes	150.1	2.5	153.7	9.9	9.0	17.3
10. Expenditure met from existing reserve						
(i) allocated to programme baseline	0.0	2.5	0.0	5.5	0.0	7.5
(ii) unallocated	3.5	0.0	5.5	0.0	7.5	0.0
11. Underspend (-) Addition to Reserve(+)	0.0	-1.0	0.0	4.4	0.0	9.8
12. PLANNING TOTAL excluding privatisation proceeds	153.6	-1.0	159.2	4.4	166.5	9.8

71. The forecast of social security spending assumes that the underlying growth in spending - ie the growth after allowing for the effects of changes in unemployment, upratings, policy changes, demographic factors etc - which is projected to have risen rapidly in 1987-88, falls back somewhat in 1988-89 and 1989-90. The forecast of local authority current spending, most of which is pay, assumes that numbers employed will rise at much the same average rate as in the last 2-3 years and that earnings increases will be somewhat above the private sector average (see para 48). This, together with the RSG settlements announced in July, implies average rates increases of about 11 per cent in 1988-89.

72. The forecast of central government pay assumes little change in numbers and earnings increases averaging below the private sector in 1988-89 and much the same as the private sector in 1989-90 (see para 49). The forecast of central government procurement assumes that non-defence spending will rise in real terms at much the same rate as over the past 5 years, and that defence spending will rise at ½ per cent a year in real terms. Local authority capital receipts and gross capital spending are assumed to be higher than in the 1987 PEWP, but by roughly equal amounts in 1988-89 and 1989-90. The forecast has partially smoothed out the projected dip in net EC contributions in 1988-89 and the rebound in 1989-90.

73. The large upward revision to the planning total forecasts for 1988-89 and 1989-90 since the Budget are largely matched by a higher inflation forecast. Consequently the increase in the planning total in real terms is less than the cash increase. In real terms the planning total and GGE (see table 33) are much the same as earlier internal forecasts. The forecast of GGE in real terms is almost identical to that made a year ago for 1988-89 and less than 1 per cent higher for 1989-90.

TABLE 33 PAST AND CURRENT FORECASTS OF GGE EXCLUDING PRIVATISATION PROCEEDS

£ billion

Forecast	1986-87		1987-88		1988-89		1989-90	
	Current prices	Real Terms*	Current Prices	Real Terms*	Current Prices	Real Terms*	Current Prices	Real Terms*
Jan 1986	169	169	176	169	186	169	-	-
June 1986	169	169	177	170	186	171	-	-
Oct 1986	170	170	178	171	188	172	200	173
Jan 1987	170	170	179	171	190	173	202	175
FSBR 1987	169	170	179	171	185	171	193	172
June 1987	169	169	179	170	190	171	203	174
Oct 1987	170	170	178	170	190	172	203	175

* in 1986-87 prices

74. The ratio of GGE (excluding privatisation proceeds) to money GDP is forecast to show a sharp fall in 1987-88 and more modest falls in 1988-89 and 1989-90. It is below the PEWP/MTFS paths in all three years.

TABLE 34 : RATIO OF GGE EXCLUDING PRIVATISATION PROCEEDS TO MONEY GDP

per cent

	1985-86	1986-87	1987-88	1988-89	1989-90
1987 PEWP	44¾	44½	44	42¾	42½
1987 FSBR	44¾	44¼	43½	42½	41¾
Oct forecast	44¾	44	42¾	41¾	41¼

(d) <u>General Government Receipts</u>

75. The recent history of forecasts of general government receipts has been a series of successive upward revisions. The current forecast continues this pattern, with substantial upward revisions to 1988-89 and 1989-90

compared the with June forecast. The upward revision since June to the forecast for 1987-88 has been smaller (about £1b.), though this still leaves the 1987-88 forecast of revenues £4b. higher than that in the FSBR.

76. Part of the upward revision to 1987-88 receipts since the FSBR can be attributed to higher economic activity, including stronger than expected stock and housing markets, which have boosted stamp duty receipts. Higher non-North Sea corporation tax for the most part reflects stronger than previously estimated activity and profits in 1986. Higher non-North Sea corporation tax is the most important single factor behind the higher total receipts now forecast for 1988-89 and 1989-90, accounting for around half of the revision since June to 1988-89 and one-third of the revision to 1989-90. The revision to the forecasts partly reflects higher profits growth for 1987 (and thus higher tax receipts for 1988-89). The remainder of the upward revision since June to the receipts forecasts for 1988-89 and 1989-90 are for the most part attributable to higher income and expenditure (income tax, VAT and NICs account for between one-third and half of the total upward revision in each year), but the forecast of local authorities rates has been raised by between £¾ to £1b. in each year.

TABLE 35: COMPARISON OF FORECASTS OF GENERAL GOVERNMENT RECEIPTS (PRE-FISCAL ADJUSTMENT FOR 1988-89 AND 1989-90)*

£ billion

Forecast:	1986-87		1987-88		1988-89		1989-90	
	Cash	Real Terms	Cash	Real Terms	Cash	Real Terms	Cash	Real Terms
January 1986	157	153	166	159	178	162	188	164
June 1986	156	156	164	158	179	164	188	166
October 1986	156	156	165	159	181	165	196	169
January 1987	158	158	169	162	184	168	197	171
FSBR 1987	159	159	169	162	178	164	187	167
June 1987	159	160	172	164	187	168	201	172
October 1987	160	160	173	165	192	174	206	178

* Forecasts made before this and last year's Budgets have been adjusted to be consistent with current tax rates and allowances. Real terms figures are at 1986-87 prices.

77. Table 36 shows non-oil taxes and national insurance contributions (NICs) as a percentage of non-oil GDP. The changes to the tax forecast since the FSBR mean that the forecast now shows a substantial rise in the pre-fiscal adjustment tax burden for 1988-89, but this is offset by the assumed cut in taxes. The projected rise for 1989-90 is smaller, and is

again offset by the assumed tax cut. Thus with the stylised assumption used here on the allocation of the fiscal adjustment, the tax burden for 1989-90 is the same as the level for 1987-88. With oil revenues as a percentage of GDP expected to be broadly flat at the projected 1987-88 level, the ratio of total taxes to money GDP is forecast to follow a similar pattern to the non-oil ratio.

TABLE 36: NON-OIL TAXES AND NICs AS A PERCENTAGE OF NON-OIL GDP

	1985-86	1986-87	1987-88	1988-89	1989-90
FSBR					
(a) pre-fiscal adjustment	37.2	37.3	37.8	37.9	37.7
(b) post fiscal adjustment	37.2	37.3	37.8	37.1	36.6
June Forecast					
(a) pre-fiscal adjustment	37.3	37.7	38.0	38.4	38.8
(b) post fiscal adjustment	37.3	37.7	38.0	37.5	37.9
October Forecast					
(a) pre-fiscal adjustment	37.0	37.5	38.0	39.1	39.4
(b) post-fiscal adjustment	37.0	37.5	38.0	38.0	38.0

MAIN FORECAST

SECRET COPY NO. 1

Alex: Pls spk on this. N.

FROM: **P N SEDGWICK**
DATE: 9 OCTOBER 1987

CHANCELLOR

Ch
Much as expected, with massive fiscal adjustment (£13½ bn) but worries about RPI & BoP.
AA

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
PCC
MEG
Mr Hawtin
Mr Luce
Mr Moore
Miss Peirson
Mr Grice
Mr Matthews
Mr Melliss
Mr Mowl
Miss O'Mara
Mr Riley
Mr Cropper
Mr Tyrie
Mr Call

but also the rate assumption (£DM assumptions) & margin of error (see doc commentary passim)

TREASURY ECONOMIC FORECAST

I attach a copy of the main report of the recent forecasting exercise, which reflects judgements taken at a series of meetings with Sir T Burns. The assumptions in the forecast on monetary policy and the fiscal stance were taken in consultation with Sir T Burns and Mr Cassell as the results of the forecast emerged.

2. The other detailed reports on this exercise are

World Economic Prospects (Mr Matthews, IF2)

Public Finances (Mr Mowl, PSF)

The Financial Prospect (Mr Bottrill, EA2).

? Real growth in GGE 1987/8 on 1986/7

No characteristics forecast.

P.N.S

P N SEDGWICK

SECRET

TREASURY ECONOMIC FORECASTING EXERCISE

OCTOBER 1987 REPORT

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SECRET

TREASURY ECONOMIC FORECASTING EXERCISE

REPORT BY EA AND PSF

(1) SUMMARY

The forecast covers the period to the end of 1989 (1989-90 for public finances). Table 1 summarises the results and compares them with earlier exercises and with the current average of outside forecasts.

(i) Main results

(a) Following the latest CSO upward revisions, in the Blue Book and subsequently, the growth of **money GDP** in 1986-87 is, at 6½ per cent, very close to that envisaged in the 1986 MTFS. With only limited data available on the early quarters of 1987-88 the prospect is for money GDP growth of 9 per cent, over a point above the figure in the 1987 MTFS. This overshoot could be greater if, following past practice, the CSO revises up the GDP data for the early part of the financial year. The forecast is for overshoots of the MTFS growth rates for money GDP that average almost 2 percentage points in 1988-89 and 1989-90. Both higher real growth and higher inflation than assumed in the MTFS contribute to these overshoots.

(b) Both real **GDP** and **domestic demand** appear to be growing at higher rates in the UK than in the rest of the G7. The forecast is for growth of consumers' expenditure of 4¾ per cent in 1987 and 4½ per cent in 1988, lower than the very high rate of 5¾ per cent recorded for 1986. This deceleration of consumers' expenditure is, however, offset by a strong rise in investment. Total domestic demand grows at 4 per cent in 1987 and 1988, before dropping to 3 per cent in 1989. UK domestic demand growth in 1987 and 1988 is on average 1 per cent higher than the average for the rest of the G7.

The latest forecast is for GDP growth of 4 per cent in 1987 - in line with the June forecast, but above the FSBR forecast of 3 per cent. With nearly all indicators suggesting that activity continues to be strong in the second half of 1987, forecast GDP growth in 1988 is 3 per cent (half a percent higher than in the FSBR and the June forecast) and 2½ per cent in 1989. Growth of **manufacturing output** could be over 5 per cent in 1987, though somewhat lower thereafter. **Unemployment** should continue to fall at a rapid rate in the near future, though as output growth moderates the rate of decline is likely to be less.

(c) **RPI** inflation in 1987(4) is likely to be very close to the FSBR forecast of 4 per cent, though above the 1986 Autumn Statement forecast of 3¾ per cent. The forecast is for a pick up to 5¼ per cent by

? 1988(4). This owes something to the rise in short term interest rates - and therefore the mortgage rate - that is judged necessary to keep the sterling index constant while the UK economy is relatively so buoyant. However, most of the rise in RPI inflation between the fourth quarters of 1987 and 1988 is the result of

the assumed **revalorisation of specific duties** in the 1988 budget after the standstill this year,

a large rise in **LA rates** in 1988-89, given the forecast of their current expenditure and the recent RSG settlement,

?

and some substantial increases in certain **nationalised industry prices** (plus BGC), following a period in which nominal prices have hardly risen and real prices have fallen substantially.

These factors, together with a gradual increase in unit labour costs, will have an increasing influence on the RPI from the second quarter of 1988.

With the exception of the assumed rise in the mortgage rate nearly all the factors that are forecast to cause a rise in RPI inflation between 1987(4) and 1988(4) will cause the inflation rate of the **GDP deflator** (at market prices) to rise between 1987-88 and 1988-89. The GDP deflator is also likely to be boosted by rising costs and margins in the construction industry, where the recent boom in output seems likely, on the strength of a recent further surge in orders, to continue for some while. The forecast is for construction prices to accelerate a little later than suggested in the June forecast, from early 1988 onwards.

This point again ?

ie hasn't happened yet.

The forecast has the relatively satisfactory recent performance of **unit labour costs in manufacturing** continuing, although growth in the range of 2½-4 per cent throughout the period is slightly above average growth in the UK's principal competitors. Strong productivity growth and the continued fall in employers' pension contributions keep growth of unit labour costs in manufacturing some 5 percentage points below growth in average earnings. Indeed these factors probably reduce the incentive for employers to press for more moderate growth in earnings.

XR?

(d) **GNP growth of the major 7** (less the UK) is likely to remain close to the 2¾ per cent recorded for 1986. There has, however, been an upturn in the growth of industrial production and world trade in manufactures which should continue in 1988. Short term interest rates are forecast

What is forecast assumption?

to rise further in the US - with rates in Japan and Germany remaining unchanged - to moderate the likely fall in the dollar exchange rate.

(e) It is extremely difficult to analyse the recent behaviour of the **current account**, a difficulty compounded by frequent and large revisions to the 'recorded' data for invisibles and doubts about the seasonal adjustment of visible trade. The visible balance was surprisingly favourable in the early months of the year. Since then there has been a sharp deterioration.

Internal forecasts for 1987 made during much of 1986 and the early part of 1987 showed relatively small current account deficits (as a proportion of GDP) on the basis of rather less domestic demand and output in the UK economy than has in the event occurred. At the same time the world economy has been less buoyant than forecast. For given activity at home and abroad the current account has so far been better than expected. As with the June exercise, the present forecast attempts to take account of this record.

In both 1988 and 1989 North Sea production is forecast to fall by about 5 per cent. With a constant (indexed) oil price at $18 this will produce falls in the **balance of trade on oil** of just under £1b. in each year. Over the forecast period UK labour costs rise slightly more than those in competing economies (in domestic currencies), so that, with short term interest rates set to keep the sterling index at 72.5, there is a small deterioration in measured competitiveness over the period. This, together with higher growth of domestic demand and output in the UK than in the rest of the G7, produces a £2½b. deterioration in **the non-oil current account** between 1986 and 1988, producing overall current account deficits of £2½b. (spot on) and £4½b. ? in 1987 and 1988 respectively. While the growth of domestic demand falls in 1989 it remains above growth in the rest of the G7, contributing to a further deterioration in the current account.

(f) The emergence of a growing current deficit coupled with continued outward investment flows implies a need for substantial offsetting **capital account** inflows. The forecast is that UK companies and banks are able to attract these at the projected interest rates, and that confidence in sterling is sufficient to keep the sterling index constant. (With the dollar assumed to fall gradually, the assumption of a flat sterling index implies a very small fall in the £/DM rate over the period.) A weakening of sentiment would make it more difficult to finance the projected current deficit, and put upward pressure on interest rates.

These are not the lowest assumptions, & not v. comfortable

TABLE 1 : SUMMARY OF FORECAST

	FSBR 1987	SUMMER 1987	OCTOBER 1987	AVERAGE OUTSIDE FORECAST SEPTEMBER 1987
A THE WORLD ECONOMY				
1. GNP (MAJOR 7 EXCLUDING UK) (per cent change on a year earlier)				
1986	2.6	2.5	**2.7**	
1987	2.6	2.3	**2.5**	
1988	3.0	2.8	**2.6**	
1989	3.0	2.8	**2.4**	
2. DOMESTIC DEMAND (MAJOR 7 EXCLUDING UK) (per cent change on a year earlier)				
1986	3.8	3.7	**3.8**	
1987	3.0	2.6	**2.6**	
1988	3.2	2.8	**2.6**	
1989	3.0	2.8	**2.5**	
3. WORLD TRADE IN MANUFACTURES (weighted by UK market shares: per cent change on a year earlier)				
1986	2.4	2.1	**1.3**	
1987	3.4	2.6	**2.6**	
1988	4.1	3.2	**3.4**	
1989	5.0	4.3	**3.8**	
B UK ACTIVITY AND DEMAND				
4. GDP VOLUME (non-North Sea GDP in brackets) (per cent change on a year earlier)				
1986	2.6(2.7)	2.8(2.9)	**3.1(3.2)**	
1987	3.0(3.1)	3.9(4.1)	**4.1(4.5)**	3.2
1988	2.4(2.9)	2.3(2.8)	**3.0(3.5)**	2.4
1989	2.4(2.8)	1.7(2.1)	**2.4(2.8)**	
5. VOLUME OF DOMESTIC DEMAND (per cent change on a year earlier)				
1986	3.2	3.5	**3.8**	
1987	3.5	3.6	**3.9**	
1988	2.4	3.3	**4.1**	
1989	2.2	2.0	**2.9**	
6. UNEMPLOYMENT (UK S.A. EXCLUDING SCHOOL LEAVERS million)				
1986 Q4	3.14	3.14	**3.14**	
1987 Q4	2.88	2.73	**2.74**	2.84
1988 Q4	3.01	2.58	**2.52**	2.82
1989 Q4	2.94	2.61	**2.54**	

Probably a bit pessimistic re world

Why has changed esp 1988?

	FSBR 1987	SUMMER 1987	OCTOBER 1987	Rel to FSBR	(calendar yrs) o/w output	(financial year) o/w inflation
C INFLATION AND MONEY GDP						
7. MONEY GDP (MARKET PRICES) (per cent change on a year earlier)						
1986-87	6.1	6.3	**6.6**			
1987-88	7.5	8.8	**8.9**	+1.4	+1.1	+0.1
1988-89	6.4	7.9	**8.5**	+2.1	+0.6	+1.4
1989-90	6.1	7.1	**7.8**	+1.7	–	+1.6

	FSBR 1987	SUMMER 1987	OCTOBER 1987	AVERAGE OUTSIDE FORECAST SEPTEMBER 1987
8. RPI (excluding mortgage interest payments in brackets) (per cent change on a year earlier)				
1986 Q4	3.4(3.4)	3.4(3.4)	**3.4(3.4)**	
1987 Q4	3.9(3.4)	3.8(3.6)	**3.9(3.7)**	4.0
1988 Q4	3.3(3.0)	5.1(4.4)	**5.3(4.6)**	4.6
1989 Q4	3.3(3.2)	4.2(3.9)	**4.3(3.9)**	
9. GDP market price deflator (per cent change on a year earlier)				
1986-87	3.2	3.0	3.0	
1987-88	4.5	5.0	4.6	
1988-89	4.0	5.7	5.4 ?	
1989-90	3.6	5.1	5.2	
D PUBLIC FINANCES				
10. PSBR - £ billion				
1986-87	4.1	3.3	**3.5**	
1987-88	3.9	1.0	**-1.2**	3.4
1988-89	4.4	0.8	**-5.0**	
1989-90	4.9	0.8	**-5.4**	
11. PSBR - % OF GDP				
1986-87	1.1	0.9	**0.9**	
1987-88	1.0	0.2	**-0.3**	
1988-89	1.0	0.2	**-1.1**	
1989-90	1.0	0.2	**-1.1**	
12. ANNUAL FISCAL ADJUSTMENT - £ billion				
1988-89	3.2*	7.4*	**13.6***	
1989-90	1.7*	1.1*	**2.8***	
allocated to				
(a) reducing personal taxes				
1988-89	3.2	3.7	**4.1****	1.8
1989-90	1.7	0.5	**2.0**	
(b) reducing PSBR				
1988-89	0.0	3.7	**9.5**	
1989-90	0.0	0.6	**0.8**	

& pr

3.4 / 1 / 0.6

when near things last a year-on-year change of 1.2 bn?

April 1/3 = 4.5

*Assuming PSBR ratio of 1 per cent as in 1987 MTFS.
**This is one third of the fiscal adjustment remaining after the higher than previouslyassumed level of privatisation receionts has been used to reduce the PSBR.

	FSBR 1987	SUMMER 1987	OCTOBER 1987	AVERAGE OUTSIDE FORECAST SEPTEMBER 1987
E MONETARY CONDITIONS				
13. SHORT TERM INTEREST RATES (per cent))				
1986 Q4	11.2	11.2	**11.2**	
1987 Q4	10.3	9.5	**10.5**	9.5
1988 Q4	10.1	10.5	**11.0** ?	8.9
1989 Q4	9.7	10.5	**11.0**	

	FSBR 1987	SUMMER 1987	OCTOBER 1987	AVERAGE OUTSIDE FORECAST SEPTEMBER 1987
14. MO (per cent change on a year earlier)				
1986-87	4.3	4.3	**4.3**	range
1987-88	4.0	4.3	**5.1**	2–6
1988-89	3.4	4.0	**4.4**	1–5
1989-90	3.0	3.4	**3.4**	1–5
15. STERLING INDEX (1975=100)				
1986	72.8	72.8	**72.8**	
1987	70.3	71.7	**72.0**	71.8(Q4)
1988	69.3	72.0	**72.5**	70.5(Q4)
1989	67.3	72.0	**72.5**	
16. £/DM EXCHANGE RATE				
1986	3.19	3.19	**3.19**	
1987	2.78	2.93	**2.95**	
1988	2.67	2.86	**2.94**	
1989	2.52	2.77	**2.87**	
17. RELATIVE UNIT LABOUR COSTS (1980=100)				
1986	77.6	77.7	**77.3**	
1987	74.0	75.2	**74.8**	
1988	73.5	77.1	**76.7**	
1989	70.1	78.6	**76.9**	

F TRADE AND CURRENT ACCOUNT

	FSBR 1987	SUMMER 1987	OCTOBER 1987	AVERAGE OUTSIDE FORECAST SEPTEMBER 1987
18. VOLUME OF NON-OIL EXPORTS OF GOODS AND SERVICES (EXCL. ERRATICS) (per cent change on a year earlier)				
1986	1.9	1.9	**2.0**	
1987	5.8	4.4	**6.1**	v. low
1988	4.0	3.6	**2.6**	
1989	5.1	4.5	**3.0**	
19. VOLUME OF NON-OIL IMPORTS OF GOODS AND SERVICES (EXCL. ERRATICS) (per cent change on a year earlier)				
1986	5.5	5.4	**5.7**	
1987	6.9	3.9	**7.2**	
1988	1.9	4.7	**4.8**	
1989	2.7	3.5	**2.9**	
20. CURRENT BALANCE £ billion				
1986	-1.1	-0.1	**-1.0**	
1987	-2.7	-0.5	**-2.4**	-1.1
1988	-1.7	-0.9	**-4.3**	-2.3
1989	-0.4	-2.3	**-5.6**	

(g) The prospects for **public finances** are again better than in earlier forecasts. The cumulative PSBR in the first six months of 1987-88 is about £3½b. below the budget profile. The major part of this shortfall is on the CGBR(O), with higher tax receipts the main explanation, but with central government expenditure below profile. Local authority borrowing has also been below profile. For 1987-88 the forecast is for a negative PSBR of £1b.

AS: Publish either (+)£1 bn or (+)£2 bn even

The forecasters attempt to predict the level of **public expenditure** that will occur. The forecast therefore implicitly includes judgements both on the results of the current round of Ministerial discussions (and for 1989-90 the results of the autumn 1988 discussions) and on the influence of the forecast evolution of the economy on demand led public expenditure. (Annex I summarises the assumptions on public expenditure.) The forecast has the outturn for the **planning total** (less privatisation receipts) in 1988-89 and 1989-90 respectively £5b. and £10b. above the previously announced plans (including the reserve). The emerging outcome for 1987-88 and the forecast for public expenditure in the later years implies that the ratio of general government expenditure (excluding privatisation receipts) to GDP starts off 1¾ percentage points below the value in the last PEWP and continues to fall further in 1988-89 and 1989-90.

Even with their current spending likely to exceed provision at much the same rate as in recent years and with the proportion of expenditure financed by central government grant falling, **local authorities' borrowing** should be close to its 1986-87 level during the forecast period as a result of a large increase in rates and buoyant capital receipts. **Public corporations' finances** benefit from the buoyant level of activity over the forecast. Nevertheless rising real levels of investment lead to an increased requirement for external finance, despite positive real price increases.

With the forecast levels of nominal and real demand and output higher than in earlier forecasts, forecast **tax receipts** (pre-fiscal adjustment) are higher. More real fiscal drag has contributed to slight upward revisions since June to the effective tax rates for PAYE and onshore CT. The share of pre-fiscal adjustment non-North Sea taxes in non-North Sea money GDP rises over the forecast period.

With the shares of public expenditure and pre-fiscal adjustment government revenues in GDP behaving so differently there are large fiscal adjustments. The forecast makes the stylised assumption that - after adjusting the PSBR for the higher than previously assumed

NB

level of privatisation receipts - for 1988-89 one third of the available fiscal adjustment is allocated to cuts in personal taxes and the other two thirds to reduce further the PSBR below the level in the 1987 FSBR. In 1989-90 the PSBR ratio is maintained at the assumed level for the previous year and the additional fiscal adjustment that is available is allocated to cuts in personal taxes. This produces cuts in personal taxes of £4¼b. and £2b. in 1988 and 1989 budgets. Even with these assumed cuts the share of post fiscal adjustment government revenues in money GDP does not change over the forecast period. The PSBR adjusted for privatisation receipts and the PSFD are - as proportions of money GDP - lower in 1988-89 and 1989-90 than at any time since the war except in the late 1940s and early 1950s and in 1969-70 and 1970-71. (See Annex II.)

(h) The forecast for public finances in the UK implies a markedly greater *ex post* tightening of fiscal policy than in the rest of the G7 taken together, as shown by the general government deficit - the only comparable measure of fiscal stance available for all G7 countries.

TABLE 2 : GENERAL GOVERNMENT FISCAL DEFICITS AS A SHARE OF GDP (%)

	1979-85	1986	1987	1988	1989
UK	3.1	2.6	1·8 ~~2.9~~	1·1 ~~1.4~~	0.6
G7 (less UK)	3.1	3.1	2.8	2.7	2.7

x Germany (x other [illegible] G7)

(ii) **Main issues and risks**

2. It is invidious to label individual judgements as particularly important or vulnerable. Nevertheless in the current exercise there has inter alia been detailed discussion of

? savings

- **the likely extent of the fall in the private sector surplus,**
- **the prospects for pay,**
- **the short term prospects for the current account,**

and - **the robustness of the projections for public sector finances.**

(a) The forecast implies a decline in the financial surplus of the private sector from its current high level. (Annex II sets out the data for sectoral surpluses and deficits over a long historical period.) Some fall in the company sector surplus seems very likely given the good prospects for capital investment revealed in intentions surveys. Indeed there must be a significant risk that, following the recent buoyancy of the economy, investment will be stronger than in the forecast.

The prospect for the personal sector is particularly uncertain. The personal sector accounts include companies' pension funds which, following the strong rise in equity markets at home and abroad, have found themselves with assets well in excess of their liabilities. The principal reaction of companies has been to attempt to rein back their surpluses by cutting employers' contributions. This reduces measured personal sector (though not household sector) saving. This process is likely to continue, particularly as companies will be taking steps to meet the requirement, introduced in the 1986 budget, that pension funds' surpluses, measured on the Government Actuary's assumptions, should not exceed 5 per cent of liabilities. To allow for this the forecast has the personal saving ratio declining slightly, even though there is a rise in the savings ratio if employers' contributions are ignored. (See Chart C on page .)

In normal circumstances the personal sector saving ratio would rise significiantly at a time of strong growth in disposable income. This does not appear to have happened either in 1986 or - on the basis of available data - in 1987. But despite this it is possible that, contrary to what is forecast some rise could occur in 1988, producing lower growth of domestic demand and a more favourable current account than now forecast.

gt uncertd

While such a development is possible there is a greater risk that personal saving, adjusted for the fall in employers' contributions, will not rise as much as envisaged in the forecast. The drop in the growth of consumers' expenditure from the 5¾ per cent recorded for 1986 to the forecasts of 4¾ and 4½ per cent in 1987 and 1988 depends critically on the judgement that the saving ratio, when adjusted for the fall in employers' contributions, will rise to a level over 1½ percentage points above the recorded 1986 level. Some rise in saving by households would be expected as both inflation and interest rates rise next year, but the extent of the forecast rise does mark a major break with behaviour so far in the 1980s. A faster than forecast growth of consumers' expenditure or company spending in 1987 and 1988 would have adverse consequences for the current account and domestic inflationary pressures.

(b) While there are already signs that private sector **pay settlements** and **average earnings** have begun to accelerate, the record on **labour costs** has been satisfactory. With the economy growing rapidly and RPI inflation rising there is a risk that the acceleration of earnings could be greater than the very slight upturn envisaged in the forecast.

(c) The very strong productivity growth in recent years does suggest that the UK's industrial performance has improved relatively to the rest of the G7 and that as a result a significant trend deterioration in trade performance is less likely. The evidence on this is, however, far from conclusive. A stronger than forecast surge in imports in response to strong domestic demand growth in the second half of 1987 and 1988 could be evidence that the forecast is too optimistic about industrial performance. This would mean both weaker GDP growth (with net exports lower) and a worse current account than forecast.

(d) The continuous improvement in recorded and forecast public finances since mid 1986-87 almost strains credulity. The prospect for onshore corporation tax is particularly important with increases on a year earlier of £3-3½b. forecast for both 1987-88 and 1988-89. By 1989-90 forecast CT receipts are approximately three times the 1984-85 level. If public expenditure were to over run the last published plans by less than the forecast assumes the improvement in public finances would be even more marked and the scope for fiscal adjustment correspondingly greater.

Most of the improvement since the June forecast in the overall prospect for public finances in 1988-89 and 1989-90 is the result of a higher forecast level of activity. The share of pre-fiscal adjustment of non-oil taxes in money GDP is about ½ a percentage point higher in both 1988-89 and 1989-90, whereas the level of real GDP is 2 per cent higher in 1989. If growth were less than forecast the ex post fiscal position would obviously be a good deal less favourable. Nevertheless, with a total fiscal adjustment in 1988-89 of £13½b. there would still be scope for some combination of further reductions in borrowing and tax cuts, even if taxes were markedly less buoyant than in the forecast.

(2) THE WORLD ECONOMY

3. There was a slowdown in the first half of 1987 in domestic demand growth in the United States, Germany and France that was not offset elsewhere among the major industrial countries. Exports of the group as a whole are, however, picking up and their import growth is slowing, so that the gap between domestic demand growth and real GNP growth in 1987 should be much lower than in 1986. Stockbuilding was particularly strong in the major countries in the first half of 1987 and, to the extent that this was involuntary, subsequent destocking could depress growth. This could be offset by the effects of the Japanese Government's fiscal package and, in 1988, tax cuts in Germany. The WEP sees real domestic demand in the other

major countries as a whole growing by 2.6 per cent in 1987, and real GNP growing by 2.5 per cent, with similar growth rates over the next two years. This is broadly in line with our latest estimates of growth in productive potential.

4. The forecast for the world economy incorporates the judgement that downward pressure on the dollar exchange rate will be fairly mild. This would enable the Federal Reserve to keep interest rate rises to the minimum necessary to control domestic inflationary pressures. With only a modest reduction in the Federal budget deficit in prospect (despite the new Gramm-Rudman deficit reduction programme), the resulting forecast shows the US current account deficit declining only gradually. There is a significant risk that such a slow turnaround would lead to a serious weakening of confidence in the dollar and a sharp drop in its exchange rate, causing the Fed to raise US interest rates substantially. In Japan and Germany the monetary authorities remain very reluctant to lower interest rates, and they may want to raise them for domestic reasons. Nevertheless strong upward pressure on their exchange rates might force them into further modest cuts. The forecast has German and Japanese short rates at their current levels, which with the assumed rise in US rates, involves a small rise in average world short rates.

5. Prospects for oil prices are clouded by developments in the Gulf and doubts about OPEC's ability to restrict production. The forecast is that the oil price (North Sea average) will be around $18 per barrel in the period to end-1988, and that the real price will be constant thereafter. **Non-oil commodity prices** have been rising in real terms during 1987. The forecast is for a further gradual rise in real non-food commodity prices until the end of 1988 as world industrial production strengthens, but food prices are expected to remain weak.

TABLE 3 : G7 (excluding UK) GROWTH AND INFLATION
(IMF World Economic Outlook in brackets)

Percentage changes on a year earlier	1986	1987	1988	1989
Real GNP	2.7	2.5(2.5)	2.6(2.7)	2.4
Domestic Demand	3.8	2.6(2.6)	2.6(2.7)	2.5
Industrial Production	0.9	2.8	4.4	4.3
Consumer prices	1.8	2.6(2.9)	3.0(3.4)	2.8

Note: IMF figures include UK

6. Total imports grew by almost 5 per cent in 1986 when oil trade was very buoyant following the fall in the price. Imports of manufactures are estimated to have grown by only 2 per cent. In 1987 the forecast is for

lower total world import growth, of about 3½ per cent, but a pick up in the growth of imports of manufactures to around 4 per cent. In later years world trade is expected to pick up as NODCs, and to a much lesser extent OPEC, increase their imports.

7. Total world trade in manufactures continues to grow more quickly than developed countries exports of manufactures throughout the forecast period because it is assumed that developing countries, and the Asian NICs in particular, will continue to increase their market share. Weighting developed countries exports by UK market share also reduces their growth, because OPEC is a relatively important UK market. Of the difference in 1987-88 and 1988-89 between growth in total world trade in manufactures and the UK market weighted version of developed countries trade in manufactures roughly two thirds results from the difference of coverage (ie the developed countries' loss of share to the NICs) and one third from the weighting.

TABLE 4 : THE VOLUME OF WORLD VISIBLE TRADE
(IMF World Economic Outlook in brackets)

percentage change on year earlier	1986	1987	1988	1989
Total world imports	4.7(4.9)	3.5(3.6)	4.2(4.5)	4.0
of which:-				
- Major seven	9.1	4.9	3.9	3.3
- OPEC	-20.5	-10.1	0	2.5
- Non-OPEC developing countries	1.2	3.3	5.5	6.0
Total world imports of manufactures	1.9	3.8	4.9	4.8
Main developed countries' exports of manufactures weighted by UK market share	1.3	2.6	3.4	3.8

(3) TRADE AND THE BALANCE OF PAYMENTS

8. The current balance, which recorded a surplus in the first four months of the year, returned to deficit in May and has shown average monthly deficits since then averaging £400 million, although individual monthly figures have been erratic. A return to deficit in the latter half of the year had always seemed likely. The scale of the deterioration, however, has been greater than expected at the time of the June forecast, although the current account for the year as a whole could still be close to the £2½ billion deficit forecast in the FSBR.

TABLE 5 : UK CURRENT ACCOUNT (£bn)

What is avge margin of error?

	Visible trade balances			Net invisibles			Current balance
	Manufactures	Oil	Other	Services	IPD	Transfers	
1986	-5.5	4.1	-7.0	5.0	4.7	-2.2	-1.0
1987	-7.9	4.3	-6.4	5.6	5.5	-3.4	-2.4
1988	-10.2	3.3	-6.3	5.5	6.8	-3.4	-4.4
1989	-11.6	2.4	-6.2	5.7	7.6	-3.5	-5.8

9. The forecast current deficit of £2½ billion for 1987 compares with a revised estimated deficit of £1 billion in 1986. The widening in the deficit is more than accounted for by a larger deficit on trade in manufactures, which is offset only in part by a higher surplus on oil trade, a smaller deficit on trade in other goods, and a modest improvement in invisibles. In 1988 the forecast is for the current account deficit to increase to around £4½ billion followed by a further widening to £5¾ billion in 1989, with an increasing deficit on manufactured trade and a worsening in the oil balance more than offsetting a rise in the invisibles surplus.

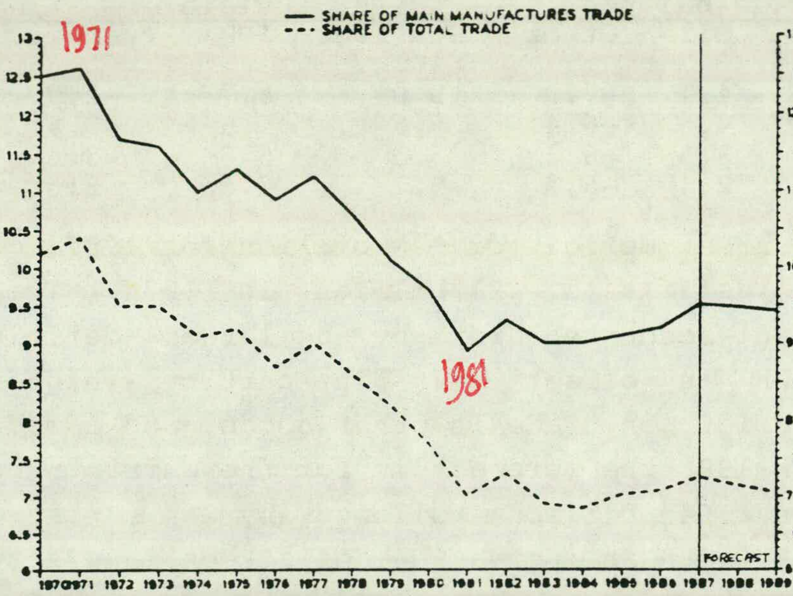
<u>Non-oil visible trade</u>

10. The rising deficit on trade in manufactures in 1987 and 1988 mainly reflects faster domestic growth in the UK compared to overseas. While labour cost competitiveness has deteriorated since the end of 1986, it is still significantly better than the average for 1984 and 1985. Over the forecast period there is a slight deterioration. (See Table 26.)

11. The volume of manufactured exports, which remained flat in the first half of 1987 after the surge towards the end of last year, appears to have begun rising again in recent months. Recorded growth, which may benefit from residual seasonal factors in the rest of this year, seems likely to continue at a modest rate to the end of next year, reflecting the slow rise in the world trade and the effects of the competitiveness loss during 1987. Growth may quicken thereafter as world trade rises more rapidly.

12. The UK's share of developed countries' exports of manufactures, which rose during 1986, may be slipping slightly during 1987, with further small falls forecast for 1988 and 1989. The forecast is for a slight fall also in the UK's share of the wider measure of world manufactured trade which includes NICs' exports. (See Chart A.). This projected share performance reflects mainly an assumption that the loss of competitiveness early this year has tended to restrain export growth fairly quickly, despite the fact that the forecast gives weight to the UK's improved export supply performance since 1981.

CHART A : UK VOLUME SHARES OF TRADE IN MANUFACTURES



13. The volume of manufactured imports which fell sharply in the first quarter of 1987, has risen rapidly again since April. Some of this volatility may reflect residual seasonal factors, but a strong rise in domestic demand for manufactures, rising capacity utilisation, and some loss of recorded competitiveness since the end of 1986 have probably been important factors. The erratic nature of the monthly figures makes difficult the assessment of the underlying trend. The forecast has a further rise in imports during the rest of this year followed by a more gradual rise during 1988 and 1989 as domestic growth falls.

14. Non-manufactured exports and imports have fallen back recently, following the exceptionally rapid growth of trade in wheat and olive oil towards the end of 1986 and in early 1987. (This rapid growth of imports and exports, largely the result of the peculiarities of the CAP, had little effect on the current balance.) Exports are projected to resume growth in 1988 and 1989 as world demand rises, but imports may be rather sluggish as the recent surge in basic material imports ends and imports of food, drink and tobacco return to their modest trend growth.

15. The non-oil terms of trade rose sharply in the first half of this year from the trough at the end of 1986 reflecting partly sterling's appreciation and partly the weakness of world food prices. The forecast is for little change in 1988 and 1989.

Oil trade

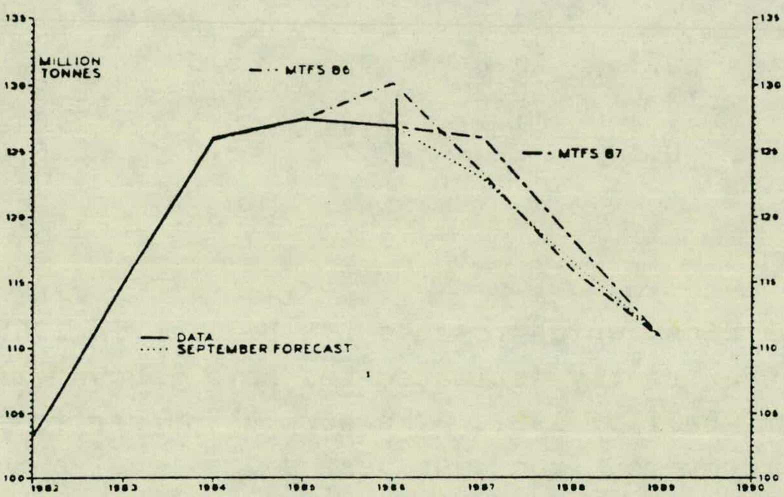
16. The strengthening in world prices during the first half of 1987 has helped to offset a lower than expected volume of North Sea output. On the assumption that oil prices remain close to their present level for the rest of the year and that some - but not all - of the production shortfall is made good, the oil trade balance should be a little higher than last year's £4 billion surplus.

TABLE 6: NORTH SEA OIL

	Average N.Sea oil price $/barrel	Average N.Sea oil price £/barrel	N.Sea output mn.tonnes	Oil trade balance £ bn	N.Sea* taxes £ bn
1986	14.2	9.7	126.9	4.1	4.8
1987	17.7	11.0	122.9	4.3	4.6
1988	18.0	10.7	116.5	3.3	4.5
1989	18.7	10.8	110.8	2.4	4.5

* financial year totals

CHART B : FORECASTS FOR NORTH SEA OIL PRODUCTION



17. The forecast that the average North Sea oil price will remain at $18 a barrel until the end of 1988 and then rise in line with world inflation implies a small fall in North Sea sterling prices next year as the dollar weakens and little change in 1989. North Sea output falls by 5 per cent a year in 1988 and 1989. The fall will largely be reflected in lower exports. The oil trade surplus is forecast to fall by about £1 billion in 1988 and a further £0.9 billion in 1989.

18. Table 7 summarises the forecast for trade volumes. Changes in aggregate exports and imports of goods and services mask divergent movements in components. The projected 3½ per cent a year growth in the volume of manufactured exports excluding erratics in 1988 and 1989 is offset partly by lower arms shipments to Saudi Arabia, a fall in oil exports and a reduction in the recent exceptionally high level of gold exports, together with a more modest growth in services credits, so that total exports only rise by 1½ per cent a year. Total imports are forecast to rise less rapidly than manufactured imports excluding erratics. This reflects mainly a decline in non-manufactured imports partly as a result of the ending of exceptional trade in olive oil and a fall in gold imports (offsetting the fall in exports).

TABLE 7 : EXPORTS AND IMPORT VOLUMES
(per cent changes on previous year)

	Manufactures excl. erratics	Erratics	Oil	Other goods	Total goods	Services	Total goods and services
Exports							
1986	1.1	28.0	2.0	5.5	3.7	1.0	3.1
1987	6.6	2.4	-0.6	6.9	5.2	4.5	5.0
1988	3.5	1.9	-4.0	0.7	1.5	1.9	1.6
1989	3.5	1.6	-6.5	2.2	1.6	1.8	1.6
Imports							
1986	5.6	-0.1	13.8	8.5	6.5	4.9	6.2
1987	9.6	+4.0	0.2	1.6	7.2	3.3	6.5
1988	7.5	-1.4	11.2	-3.0	5.3	3.6	5.0
1989	4.0	0.1	6.7	-0.7	3.2	2.6	3.1

10. Invisibles

19. The invisibles surplus, which rose to £7½ billion in 1986' compared to £5 billion in 1985, is currently estimated to have shown little further growth in the first half of 1987. The surplus on services has risen as travel earnings have recovered from last year's low level and earnings from financial services are estimated to have continued to rise. Net earnings from interests, profits and dividends (IPD), however, have fallen from the high level of late-1986 as the pound's appreciation has reduced the sterling value of overseas earnings, and margins on banks' overseas business have been squeezed.

TABLE 8 : THE BALANCE OF INVISIBLES (£ billion)

	Services	N.Sea IPD	Other IPD	EC transfers	Other transfers	Total invisibles
1986	5.0	-1.6	6.3	-0.7	-1.5	7.5
1987	5.6	-1.7	7.2	-1.7	-1.7	7.6
1988	5.5	-1.2	7.8	-1.6	-1.8	8.7
1989	5.7	-0.2	8.2	-1.7	-1.9	9.6

financial services?

20. The invisibles surplus is forecast to rise from about £7½ billion this year to £8¾ billion in 1988 and £9½ billion in 1989. The services surplus is unlikely to rise in 1988 as UK growth remains buoyant compared to overseas, but may improve in 1989 as the growth gap narrows. The main increase in the invisibles surplus seems likely to reflect falling payments abroad, to North Sea oil companies - as oil output declines - and a rise in other net IPD earnings as portfolio yields rise abroad and banks' margins return to more normal levels. Net transfers to the European Community are projected to show little change in 1988 and 1989 from this year's level. The precise profile of payments and receipts will of course depend on a number of factors on which decisions have not yet been taken. ? FS

(4) DOMESTIC DEMAND AND ACTIVITY

(a) Personal income and expenditure

21. Published figures for the first half of 1987 and retail sales for the year to August show consumer spending relatively sluggish at the start of the year, but picking up strongly since the spring. However, discrepancies in the national accounts for the first half of 1987 indicate a significant underrecording of one or more components of expenditure, so that growth of consumer spending growth may well not have fallen to 4 per cent as the recorded figures currently suggest. The figures for retail sales show growth as high as in 1986. Consumer spending seems to have been very strong in the third quarter of the year, and car registrations in August were 6 per cent higher than in August 1986.

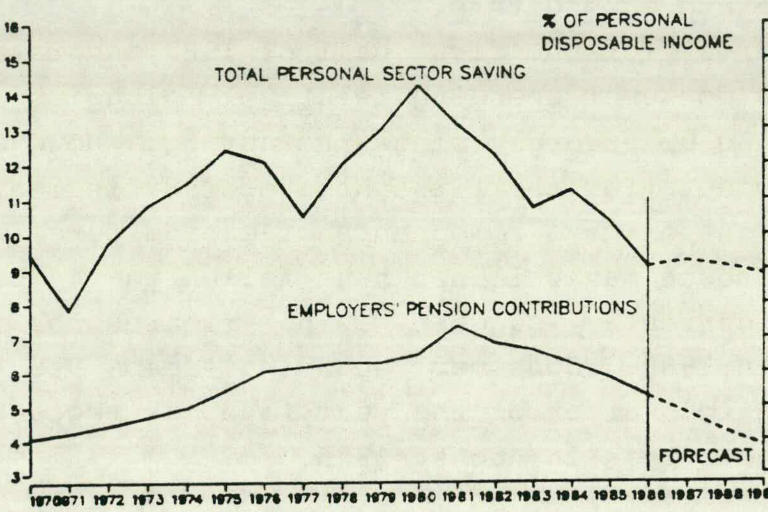
TABLE 9: RETAIL SALES AND CONSUMERS EXPENDITURE

	Retail Sales			Consumers' expenditure	
		Percentage change on			
	1980=100)	previous period	year earlier	(£ billion 1980)	(percentage change on year earlier)
1986 Q1	119.3	1.7	4.3	39.5	5.1
Q2	121.3	1.7	4.7	40.1	6.6
Q3	123.7	2.0	5.5	40.7	5.8
Q4	126.5	2.3	7.3	40.9	5.6
1987 Q1	125.4	- 0.9	5.1	41.1	4.1
Q2	128.2	2.3	5.8	41.8	4.2
Q3*	131.9	3.2	7.0		
Jan	123.6	- 2.4	4.6		
Feb	127.0	2.8	7.1		
Mar	125.5	- 1.2	3.8		
Apr	130.0	3.6	7.7		
May	125.4	- 3.5	4.8		
June	129.4	3.2	5.0		
July	131.2	1.4	7.0		
Aug	132.5	1.0	6.9		

* Average of July and August

22. Between 1980 and 1986 the personal saving ratio has fallen by about a third, and it is currently close to the levels recorded in the latter part of the 1960s and in the early 1970s, before the dramatic rise in inflation. Part of the recent fall in the saving ratio (and part of its rise in the second half of the 1970s) is probably attributable to the behaviour of employers' contributions to pension funds. (See Chart C). Employers' pension contributions are recorded as part of personal income, but short-term fluctuations in them are unlikely to affect personal expenditure to anything like the extent that changes in after tax wages and salaries do. Instead they are likely to show up in fluctuations in the personal saving ratio.

CHART C. EMPLOYERS' PENSION CONTRIBUTIONS AND THE PERSONAL SAVING RATIO



23. The rise to 1981 in pension fund contributions as a proportion of personal disposable income reflected expanding coverage of schemes and topping up payments made to cover actuarial deficits caused by the rise in inflation and the plunge in the stock market in the mid 1970s. In 1980 and 1981 there was also a rise in redundancy payments and an effect from the composition of employment. The fall in employment in this period particularly affected manual workers who would be less likely to be covered by private pension schemes.

24. The subsequent fall in pension contributions relative to wages and salaries must reflect in large part the impact on pension funds of the recovery in profitability and stock markets and the fall in inflation experienced since 1981. This has led to large actuarial surpluses, and an increasing number of firms have temporarily stopped making pension contributions. The 1986 Budget, which required reductions in actuarial surpluses where these exceeded liabilities by more than 5 per cent, and the

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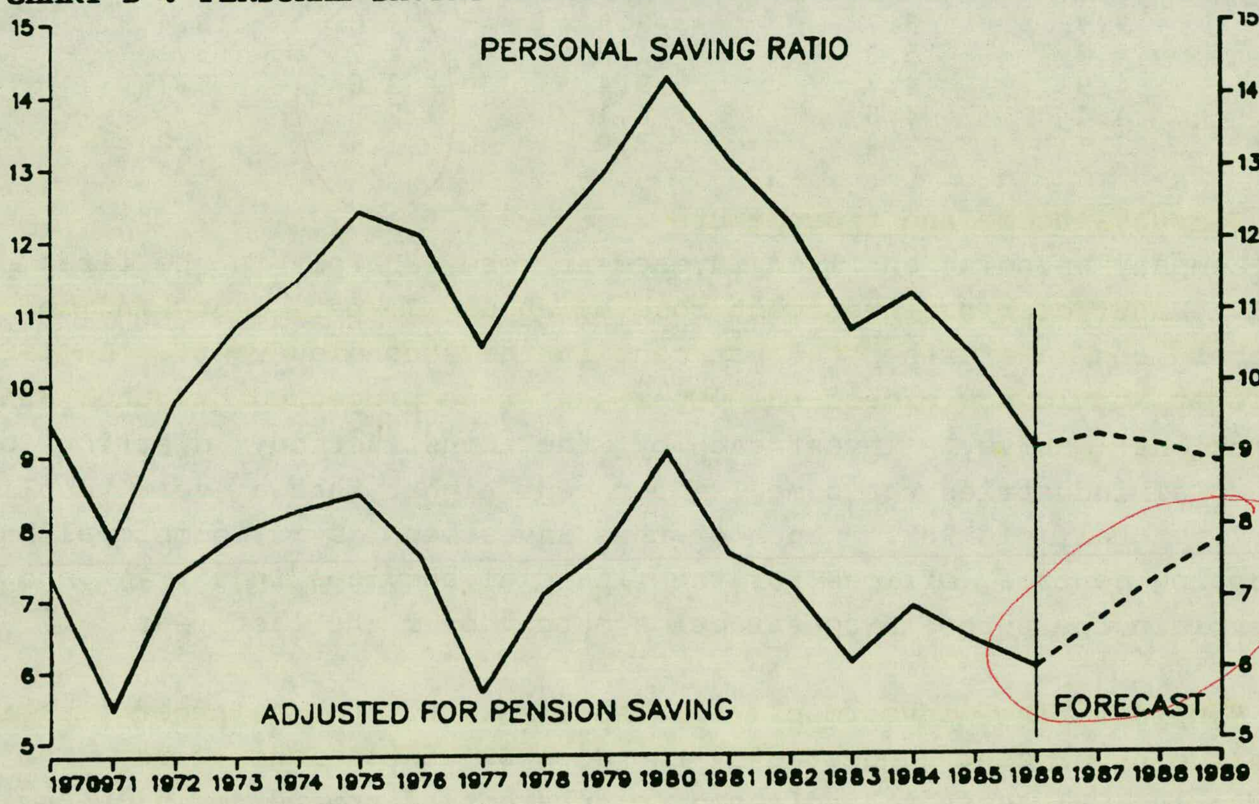
continuing rise in profitability and dividends are likely to ensure a further fall in pension contributions relative to pay. This in turn is likely to mean that the personal saving ratio is likely to fall a little further between 1987 and 1989, even though higher inflation and interest rates may be tending to restrain spending (see chart D). (The apparent rise in the recorded personal saving ratio so far in 1987 may be an illusion, reflecting under-recording of consumer spending.)

CHART D : PERSONAL SAVING ADJUSTED FOR PENSION FUND CONTRIBUTIONS



25. The published figures show real personal investment in dwellings weak in the first half of 1987, falling some 4 per cent from the second half of 1986. Spending on both improvements and investment in new dwellings was apparently lower than a year earlier in the second quarter of 1987, a development that is hard to understand given the general buoyancy of personal spending and in particular given the rise in the rate of house completions over the last year.

26. Nevertheless it does look as though housing starts, which were rising through 1986 and into the first quarter of 1987, have now flattened out. Even so for 1987 as a whole housing starts may be at least 5 per cent higher than last year. Completions should go on rising into 1988. In spite of the surprising investment figures for the first half of 1987, the forecast is for a 10 per cent rise in investment in dwellings in the year as a whole, followed by a 6 per cent rise in 1988. By 1989 investment in new dwellings may have stopped rising, although expenditure on improvements should continue to grow quite strongly.

27. Fast growth in both house prices and real personal investment combined with a falling saving ratio mean that the personal sector's financial surplus, which has already declined from about 6 per cent of GDP in 1980 to just over 1 per cent in 1986, is likely to fall further.

TABLE 10: REAL PERSONAL INCOME AND EXPENDITURE

	Real personal disposable income	Real consumers' expenditure	Real investment in dwellings	Persons' net acquisition of financial assets	Personal saving ratio	Saving ratio excluding pension saving
	(Percent changes on previous year)			(£ bn)	(per cent)	(per cent)
1985	2.7	3.7	-3.9	9.0	10.4	6.4
1986	4.3	5.8	11.8	4.7	9.1	6.0
1987	4.9	4.7	9.4	3.6	9.2	6.7
1988	4.4	4.6	6.1	2.6	9.1	7.3
1989	3.1	3.4	3.9	1.4	8.8	7.8

(b) **Company income and expenditure**

28. Company spending on fixed investment rose sharply in the first half of 1987. Manufacturing investment rose by about 7 per cent in the first quarter and a further 6½ per cent in the second quarter. In 1987 as a whole it should now exceed the 4 per cent rise projected by the June DTI intentions survey. Investment by the construction, distribution and financial industries was some 12½ per cent higher than a year earlier in the first half of 1987. Much of this investment is in commercial building (shopping centres, offices for the financial services industry) and helps to explain the surge in construction output over the last year.

29. Manufacturing investment is also likely to show a larger rise in 1988 than the 6 per cent suggested by the June DTI intentions survey. The latest quarterly CBI survey indicated a substantial upward revision during the summer to intended expenditure on both buildings and plant and machinery. Other private sector business investment may also rise quite strongly again next year, and the build up of work on the Channel Tunnel will contribute to a further rise in construction work. Table 11 summarises the forecast for investment. Nationalised industry investment is much less buoyant than private sector investment, and reduces the growth of "other business" investment shown in table 11.

TABLE 11: GROSS FIXED CAPITAL FORMATION

(percentage changes on previous year)

	1986	1987	1988	1989
Business	- 3	6½	5½	3½
of which				
North Sea	- 14½	- 20	4	- 4½
Manufacturing	- 5	7	10½	8
Other business	- 1	8½	4	2½
Private dwellings	7½	7	5½	3
General government	5½	- 2½	- 3	0
Total	½	5	4½	3

30. Manufacturers reduced their stocks during the first half of 1987. Some of this destocking may have been unintended: by the summer manufacturers were telling the CBI for the first time this decade that on balance they no longer held excessive stocks. This year has also seen a decline in the balance of firms expecting stocks to fall. Distributors' stocks rose during the first half of 1987, though not enough to prevent a fall in the ratio of stocks to sales. The rise in consumer goods imports in the third quarter may indicate a stronger rebuilding of stocks. The forecast is for some further gradual fall in the stock output ratio, but at a slower pace than recorded in recent years. (The main reaction to the tax changes in the 1984 which raised the cost of stockholding should now have taken place.) This implies an increased rate of stockbuilding over the forecast period, though stockbuilding remains on a modest scale compared with ~~many~~ most years of the 1960s and 1970s.

31. Non-North Sea industrial and commercial companies' profits net of stock appreciation rose by 13 per cent between the first halves of 1986 and 1987. Part of this rise is accounted for by reallocation of newly privatised companies (especially BGC) to the private sector. Excluding the profits of such companies the growth of profits was probably 10-11 per cent over this period - a slower rate of growth than recorded in recent years but still above the growth of money GDP. For 1987 as a whole the underlying growth of non-North Sea ICCs' profits is forecast to be similar to that experienced in the first half of the year. Profit growth may slow further in 1988, as output growth slows down and the rate of increase in costs rises slightly. This outlook for profits, at a time when company expenditure is likely to be rising strongly, implies a fall in companies' financial surplus - not, however, to an extent that should pose any general financial problems for companies.

TABLE 12: THE FINANCIAL POSITION OF INDUSTRIAL INDUSTRIAL AND COMMERCIAL COMPANIES

	Profits as a share of money GDP (per cent) Total	Non-oil	Rate of return on assets, non-oil ICCs' (per cent)	Net acquisition of financial assets (£ bn) (all ICCs)	Borrowing requirement (£ bn) (all ICCs)
1973-85 average	12.0	8.9	5.5	2.2	3.6
1986	15.0	12.5	8.9	6.4	6.1
1987	15.9	13.2	9.6	9.3	14.0
1988	15.2	13.0	9.2	4.2	11.0
1989	15.2	13.2	9.3	4.5	10.0

32. Table 13 shows the forecast for industrial and commercial companies' gross trading profits. The table also shows companies' net income - which is net of interest payments and receipts and corresponds roughly to the base for corporation tax. The slowing of net income growth in 1988 partly reflects the rise in interest rates forecast for the start of the year.

TABLE 13: PROFITS OF INDUSTRIAL AND FINANCIAL COMPANIES
(percentage changes on previous year)

	Non-North Sea Industrial and Commercial Companies* Gross Trading Profits	Net Income	Financial Companies Net Income
1986	19 (16)	26	21
1987	16 (13)	18½	19
1988	7½	3½	16½
1989	7½	6	6½

* Figures in brackets show growth of profits adjusted to exclude the effects of newly privatised companies being included.

(c) **Aggregate demand and output**

33. The average estimate of GDP grew by 3¾ per cent between the first halves of 1986 and 1987, while the output estimate grew by around 4¼ per cent (4¾ per cent non-North Sea). Output growth was particularly strong in the construction sector (up by 7½ per cent), and manufacturing output also recorded a rise of 5 per cent. The full extent of the rise in output is not explicable in terms of recorded expenditure. The expenditure estimate of GDP shows less than a 2½ per cent rise over the same period.

34. For 1987 as a whole the output measure of GDP seems likely to record a rise of 4 per cent or a little more. It is likely that the

average estimate of GDP will eventually show a similar increase. But there is some risk that, if the problems with the expenditure measure persist into the second half of the year, recorded growth could be a little under 4 per cent on the average estimate when the first figures for calendar 1987 are published by the CSO at around the time of the Budget. Given the record of upward revisions to GDP at the times of fast output growth it is quite likely that recorded growth for the average measure of GDP in 1987 will eventually settle down at a figure above 4 per cent.

35. Growth is expected to fall back to around 3 per cent in 1988 (3½ per cent non-North Sea). This slowing down is caused by a worse trade performance and by some deceleration in personal spending. After two years of above trend growth in 1987 and 1988, 1989 could see somewhat slower growth if the investment cycle has started to turn down by then.

TABLE 14: EXPENDITURE AND OUTPUT

(percentage changes on previous year)

	1986	1987	1988	1989
Domestic demand	3.8	3.9	4.1	2.9
Exports of goods and services	3.1	5.0	1.6	1.6
Imports of goods and services	6.2	6.5	5.0	3.1
Compromise adjustment	0.4	0.8	0	0
GDP(A)	3.1	4.1	3.0	2.4
Non-oil GDP(O)	3.1	4.5	3.5	2.8
Manufacturing output	1.1	5.2	2.9	3.2

(5) INFLATION

36. RPI inflation is likely to average close to 4 per cent in the fourth quarter of 1987, in line with the forecast published in the FSBR. Producer output prices, on the other hand, seem likely to rise some ½ per cent more on average this year than forecast at Budget time, principally as a result of higher input prices. In the third quarter of 1987 materials and fuel input prices were some 7 per cent higher than forecast at Budget time. Inflation as measured by the main national accounts deflators, however, was actually lower in the second quarter than expected at Budget time. There is currently an unusually large difference between inflation as measured by the RPI and inflation as measured by the national accounts consumption deflator. The national accounts deflators are subject to revision, and revisions tend to be upward.

Producer prices

37. Productivity growth of around 7 per cent has left manufacturers' unit labour costs virtually unchanged over the last year. In spite of the rise in materials costs over the last year, manufacturers' total unit costs are still no higher than they were at the start of 1985. Over the forecast period there is likely to be a modest rise in unit labour costs, as productivity growth reverts to its estimated underlying rate of increase, and real commodity prices may continue a gradual recovery from their exceptionally depressed levels of 1986. However, with a stable exchange rate for sterling, manufacturers will find it difficult to raise profit margins to anything like the extent they have done over the last three years. A slight reduction in inflation is expected during 1988, and inflation may fall further in 1989 if the economy slows down as forecast and competitive pressures intensify.

TABLE 15: MANUFACTURING COSTS AND PRICES

(percentage changes on previous year)

	Unit labour costs	Cost of materials and fuels	Estimated total costs	Domestic producer output prices*
1986 Q4	0.2	- 5.6	- 0.4	3.9
1987 Q4	0.9	7.7	2.2	4.8
1988 Q4	3.0	2.2	2.9	4.4
1989 Q4	2.8	3.1	2.4	3.2

* excluding food, drink and tobacco

Retail prices

38. Although retail price inflation in the fourth quarter of 1987 may turn out marginally below the Budget forecast, inflation is likely to rise during the first half of 1988 to around 5¼ per cent by the end of the year. This rise in inflation reflects in particular substantial electricity and gas price increases, a large rise in local authority rates, the loss of the benefits of the non-revalorisation of specific duties in the 1987 Budget, and a forecast rise in mortgage rates, as well as the effect of faster growth of unit labour costs.

39. Table 16 sets out changes in nationalised industry prices charged to domestic consumers over the year to 1987 Q4 and 1988 Q4, and gives real price increases over a run of financial years.

TABLE 16 : NATIONALISED INDUSTRY PRICES

(a) <u>Nominal price increases for consumers</u>

	Year to 1987 Q4	Year to 1988 Q4
Post	2.6	4.5
Rail	5.7	5.0
Electricity	- 0.3	8.0
Coal and coke	- 0.1	2.2
Bus	4.9	4.3
Water	5.6	6.4

(b) <u>real price increases (weighted average for consumers and industry)</u>

	1983-4	1984-5	1985-6	1986-7	1987-8	1988-9	1989-90
British Coal	2.3	0.0	- 1.9	- 3.1	- 4.5	- 2.9	- 2.4
Electricity	- 3.8	- 2.0	- 2.2	- 1.9	- 3.9	2.9	0.0
BSC	- 8.1	1.1	- 4.6	- 1.8	- 1.6	- 2.3	- 1.7
Post Office	- 2.0	- 1.5	- 4.2	- 2.0	- 0.8	- 0.4	- 1.0
Water	1.5	1.0	4.7	4.4	1.7	1.4	2.0
LTR	-15.7	- 3.2	1.5	2.2	2.1	4.4	4.1
British Rail	- 4.5	0.4	0.0	2.8	1.2	- 0.2	- 0.9

* Nominal changes deflated by the RPI

40. The larger increases in nationalised industry prices charged to consumers in 1988 will raise RPI inflation in 1988(4) by about ¼ per cent compared with inflation in 1987(4). Other factors that contribute to the rise in RPI inflation between 1987(4) and 1988(4) are as follows:

(i) The formula relating **gas prices** to oil prices and the RPI should give almost a 4 per cent rise in domestic prices next year, following a 4½ per cent fall this year (the difference is worth about 0.2 per cent on inflation).

(ii) The rate support grant settlement is assessed as implying an 12 per cent rise in average **local authority rate** poundages next year, compared with 7¾ per cent this year (the difference is worth 0.18 per cent on inflation).

NS.

(iii) A 1 point rise in mortgage rates compared with their end September level means that the path of mortgage interest payments adds about 0.4 per cent more to RPI inflation next year than this.

(iv) The assumed indexation of specific duties in the 1988 Budget will add a little over 0.3 per cent to RPI inflation in the latter part of 1988 compared with the latter part of 1987.

(v) Food prices are also likely to rise a little faster over the next year. Although world food prices are expected to remain relatively weak, a partial recovery in tropical beverage prices means that the prices of the foods the UK buys on world markets will rise a little more in 1988 than in 1987, and the faster rise in UK labour costs will also tend to put up food retail prices inflation.

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(vi) Petrol prices have been unexpectedly low during the summer - the normal seasonal rise did not occur - in spite of the strength of crude oil prices. Over the next year there may be little change in petrol prices, other than that resulting from the assumed indexation of petrol duties in the 1988 Budget.

(vii) Other private sector prices have risen by 3½ per cent over the last year. (They would have risen by about 4 per cent but for the non-indexation of duties in the 1987 Budget.) Making a small allowance for the possibility that some of the acceleration of producer output prices in recent months has still to feed through into these prices and for the effect of the recent rise in pay settlements, these prices could rise by around 4¼ per cent over the next year.

41. The forecast for the RPI is summarised in table 17.

TABLE 17: COMPONENTS OF THE RETAIL PRICE INDEX
(Percentage changes on previous year)

	1986 Q4	1987 Q4	1988 Q4	1989 Q4
Food prices	3.2	3.4	3.9	3.5
NI prices	3.7	2.3	6.3	4.3
Housing prices	7.1	7.5	11.4	8.1
Other prices	2.6	3.4	4.1	3.5
- of which				
petrol	3.4	-12.6	1.8	3.4
- other items	3.8	3.4	4.2	3.4
All items RPI	3.4	3.9	5.3	4.3
RPI excluding mortgage interest payments	3.4	3.7	4.6	3.9

NB

42. The annual rate of increase in the RPI should fall below 4 per cent in November when the mortgage rate increase that occurred in November 1986 drops out of the twelve month comparison. The inflation rate will rise again early next year on the assumption that the mortgage rate rises at the beginning of the year. Inflation is likely to rise quite sharply after March as post Budget increases in specific duties and rates and electricity price increases show up in the index. The forecast monthly path of retail price inflation up to the end of 1988 is shown below.

& doesn't then fall despite PSBR

TABLE 18: MONTHLY PATH OF RPI INFLATION

		All items RPI	RPI excluding mortgage interest payments			All items RPI	RPI excluding mortgage interest payments
1987	August	4.4	3.7	1988	April	4.5	4.2
	September	4.2	~~3.4~~ 3.5		May	4.9	4.3
	October	4.3	3.6		June	5.1	4.4
	November	3.8	3.7		July	5.2	4.5
	December	3.7	3.7		August	5.3	4.6
					September	5.5	4.7
1988	January	3.9	3.6		October	5.4	4.6
	February	3.9	3.6		November	5.3	4.5
	March	4.1	3.7		December	5.3	4.5

V. expens! for PX

(c) **The GDP deflator**

43. The national accounts deflators published for 1987Q2 are surprisingly low. The CSO are currently looking at some aspects of the figure for the deflator for consumers expenditure, and have indicated that it is quite likely that the figure will be revised up. The latest published figure for the GDP deflator (showing a 4.1 rise in the GDP deflator at market prices over the year to 1987Q2) does not suggest any overrun of the Budget forecast for the current financial year which was for a 4½ per cent rise in the GDP deflator.

44. For 1988-89 most of the factors tending to push up the RPI (other than the path of mortgage rates) will also affect the GDP deflator. The GDP deflator will also be affected to the extent that the current boom in construction output feeds into construction prices and the forecast has a modest allowance for this effect in 1988-89.

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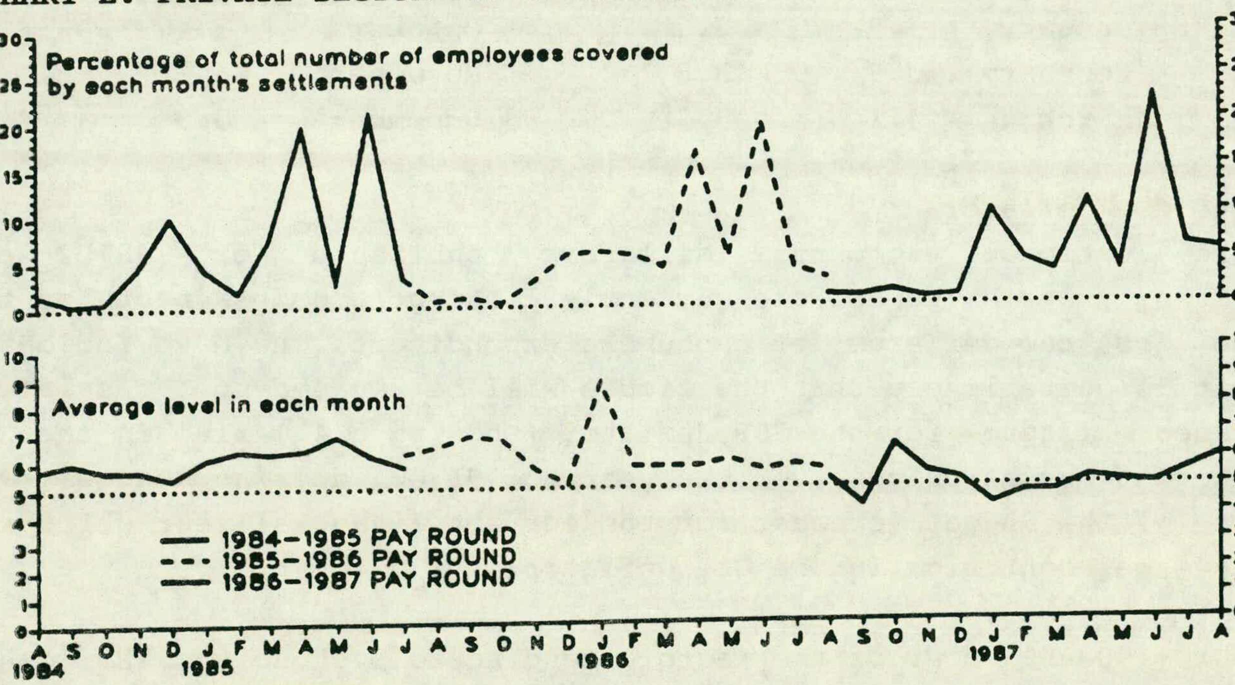
TABLE 19: FORECASTS FOR THE DEFLATOR FOR GDP AT MARKET PRICES

	1986-87	1987-88	1988-89	1989-90
MTFS				
Total	3	4½	4	3½
non-oil	6	4¼	3¾	3¼
Autumn forecast				
Total	3	4½	5½	5¼
non-oil	5¾	4	5½	5

(d) **Earnings**

45. Over the twelve months to August 1987, private sector pay settlements monitored by Department of Employment averaged 5 per cent, about ¾ per cent less than during the previous twelve month period. Settlements fell during the second half of last year, but appear to have bottomed out at around the beginning of 1987, and in the most recent month settlements averaged 6 per cent (see Chart E).

CHART E: PRIVATE SECTOR PAY SETTLEMENTS



46. Other evidence on settlements, such as that from the CBI's pay databank, tells a similar story. Although a relatively small number of employees are covered by the most recent settlements, the upward trend seems well established and it is not likely that as major settlements are concluded over the autumn they will generally be at rates below 6 per cent. This forecast assumes 6 per cent settlements on average over the next twelve months. Settlement rates may thereafter rise further (reflecting inflation at around 5½ per cent in mid 1988), but fall back in the second half of 1989 as the economy slows further and price inflation falls.

What happened in 1985?

47. Overtime has been very high in recent months - at around record levels in relation to the number of operatives - and is currently estimated to be responsible for around ½ percentage point of the 8 per cent growth of private sector earnings over the last year. Over the next two years cyclical effects will tend to reduce earnings growth, and will offset the effect of rising pay settlements.

TABLE 20: PRIVATE SECTOR SETTLEMENTS AND EARNINGS
(Contributions to changes between third quarters of successive years)

	1986-87	1987-88	1988-89
Settlements	5¼	6	6½
Drift	2¾	2	1½
Increase in average earnings	8	8	8

48. Over the twelve months to August growth in local authority earnings has been roughly in line with private sector, while central government earnings has been a little lower. Over the following twelve months, local authority pay seems likely to rise somewhat faster than private sector pay. The teachers are already due for 8.2 per cent from October and a further 1 per cent next April. The forecast assumes that they receive only 4½ per cent "new money" on top of this in the light of Cabinet's decision not to pay more than the increase in the RPI. Local authority manuals have already agreed an increase of 10½ per cent. Local authority construction workers may also do well, particularly given the pressures from construction workers' pay in the private sector (up over 10 per cent in the year to June). It seems likely that some important groups of local authority workers will continue to do better than the private sector. While others (eg further education teachers) may do worse, local authority pay on average looks likely to rise a little faster than private sector pay.

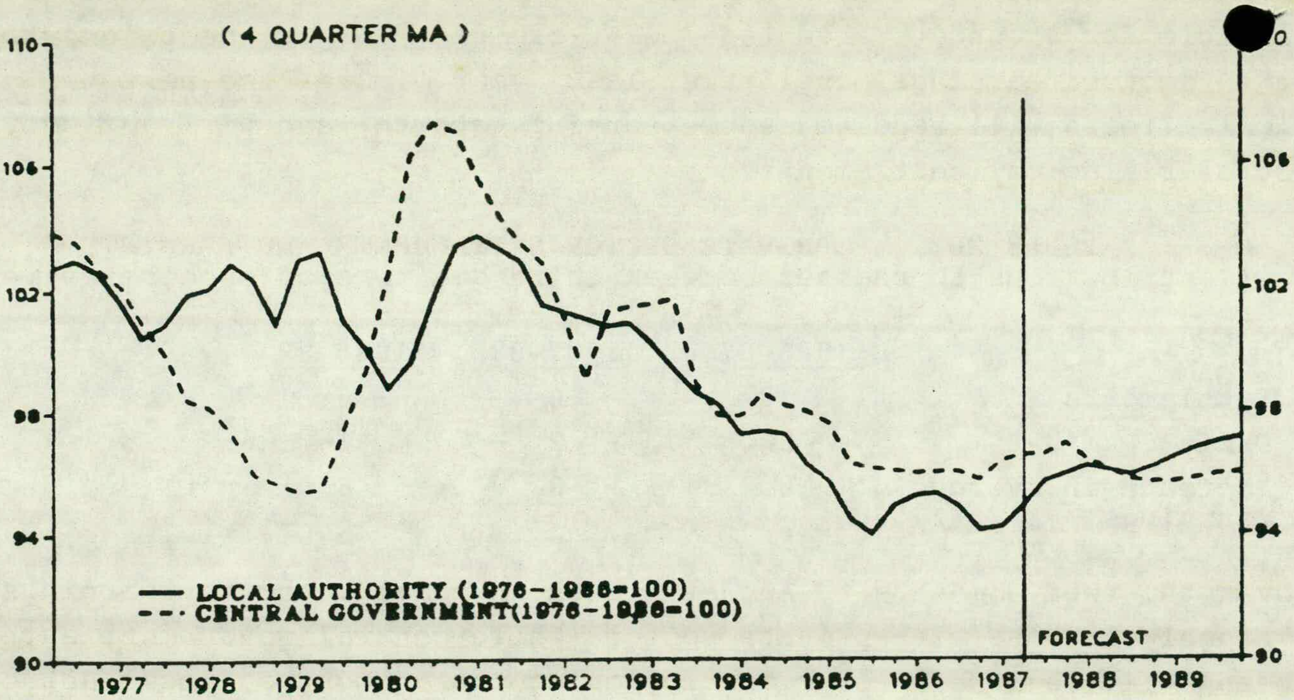
49. On the other hand, central government earnings are likely once again to rise more slowly than private sector earnings over the next year. If there is a relatively high settlement for health service employees, it could well be staged, while a settlement for civil servants below the private sector average is expected. In later years central government pay is expected to rise more closely in line with private sector pay.

TABLE 21 : PUBLIC AND PRIVATE SECTOR UNDERLYING AVERAGE EARNINGS
(percentage changes over years to August)

	Central Government	Local authorities	Private sector**
1986-87	7	8 (7)*	7½
1987-88	7	9½(9¼)*	8
1988-89	8	9 (8¾)*	8½

* figures in brackets excluding settlements for primary and secondary teachers
** adjusted for changes in overtime hours.

CHART F : RATIO OF LOCAL AUTHORITY AND CENTRAL GOVERNMENT EARNINGS TO PRIVATE SECTOR AVERAGE



(e) Labour costs

50. The forecast for private sector earnings combined with the forecast for productivity (discussed in section 6 below) produces forecast increases in labour costs in manufacturing that are modest by past standards, and close to those forecast for competitor countries.

TABLE 22 : LABOUR COST INCREASES IN MANUFACTURING
(percentage increases on previous year)

	UK	Major 7 (less UK)
1986	3.4	2.3
1987	0.0	1.3
1988	3.3 ?	1.6
1989	2.6	2.3

(6) PRODUCTIVITY, EMPLOYMENT AND UNEMPLOYMENT

51. The latest upward revisions to manufacturing output mean that manufacturing productivity is now estimated to have risen by around 7 per cent in the first seven months of this year compared with a year earlier. While much of the recent rise in productivity is the result of a cyclical increase in the intensity of use of labour (as indicated by the rise in overtime hours), it seems that underlying productivity growth may have been a little higher recently than has been previously assumed. For this forecast the projection of underlying productivity

growth has been raised from 4 to 4¼ per cent a year.

52. Employment outside manufacturing rose by over 130,000 during the first quarter of 1987. Current indications are that the second quarter showed an increase of around 120,000. Growth in output per man outside manufacturing was unusually strong during 1986 - reflecting, among other things, redundancies in the coal industry and good productivity gains in other public corporations -, but as far as can be discerned has been much slower this year. Underlying growth in private sector non-manufacturing productivity is projected at around 1¾ per cent a year (about 2½ per cent a year in terms of full time equivalents).

TABLE 23: RECORDED AND FORECAST GROWTH OF OUTPUT PER HEAD

Annual averages, percentage changes

	1964-73	1973-79	1979-86	1986-89
Manufacturing	5¾	¾	3¾	5
Non-manufacturing*	3	½	1¼	1½
Total non-oil economy	2¾	½	1¾	2¼
Whole economy	2¾	1	2	1¾

* Includes private sector and nationalised industries other than in manufacturing and oil.

53. Labour supply is forecast to grow by about 680 thousand over the three years to 1989, about 200 thousand less than in the previous three years. This projection is somewhat higher than growth shown in the projections published in the Employment Gazette because the UK's relatively strong economic performance is likely to lead to both higher net inward migration and higher participation ratios than allowed for in the Department of Employment's projections.

TABLE 24: PRODUCTIVE POTENTIAL

(Annual averages; percent changes)

	Trend non-North Sea productivity growth	Labour supply	Non-North Sea productive potential	Contribution of North Sea	Whole economy productivity potential
1973-79	1	½	1½	½	2¼
1979-86	1½	½	2	¼	2¼
1986-89	2	¾	2¾	- ½	2½

54. Growth in the "working population" - the sum of employment and unemployment - has been very low over the past year: around 40,000 between mid 1986 and mid 1987, below the projected growth in labour supply, and down from increases of over 500,000 a year between mid 1983 and mid 1985. This is the phenomenon publicised by Layard and Clarke. The employment programmes which have been expanding recently and other measures such as Restart have tended to reduce the working population. (This is not the case with the Community Programme, whose participants are generally counted as employees and so remain in the working population).

55. But government programmes and Restart are not the only factors responsible for the recent slow growth of the working population. One important factor has been that the composition of employment growth has changed somewhat in favour of areas where most of the jobs are filled by men. Construction employment has started to rise, manufacturing employment has flattened out, and the programme of redundancies in the coal industry has - at least for a while - come to an end. Thus a higher proportion of new jobs have been going to claimants, and a smaller proportion to non-claimants. Moreover, the growth of the "working population" between 1983 and 1985 was quite exceptional relative to growth in the population of working age. It was never likely to be sustained and does not provide a reasonable benchmark against which to assess the impact of Restart and other recent measures. Between mid 1986 and mid 1987 the shortfall of growth in the working population relative to the projected increase in population of working age was some 130,000 - much less than the fall in unemployment over this period (roughly 290,000 including school-leavers). As shown in table 25, on our estimates of the effects of the various measures, about two thirds of the improvement in the adult unemployment trend as between the year to mid 1986 and the year to mid 1987 is attributable to underlying economic factors rather than to the effect of measures.

56. Unemployment is likely to fall more slowly during the forecast period. This is primarily because the 5 per cent growth in manufacturing output and 7 per cent rise in construction output forecast for this year are not forecast to be repeated over the next two years and so male employment growth will slow down. Nevertheless, helped by the removal from the count in September 1988 of everyone under 18, unemployment could go on falling into 1989.

SECRET

TABLE 25 CHANGES IN ADULT UNEMPLOYMENT

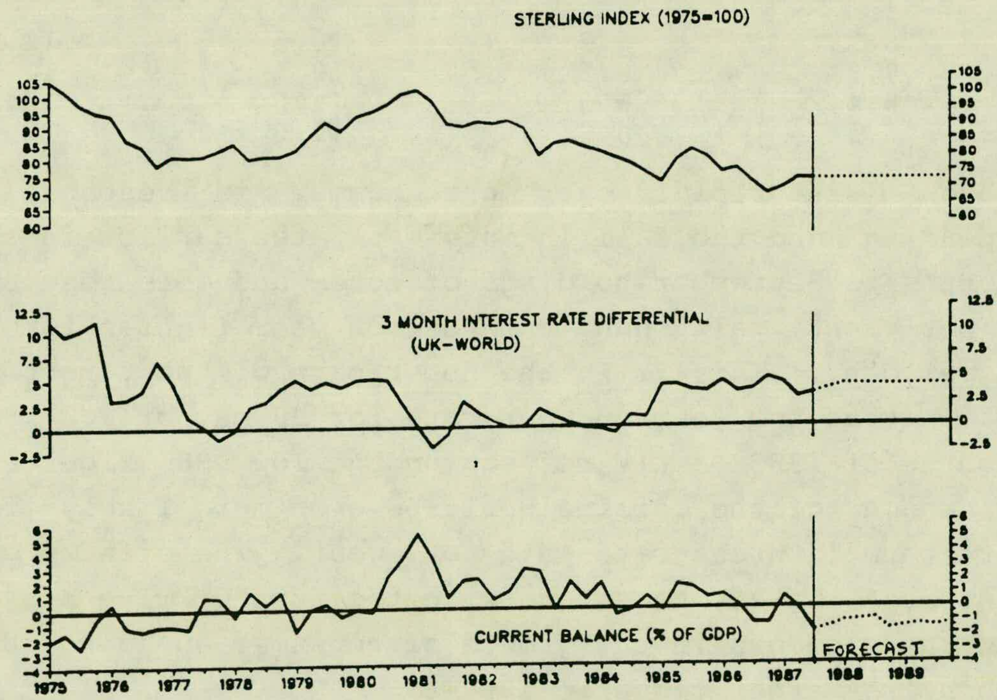
(seasonally adjusted 000s)

	Unemployment	Effects of employment and training measures, restart and availability testing	Underlying unemployment
1985(2)-1986(2)	+ 88	- 64	152
1986(2)-1987(2)	- 238	- 173	- 65
1987(2)-1988(2)	- 322	- 117	- 205
1988(2)-1989(2)	- 135	- 64	- 71

(7) FINANCIAL CONDITIONS

57. WEP has a rise in US interest rates during 1988, which is judged sufficient to limit the fall in the dollar exchange rate to modest proportions. With interest rates in the other major economies flat the average world interest rate rises. Because this rise in the average world interest rate is the consequence of likely downward pressure on the dollar exchange rate there could be some upward pressure on sterling against the dollar. However, the prospect that the UK current account deficit will widen in 1988 and 1989 could raise expectations of some decline in the sterling exchange rate with a need for an increase in interest rates in order to achieve a constant sterling index.

CHART G : STERLING AND THE CURRENT BALANCE



SECRET

TABLE 26: EXCHANGE RATES AND COMPETITIVENESS
(average yearly rates)

	US dollar index (1975=1000)	Sterling index (1975=100)	$/£	DM/£	DM/$	Relative unit labour costs (1980=100)
1984	134.6	78.6	1.34	3.79		82.9
1985	140.7	78.2	1.30	3.78		84.5
1986	114.8	72.8	1.47	3.19		77.3
7 Oct	101.5	73.3	1.64	2.998		75.4
1987	102.4	72.0	1.61	2.94	1.826	74.8
1988	98.1	72.5	1.68	2.94	1.75	76.7
1989	94.6	72.5	1.73	2.87	1.659	76.9

58. Domestic factors also point to upward pressure on interest rates. MO will be very close to the top of its target range in the near future, reflecting strong growth in consumers' expenditure. Money GDP growth is expected to overshoot the objectives set in the 1987 FSBR in every year in the forecast period. Continued strong credit demand from the private sector - both companies and persons - tends to offset the decline in the needs of the public sector. The forecast has short-term interest rates rising over the next few months to reach 11 per cent by the middle of 1988Q1. This rise, however, is not sufficient to bring the growth of money GDP back to its MTFS path.

TABLE 27: INTEREST RATES

	3-month US interest rates	3-month world rates	3-month sterling LIBOR	Mortgage rate
7 October	7.9	6.9	10.2	11.3
1986-87	6.2	6.3	10.5	11.7
1987-88	7.3	6.6	10.1	11.5
1988-89	8.4	6.9	11.0	12.3
1989-90	8.5	6.9	11.0	12.3

59. M0 has been rising rapidly over the summer in response to buoyant consumer spending and the fall in interest rates earlier in the year. In the three months to September holdings of notes and coin rose at an annual rate of 8 per cent, although the year on year figures for M0 have been closer to 5 per cent. This is in the upper part of the target range, and the forecast is that the year-on-year rate for M0 may breach its ceiling in the early months of 1988 partly reflecting the low M0 figures in early-1987. (A breach of the ceiling would be even more likely if the assumed rise in short term interest rates did not occur.) The effects of the recent rise in interest rates together with the further rise projected in the forecast and the slowdown in the growth of consumer spending should bring M0 back within its target range in 1988-89.

TABLE 28: MONETARY AGGREGATES AND CREDIT

(per cent change on a year earlier)

	M0 MTFS range	M0 Actual forecast	M3	M4	Lending by banks and building societies
August 1987	-	4.7	22.1	15.6	18.8
1986-87	2-6	4.3	19.0	14.9	18.5
1987-88	2-6	5.1	20.4	14.9	18.9
1988-89	1-5	4.4	16.2	13.8	17.2
1989-90	1-5	3.4	13.0	12.7	14.8

60. Broad money has continued to grow rapidly, with M3 increasing by 22 per cent in the year to August reflecting a continued strong rise in deposits by persons, ICCs, and building societies with some slowdown in deposits by other financial institutions after the surge early in the year. The forecast is that M3 growth may slow next year. Persons' deposits may continue to rise rapidly reflecting rising personal incomes and the relative attractiveness of high-interest bank accounts. Companies' deposits, however, may increase less rapidly than in the recent past as their investment in real asset rises. Deposits by financial institutions may grow markedly less quickly than recently as a result of lower inflows to pension funds and a slower rise in their total portfolio. The growth of M4 which contains a greater proportion of personal sector deposits, continues to rise less rapidly than M3 initially, but the gap closes later in the forecast period.

61. Lending by banks and building societies which rose by 19 per cent in the year to August, is forecast to rise by a further 17 per cent in 1988-89 before slowing in 1989-90. Lending to companies is projected to rise as ??? less buoyant securities markets limit at least to some extent companies' scope to rely on equity issues. Lending to persons is also projected to rise steadily for both housing and other purposes. Competitive pressures on building societies and the limit on their access to wholesale funds continues to erode their share of new mortgage advances.

62. The PSBR is assumed to be funded fully outside the banking system, but the move to a negative borrowing requirement leads to net gilt repayments of £7 billion in 1988-89 and £6½ billion in 1989-90 - even on the assumption that receipts from National Savings are reduced to £1 billion a year. Gross gilt sales fall from £9½ billion in the current financial year to £3½ billion in 1988-89 and £1½ billion in 1989-90.

63. The emergence of a growing current account deficit coupled with continued net direct investment outflows and further portfolio investment abroad by financial institutions implies the need for substantial

offsetting capital inflows. The precise form of these is difficult to judge. The forecast assumes that corporate security issues on both the euro currency and US commercial paper market will play a significant role. Banks are also assumed to increase both their foreign currency and sterling borrowing from abroad for on-lending to residents. Net overseas sales of gilts are projected at zero. The forecast assumes that £1 billion of the intervention so far in 1987-88 is unwound before the end of the financial year with a further £1 billion in 1988-89.

TABLE 29: NET EXTERNAL CAPITAL FLOWS

	Direct invest -ment††	Non bank port-folio*	Banks' foreign currency†	Banks' ster-ling	Other	Official reserves	Balan-cing item	Current balance
1986	-6.0	-7.1	2.9	-0.4	2.8	-2.9	11.7	-1.0
1987	-10.0	7.1	6.2	3.8	2.8	-5.7	-1.8	-2.4
1988	-5.3	0.8	2.2	2.2	2.1	1.3	1.0	-4.3
1989	-5.5	0.9	4.2	2.2	2.5	0.3	1.0	-5.6

* includes gilts
† includes securities
†† includes oil

drops for 1987 & date?

(8) **PUBLIC FINANCES**

64. Table 30 summarises the forecast and compares it with the numbers in the FSBR, and with the internal June forecast. The projections in the FSBR were on the basis of certain conventional assumptions and not a central forecast.

TABLE 30 : PUBLIC SECTOR EXPENDITURE, REVENUE, AND BORROWING (£ billion)

	1986-87 Outturn	1987-88 FSBR	1987-88 June Fore-cast	1987-88 Oct. Fore-cast	1988-89 FSBR	1988-89 June Fore-cast	1988-89 Oct. Fore-cast	1989-90 FSBR	1989-90 June Fore-cast	1989-90 Oct Fore-cast
General Government Expenditure	165	174	173	172½	180	185	184	188	198	197
General Government receipts	160	169	172	173	178	187	192	187	201	206
Assumed cuts in personal taxes (cumulative)					3	3	4	5	5	6
GGBR	5	5	2	-½	5	2	-3	6	2	-4
Public corporations' overseas and market borrowing	-1½	-1	-1	-½	-1	-1	-2	-1	-1	-2
PSBR	3½	4	1	-1	4	1	-5	5	1	-5
(per cent of GDP) brackets)	(1)	(1)	(¼)	(-¼)	(1)	(¼)	(-1)	(1)	(¼)	(-1)
ex PR	8(2)			4½(1)			1(¼)			1(¼)

Aha! You were right to say PSBR=1% of GDP was right – but you got sign wrong!

(a) **1987-88**

65. The PSBR for 1987-88 is now forecast to be a surplus of £1b. The

margins of error attached to PSBR forecasts made at this time of the year, whilst lower than those for the Budget forecast, are still very high. The average absolute error is around 0.8 per cent of GDP (£3b.). still?

66. The latest forecast represents an undershoot on the FSBR forecast of £5b., and a reduction of £2b. from the June forecast. Table 31 shows the main components of the £5b. reduction in the PSBR forecast since the Budget. Over three-quarters of the predicted undershoot of the FSBR forecast is accounted for by lower central government own account borrowing, with most of the remainder due to lower local authorities' borrowing. The forecast of public corporations' market and overseas borrowing is little changed. Looked at another way three-quarters of the downward revision to the forecast has been on general government receipts, and one-third to general government expenditure.

3/4 + 1/3 !

TABLE 31 : CONTRIBUTION TO THE CHANGE IN THE 1987 PSBR FORECAST SINCE JUNE AND THE FSBR

	£ billion Changes since FSBR	June
- higher North Sea revenues from a higher North Sea oil price;	-¾	-
- higher non-North Sea corporation tax reflecting upward revisions to 1986 profits data and higher dividend payments (generating ACT) in 1987;	-1	-½
- higher income tax, in line with experience to date and mainly reflecting higher money incomes;	-¾	-¾
- higher national insurance contributions, reflecting higher money incomes;	-½	~~-½~~ —
- higher VAT, in line with outturn to date, and reflecting buoyant expenditure and - we think - a larger than expected reduction in arrears as a result of the Keith reforms;	-½	-½
- higher stamp duty as a result of the buoyant housing and stock markets;	-½	~~-½~~ —
- higher privatisation proceeds;	-¼	-¼
- a lower public expenditure planning total (excluding privatisation proceeds);	-1	-1¼
- offsetting increases, mainly lower 'other' receipts and higher national accounts adjustments	+¼	+1¼
TOTAL CHANGE IN PSBR FORECAST	-5	-2

What to publish (a) on PX — much as last?
(b) on PSBR — either £1bn or £2bn
(strong case for latter if average margin of error £3bn)

67. Lower expenditure and higher receipts have contributed roughly equally to the £2b. reduction in the PSBR since June. The main upward revisions on the receipts side have been to income tax, non-North Sea corporation tax and VAT. On the expenditure side the main reduction is lower local authority net capital spending, reflecting higher capital receipts, but the forecasts of social security spending and nationalised industries' EFLs have also been reduced.

(b) Fiscal adjustment and PSBR in 1988-89 and 1989-90

68. The MTFS assumption of PSBRs of one per cent of GDP would, on present projections, imply a massive fiscal adjustment in 1988-89 of around £13½b., with a further annual fiscal adjustment of £3b. in 1989-90. The forecast makes the stylised assumption that higher than previously planned privatisation proceeds are used to reduce the PSBR and that one third of the remaining available fiscal adjustment for 1988-89, calculated on this basis, reduces personal taxes, with the remaining two thirds reducing the PSBR to a surplus equivalent to about 1 per cent of GDP. The assumed cut in taxes is a little larger than in the June forecast. In 1989-90 the PSBR is maintained at the arbitrary surplus of 1 per cent of GDP, and there is scope for a further cut in personal taxes of £2b.

13½
o/w 1 priv procs (↓PSBR)
12½
o/w 4.1 ↓ taxes
8.4 ↓ PSBR
1/3 is 4.2 – not 4.1

(c) Public expenditure

69. The forecast of the planning total excluding privatisation proceeds in 1987-88 has been revised down since June, and instead of a small overspend of the 1987 PEWP plans, a £1b. undershoot is now forecast. Substantial overspends of the PEWP totals are forecast for 1988-89 and 1989-90, only a little less than those forecast in June. The forecast for these years takes account both of the differences between the economic assumptions used in the PEWP and of the economic prospects in the forecast, together with other pressures on programmes which past experience suggests are likely. The forecast is in effect attempting to anticipate not only the final outcome of the current survey (and in the case of 1989-90 the next survey as well), but also any eventual over or underspend on the finally agreed planning totals. The forecast incorporates some modest additions to expenditure in 1989-90 following the buoyant performance of the economy in general and public finances in particular in 1987 and 1988. Privatisation proceeds of £5¼b. are assumed for 1987-88, in line with PE's latest assessment. Proceeds of £6b. a year are assumed for 1988-89 and 1989-90.

70. Table 32 sets out forecast increases in actual programme spending compared with the 1987 PEWP in terms of economic rather than departmental categories. About half the projected excess above current programme plans is accounted for by social security and local authority current expenditure. These are areas over which the Government has limited direct control.

TABLE 32 : FORECAST ADDITIONS TO PROGRAMME BASELINES

£ billion

	1987-88		1988-89		1989-90	
	PEWP 1987	Forecast Claims on Reserve	PES 1987 Base-line	Forecast additions to baseline	PES 1987 Base-line	Forecast additions to baseline
Allocated to programmes						
1. Social Security (including HB)	44.7	0.5	46.1	2.2 5.1	48.0	4.1 9.3
2. LA current (excluding HB)	32.5	1.1	33.7	2.9	34.6	5.2
3. CG pay	24.8	0.5	25.8	1.5	26.6	2.9
4. CG procurement	24.6	0.1	25.0	1.4	25.9	2.3
5. LA capital	4.3	-0.7	4.0	-0.2	4.1	0.0
6. EC	0.9	0.4	0.4	0.9	1.1	0.6
7. Nationalised industries	0.7	-0.1	0.3	0.3	-0.1	0.7
8. Other	17.8	0.6	18.3	0.9	18.8	1.5
9. Total programmes	150.1	2.5	153.7	9.9	9.0	17.3
10. **Expenditure met from existing reserve**						
(i) allocated to programme baseline	0.0	2.5	0.0	5.5	0.0	7.5
(ii) unallocated	3.5	0.0	5.5	0.0	7.5	0.0
11. **Underspend (-) Addition to Reserve(+)**	0.0	-1.0	0.0	4.4	0.0	9.8
12. PLANNING TOTAL excluding privatisation proceeds	153.6	-1.0	159.2	4.4	166.5	9.8

71. The forecast of social security spending assumes that the underlying growth in spending - ie the growth after allowing for the effects of changes in unemployment, upratings, policy changes, demographic factors etc - which is projected to have risen rapidly in 1987-88, falls back somewhat in 1988-89 and 1989-90. The forecast of local authority current spending, most of which is pay, assumes that numbers employed will rise at much the same average rate as in the last 2-3 years and that earnings increases will be somewhat above the private sector average (see para 48). This, together with the RSG settlements announced in July, implies average rates increases of about 11 per cent in 1988-89.

72. The forecast of central government pay assumes little change in numbers and earnings increases averaging below the private sector in 1988-89 and much the same as the private sector in 1989-90 (see para 49). The forecast of central government procurement assumes that non-defence spending will rise in real terms at much the same rate as over the past 5 years, and that defence spending will rise at ½ per cent a year in real terms. Local authority capital receipts and gross capital spending are assumed to be higher than in the 1987 PEWP, but by roughly equal amounts in 1988-89 and 1989-90. The forecast has partially smoothed out the projected dip in net EC contributions in 1988-89 and the rebound in 1989-90.

?

73. The large upward revision to the planning total forecasts for 1988-89 and 1989-90 since the Budget are largely matched by a higher inflation forecast. Consequently the increase in the planning total in real terms is less than the cash increase. In real terms the planning total and GGE (see table 33) are much the same as earlier internal forecasts. The forecast of GGE in real terms is almost identical to that made a year ago for 1988-89 and less than 1 per cent higher for 1989-90.

TABLE 33 PAST AND CURRENT FORECASTS OF GGE EXCLUDING PRIVATISATION PROCEEDS

£ billion

Forecast	1986-87 Current prices	1986-87 Real Terms*	1987-88 Current Prices	1987-88 Real Terms*	1988-89 Current Prices	1988-89 Real Terms*	1989-90 Current Prices	1989-90 Real Terms*
Jan 1986	169	169	176	169	186	169	-	-
June 1986	169	169	177	170	186	171	-	-
Oct 1986	170	170	178	171	188	172	200	173
Jan 1987	170	170	179	171	190	173	202	175
FSBR 1987	169	170	179	171	185	171	193	172
June 1987	169	169	179	170	190	171	203	174
Oct 1987	170	170	178	170	190	172	203	175
		% gwth		0		1¼		1¾

* in 1986-87 prices

74. The ratio of GGE (excluding privatisation proceeds) to money GDP is forecast to show a sharp fall in 1987-88 and more modest falls in 1988-89 and 1989-90. It is below the PEWP/MTFS paths in all three years.

TABLE 34 : RATIO OF GGE EXCLUDING PRIVATISATION PROCEEDS TO MONEY GDP

per cent

	1984-85	1985-86	1986-87	1987-88	1988-89	1989-90
1987 PEWP		44¾	44½	44	42¾	42½
1987 FSBR		44¾	44¼	43½	42½	41¾
Oct forecast		44¾	44	42¼	41¾	41¼

(d) <u>General Government Receipts</u>

75. The recent history of forecasts of general government receipts has been a series of successive upward revisions. The current forecast continues this pattern, with substantial upward revisions to 1988-89 and 1989-90

compared the with June forecast. The upward revision since June to the forecast for 1987-88 has been smaller (about £1b.), though this still leaves the 1987-88 forecast of revenues £4b. higher than that in the FSBR.

76. Part of the upward revision to 1987-88 receipts since the FSBR can be attributed to higher economic activity, including stronger than expected stock and housing markets, which have boosted stamp duty receipts. Higher non-North Sea corporation tax for the most part reflects stronger than previously estimated activity and profits in 1986. Higher non-North Sea corporation tax is the most important single factor behind the higher total receipts now forecast for 1988-89 and 1989-90, accounting for around half of the revision since June to 1988-89 and one-third of the revision to 1989-90. The revision to the forecasts partly reflects higher profits growth for 1987 (and thus higher tax receipts for 1988-89). The remainder of the upward revision since June to the receipts forecasts for 1988-89 and 1989-90 are for the most part attributable to higher income and expenditure (income tax, VAT and NICs account for between one-third and half of the total upward revision in each year), but the forecast of local authorities rates has been raised by between £¾ to £1b. in each year.

TABLE 35: COMPARISON OF FORECASTS OF GENERAL GOVERNMENT RECEIPTS (PRE-FISCAL ADJUSTMENT FOR 1988-89 AND 1989-90)*

£ billion

Forecast:	1986-87		1987-88		1988-89		1989-90	
	Cash	Real Terms	Cash	Real Terms	Cash	Real Terms	Cash	Real Terms
January 1986	157	153	166	159	178	162	188	164
June 1986	156	156	164	158	179	164	188	166
October 1986	156	156	165	159	181	165	196	169
January 1987	158	158	169	162	184	168	197	171
FSBR 1987	159	159	169	162	178	164	187	167
June 1987	159	160	172	164	187	168	201	172
October 1987	160	160	173	165	192	174	206	178

* Forecasts made before this and last year's Budgets have been adjusted to be consistent with current tax rates and allowances. Real terms figures are at 1986-87 prices.

77. Table 36 shows non-oil taxes and national insurance contributions (NICs) as a percentage of non-oil GDP. The changes to the tax forecast since the FSBR mean that the forecast now shows a substantial rise in the pre-fiscal adjustment tax burden for 1988-89, but this is offset by the assumed cut in taxes. The projected rise for 1989-90 is smaller, and is

again offset by the assumed tax cut. Thus with the stylised assumption used here on the allocation of the fiscal adjustment, the tax burden for 1989-90 is the same as the level for 1987-88. With oil revenue as a percentage of GDP expected to be broadly flat at the projected 1987-88 level, the ratio of total taxes to money GDP is forecast to follow a similar pattern to the non-oil ratio.

TABLE 36: NON-OIL TAXES AND NICs AS A PERCENTAGE OF NON-OIL GDP

	1985-86	1986-87	1987-88	1988-89	1989-90
FSBR					
(a) pre-fiscal adjustment	37.2	37.3	37.8	37.9	37.7
(b) post fiscal adjustment	37.2	37.3	37.8	37.1	36.6
June Forecast					
(a) pre-fiscal adjustment	37.3	37.7	38.0	38.4	38.8
(b) post fiscal adjustment	37.3	37.7	38.0	37.5	37.9
October Forecast					
(a) pre-fiscal adjustment	37.0	37.5	38.0	39.1	39.4
(b) post-fiscal adjustment	37.0	37.5	38.0	38.0	38.0

ANNEX I: PUBLIC EXPENDITURE ASSUMPTIONS

The forecast of public expenditure in 1987-88 takes account of the latest monthly data on expenditure, the expected evolution of the economy over the rest of the year (which affects such programmes as social security) and Treasury expenditure divisions' assessments of the likely final outturn. For 1988-89 and 1989-90 the forecasters attempt to predict the level of public expenditure that will occur (as opposed to the programme plans which will eventually be agreed). The forecast therefore implicitly includes judgements both on the results of the current round of Ministerial discussions (and for 1989-90 the results of the autumn 1988 discussions) and on the influence of the forecast evolution of the economy on demand led public expenditure.

2. In constructing the forecast it is necessary to make detailed assumptions in certain areas. The main ones were as follows:

(i) The outturn percentage for local authorities' Aggregate Exchequer Grant, which on the basis of the forecasters' view of relevant expenditure, is forecast to fall from 45¾ per cent (GB, accruals) in 1987-88 to 45~~¼~~ per cent in 1988-89, is assumed to fall a further ½ percentage point in 1989-90.

(ii) The forecast assumes an increase in the VAT ceiling for EC own resources contributions from 1.4 to 1.6 per cent with effect from 1 January 1988 and that a Community Budget is agreed before 31 March 1988.

(iii) Privatisation proceeds are assumed to be £6 billion per annum in 1988-89 and 1989-90. For 1987-88 PE's latest best estimate of £5¼ billion is used.

(iv) The Treasury Supplement to the National Insurance Fund is assumed to be reduced by 2 per cent in 1988-89 and a further 2 per cent in 1989-90, to a level of 3 per cent.

3. The table below compares the forecast with the main economic assumptions used in the 1987 PEWP, the 1987 MTFS, and with assumptions which have either already been agreed, or proposed (Mr Davies' minute of 2 October to the Chancellor) for use in the forthcoming Autumn Statement and PEWP.

	1986-87	1987-88	1988-89	1989-90	1990-91
GDP Deflator (%)					
1987 PEWP	3	3¾	3½	3	
1987 MTFS	3¼	4½	4	3½	
October Forecast	3	4½	5½	5¼	
Proposed New Assumption	3	4½	5	3½	3
Money GDP (%)					
1987 PEWP	5½	7	6	5½	
1987 MTFS	6	7½	6½	6	
October Forecast	6½	9	8½	7¾	
Money GDP (£b)					
1987 PEWP	380.2	407.0	431.4	455.2	
1987 MTFS	382.4	411.0	437.2	463.8	
October Forecast	385.3	419.5	455.1	490.4	
Unemployment (Adult, GB millions)					
1987 PEWP	3.1	3.05	3.05	3.05	
October Forecast	3.0	2.7	2.5	2.5	
Agreed New Assumption	3.0	2.7	2.6	2.6	
RPI* (%)			Q(4)87	Q(4)88	Q(4)89
1987 PEWP			3¾	3½	
October Forecast			4.2	5¼	
Proposed New Assumption			4.2	5 4¾	3¼
Average Earnings (%)					
March Assumptions		6½	6	5½	5
October Forecast	8	8¼	8	8	
Agreed New Assumption		7½	6½	5½	5
UK 3 month LIBOR					
March Assumptions		9¾	9½	9½	9
October Forecast		10	11	11	
Proposed New Assumption		10	10	9½	9
UK 20 year gilt rate					
March Assumptions		9	9	9	9
October Forecast		10	11	11	11
Proposed New Assumption		10	10	9	9
6 month dollar LIBOR					
March Assumptions		7	8½	9	9½
October Forecast		7¾	8¾	9	
Proposed New Assumption		7½	8½	9	9

* increases in year to previous September

ANNEX [redacted] : SECTORAL SURPLUSES AND DEFICITS

Table IIA compares sectoral net acquisition of financial assets by sector (sectoral surpluses and deficits) as proportions of money GDP since 1948. The overseas sector surplus is the current account deficit with the sign changed. Similarly the public sector's surplus is the PSFD with the sign changed.

The large forecast residual error reflects and continues discrepancies between the measures of GDP in the first half of 1987. Normally the residual error comes down as the CSO reduces measurement of errors for a particular period.

For 1988-89 and 1989-90

(i) The **total private sector surplus** is lower than in any year since 1974-75. It is not particularly low compared with earlier experience.

(ii) The **personal sector surplus** is low in comparison with experience in the years from 1960. It is not low in comparison with the earlier period.

Table IIB shows the PSBR, the PSBR adjusted for privatisation receipts, and the PSFD (public sector financial deficit) as proportions of money GDP.

For 1988-89 and 1989-90

(i) The **PSBR** ratio, at -1 per cent, is lower than in every year since 1952 except 1969-70.

(ii) The **PSFD** ratio is lower than in every year except 1968-69, 1969-70, and the three years to 1950.

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TABLE IIA: NET ACQUISITION OF FINANCIAL ASSETS BY SECTOR
(AS PER CENTAGE OF GDP)

	Personal (1)	ICC (2)	Financial (3)	Total Private Sector (4)	Public (5)	Overseas (6)	Residual Error (7)
Calendar Years							
1948	- 2.8	1.8	0.3	- 0.7	2.2	- 1.4	- 0.2
1949	- 2.6	2.1	0.3	- 0.1	2.4	- 1.2	- 1.1
1950	- 2.1	3.1	0.3	1.3	2.6	- 3.3	- 0.6
1951	- 3.2	2.5	0.3	- 0.4	- 1.6	2.2	- 0.2
1952	0.1	4.0	0.5	4.6	- 3.4	- 1.0	- 0.1
1952	- 0.4	3.7	0.3	3.7	- 4.1	- 0.8	1.2
1954	- 1.6	3.6	0.4	2.3	- 2.4	- 0.6	0.7
1955	- 1.4	2.1	0.4	1.1	- 2.0	+ 0.8	0.1
1956	0.2	2.0	0.3	2.6	- 2.6	- 1.0	1.0
1957	0.0	1.5	0.4	1.9	- 2.4	- 1.0	1.5
1958	- 0.6	2.1	0.3	1.8	- 1.9	- 1.6	1.7
1959	- 0.3	1.8	0.2	1.6	- 2.2	- 0.7	- 1.3
1960	1.1	0.9	0.2	2.3	- 2.7	+ 0.9	- 0.4
1961	2.3	- 0.2	0.2	2.4	- 2.6	- 0.2	0.5
1962	2.0	0.0	0.2	2.1	- 1.8	- 0.5	0.2
1963	1.9	1.4	- 0.2	3.0	- 2.6	- 0.4	0.0
Financial Years							
1963/64	1.9	1.8	- 0.3	3.4	- 3.3	0.0	- 0.1
1964/65	2.6	- 0.6	- 0.5	1.5	- 2.4	1.0	- 0.1
1965/66	3.6	- 1.0	- 0.5	2.1	- 1.7	0.2	- 0.6
1966/67	2.5	0.8	- 0.7	2.6	- 2.6	- 0.4	0.4
1967/68	2.0	1.6	- 0.8	2.8	- 4.2	1.1	0.2
1968/69	1.2	0.5	- 1.1	0.6	- 0.8	0.3	- 0.1
1969/70	1.5	0.7	- 1.6	0.6	1.7	- 1.5	- 0.8
1970/71	2.1	0.8	- 1.2	1.7	0.4	- 1.1	- 1.0
1971/72	0.1	2.4	- 0.7	1.8	- 1.1	- 1.7	1.1
1972/73	1.4	2.5	- 0.5	3.3	- 3.0	0.4	- 0.7
1973/74	3.4	0.0	- 0.7	2.7	- 4.6	2.0	- 0.1
1974/75	4.3	- 1.7	- 0.7	2.0	- 6.7	3.6	1.2
1975/76	4.1	0.9	- 0.7	4.3	- 7.3	1.0	2.0
1976/77	3.4	- 0.5	0.2	3.1	- 5.7	1.1	1.5
1977/78	2.6	1.1	0.3	4.0	- 4.4	0.0	0.4
1978/79	4.5	0.3	0.2	5.0	- 4.8	- 0.3	0.1
1979/80	4.4	- 0.3	0.2	4.2	- 3.9	0.1	- 0.4
1980/81	6.6	0.3	- 0.3	6.6	- 5.0	- 2.5	0.8
1981/82	4.9	0.3	- 0.2	5.0	- 2.0	- 1.8	- 1.2
1982/83	3.5	2.0	0.1	5.6	- 2.9	- 1.6	- 1.0
1983/84	2.9	2.4	0.4	5.7	- 3.7	- 0.9	- 1.1
1984/85	3.2	2.2	0.0	5.4	- 4.0	0.0	- 1.4
1985/86	2.3	1.9	0.3	4.6	- 2.3	- 1.1	- 1.2
1986/87	1.3	1.7	1.4	4.5	- 2.5	0.2	- 2.2
Forecast							
1987/88	0.5	1.9	0.9	3.2	- 1.0	1.0	- 3.1
1988/89	0.5	0.8	1.1	2.4	- 0.5	1.0	- 3.0
1989/90	0.2	1.0	0.9	2.1	- 0.3	1.2	- 3.0

NB: Columns 1 + 2 + 3 = 4
Columns 4 + 5 + 6 + 7 = 0

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Table IIB: PUBLIC SECTOR BORROWING as a percentage of GDP

	PSBR	PSBR less Privatisation proceeds	PSFD
1948			-2.2
1949			-2.4
1950			-2.6
1951			1.6
1952	5.0		3.5
1953	3.4		4.1
1954	2.0		2.4
1955	2.4		2.0
1956	2.7		2.6
1957	2.2		2.4
1958	2.1		1.9
1959	2.3		2.2
1960	2.7		2.7
1961	2.5		2.6
1962	1.9		1.8
1963	2.7		2.6
1963-64	3.3		3.4
1964-65	2.7		2.4
1965-66	2.6		1.7
1966-67	2.9		2.6
1967-68	4.9		4.2
1968-69	0.8		0.8
1969-70	-1.2		-1.7
1970-71	1.5		-0.4
1971-72	1.6		1.1
1972-73	3.6		3.0
1973-74	5.8		4.6
1974-75	9.0		6.7
1975-76	9.3		7.3
1976-77	6.4		5.7
1977-78	3.6	3.9	4.4
1978-79	5.3	5.3	4.8
1979-80	4.8	5.0	3.9
1980-81	5.4	5.5	5.0
1981-82	3.3	3.5	2.0
1982-83	3.1	3.3	2.9
1983-84	3.2	3.5	3.7
1984-85	3.1	3.7	4.0
1985-86	1.6	2.3	2.3
1986-87	0.9	2.0	2.5
		Forecast	
1987-88	-0.3	1.0	1.0
1988-89	-1.1	0.2	0.5
1989-90	-1.1	0.1	0.3

FINANCIAL FORECAST

SECRET

COPY No. 2

FROM: A BOTTRILL

DATE: 12 October 1987

ECONOMIC SECRETARY

cc: Chancellor of the Exchequer
Chief Secretary
Financial Secretary
Sir Peter Middleton
Sir Terence Burns
Sir Geoffrey Littler
Mr Cassell
Mr Monck
Mrs Lomax
Mr Odling-Smee
Mr Sedgwick
Mr Peretz
Mr Scholar
Mr Mowl
Mr S Davies
Mr Grice
Mr C W Kelly
Miss Noble
Mr Ilett
Mr Westaway
Mr Owen
Mr Courtney
Mr Pike
Mr Allum
Mr Lyon
Mr Dhar

FINANCIAL FORECAST

The attached note on the Autumn Financial Forecast complements that on the Treasury Economic Forecast circulated by Mr Sedgwick on 8 October. The forecast examines the prospects to the end of the financial year 1989-90.

ABottrill

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CONTENTS

ASSUMPTIONS AND SUMMARY

The main policy assumptions underlying the forecast are:

- Interest rates are varied to achieve a stable sterling exchange rate index of 72½.
- The PSBR is fully funded each year by the non-bank private sector and the overseas sector.
- National Savings raise £2 billion this year and £1 billion a year in 1988-89 and 1989-90.
- Building societies' wholesale funding limit is unchanged.

Table 1: Summary of the forecast

(per cent change on previous year)

	3-month interest rate	Sterling index 1975=100	M0	M3	M4	Bank + B.Soc lending	Money GDP
1986-87	10.5	71.5	4.3	19.0	14.9	18.6	6.6
1987-88	10.1	72.6	5.1	20.4	14.9	17.8	8.9
1988-89	11.0	72.5	4.4	16.2	13.8	16.2	8.5
1989-90	11.0	72.5	3.4	13.0	12.7	15.7	7.8

2. The policy implications of maintaining a stable sterling effective exchange rate are complicated by the outlook for the US dollar. Against a background where the dollar is projected to fall further, the pound - along with the yen and the main continental European currencies - might face upward pressure. But we have given weight to the fact that the worsening UK current balance is likely to raise expectations of a sterling depreciation putting downward pressure on the pound. Money GDP is also growing faster than the MTFS objective. Both external and domestic circumstances, therefore, point to the need for higher interest rates to sustain the pound and restrain money GDP growth. The forecast includes a further 1 per cent rise in interest rates by early-1988 although this still leaves money GDP growth well above its target range.

3. Other monetary indicators also offer buoyant signals. M0 is rising rapidly and is forecast to breach its ceiling early in 1988 although higher interest rates and slower consumer spending growth should help keep it within its MTFS target range in the later part of the forecast. M3 which has also risen rapidly, may grow less quickly next year as companies' and financial institutions' deposits rise more slowly. This will tend to bring it more into line with M4. Lending to the private sector by banks and building societies, however, is forecast to slow only gradually, financed at least partly by both sterling and foreign currency external borrowing.

4. Particular issues in the forecast include:

- the readiness of the overseas sector to finance a growing UK current deficit at the projected interest rates

- the extent to which declining public sector borrowing needs will be offset by increased private sector borrowing and the net effect on real interest rates

- the extent to which the non-financial private sector will turn to liquid assets in the form of bank and building society deposits against a background where equity returns are likely to be less attractive than recently

- the balance that companies will strike between issuing securities and turning again to banks for their financing needs

- the effect on financial institutions' portfolios of the Government becoming a heavy net purchaser of gilts

- the increasing constraint placed on building societies by the limits on their access to wholesale funding.

THE EXCHANGE RATE AND INTEREST RATES

5. The sterling index which showed some weakness in the summer, has been generally firmer since the rise in UK interest rates in early-August. Sterling's latest firmness has occurred despite the poor August trade figures and has coincided with some renewed downward pressure on the dollar exchange rate and increases in US interest rates.

Table 2: Exchange rate and competitiveness

	Dollar effective rate 1975=100	**Sterling effective rate 1975=100**	**£/$**	**£/DM**	**Relative unit labour costs (1980=100)**
1986 Q4	110.5	68.2	1.43	2.87	71.5
1987 Q1	104.5	69.9	1.54	2.83	72.1
Q2	101.0	72.8	1.65	1.97	75.7
Q3	102.6	72.7	1.62	2.97	75.4
Q4	101.6	72.5	1.62	2.95	76.1
1988 Q4	96.8	72.5	1.70	2.89	76.8
1989 Q4	93.4	72.5	1.75	2.82	76.6

6. The dollar is assumed to depreciate by 4-5 per cent a year in effective terms in the next two years. US interest rates are assumed to rise further during 1988 and, with other countries' rates unchanged, the average world rate edges upwards.

Chart 1: The dollar and world interest rates

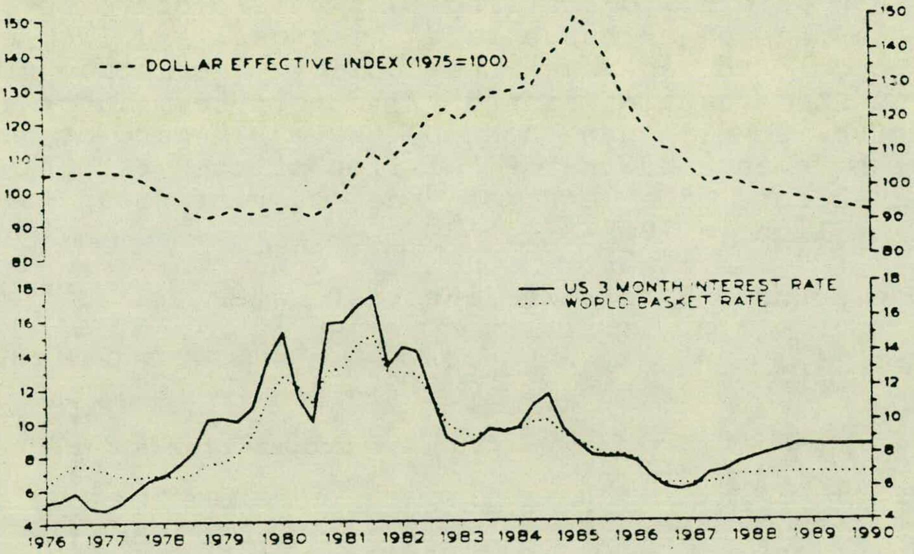
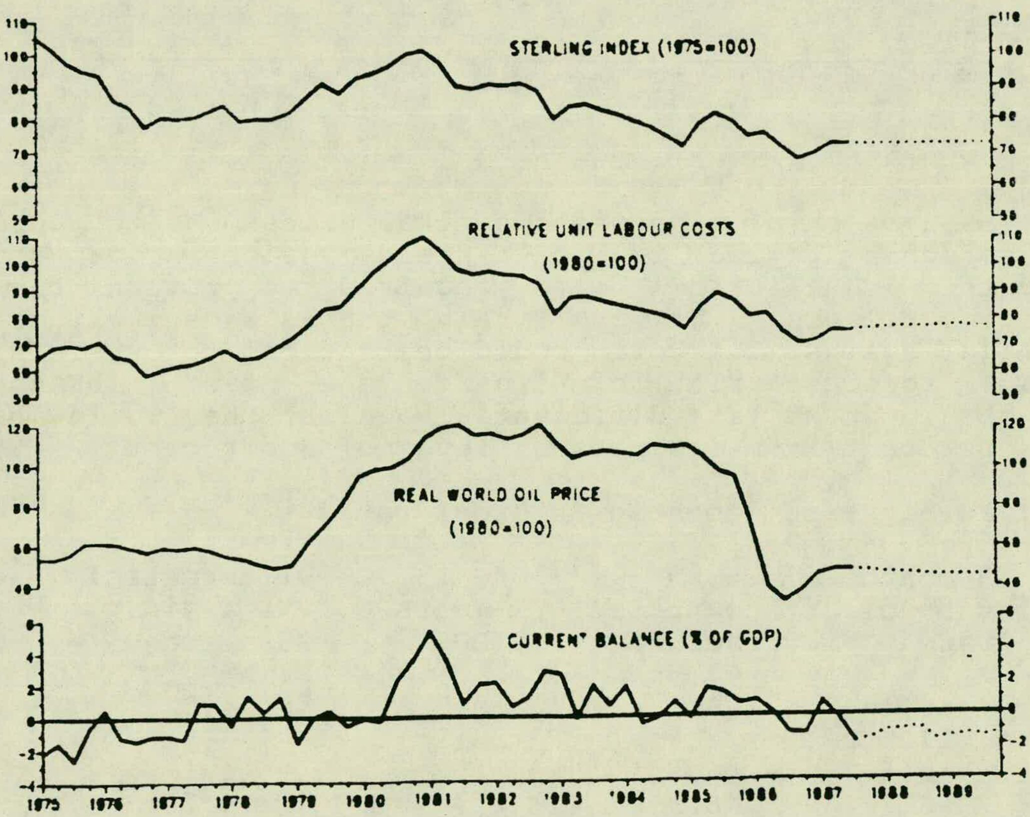
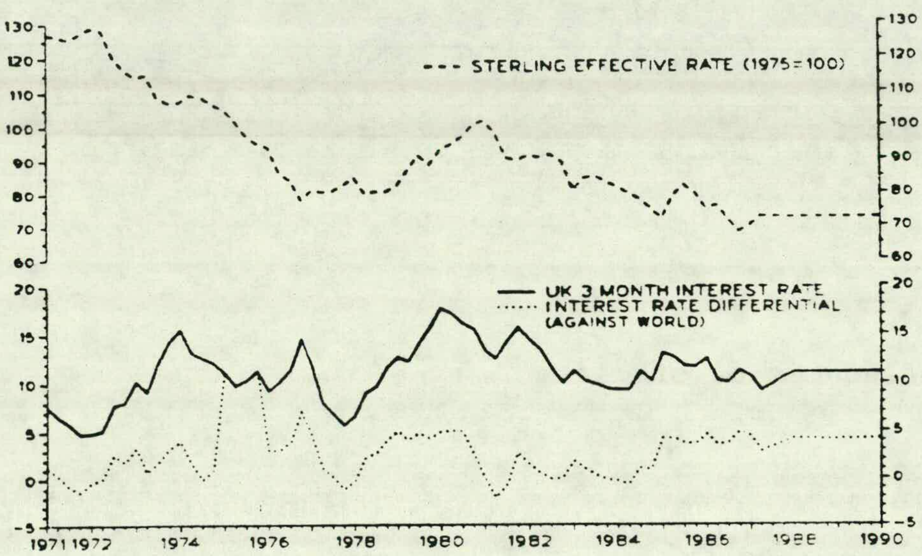


Chart 2: Influences on sterling



7. Against this background external pressures for sterling appreciation and lower UK interest rates might seem likely - other things equal. The forecast however, points to a further deterioration in the UK current account over the next two years. The forecast also shows a decline in the world real oil price next year which is not helpful to sterling. If this picture is correct there may well be a renewed exchange rate weakness and we have assumed that, in order to achieve the policy assumption of holding the sterling index constant at around 72½, short-term interest rates will need to rise to 11 per cent by the early part of next year. In addition we have assumed that £1 billion of the recent intervention is unwound before the end of the current financial year with a further £1 billion in 1988-89.

Chart 3: The pound and relative interest rates



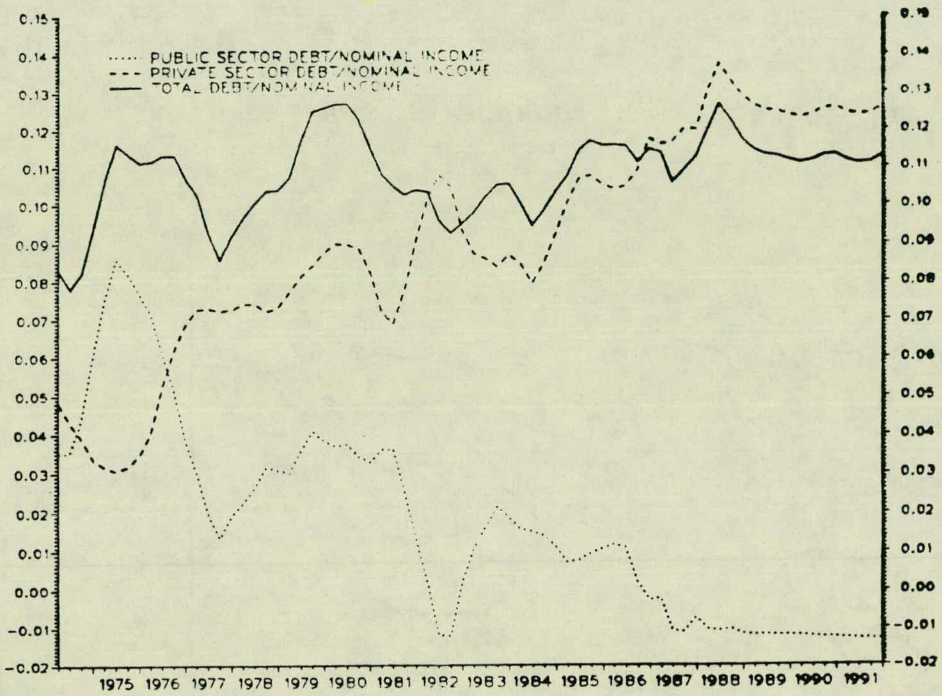
8. The assumption of a constant nominal exchange rate through the entire forecast period implies a steadily widening gap between the rate and the 'equilibrium' rate required to return the current account to balance. It is likely that a widening interest rate differential against the world would be required to sustain such a gap. The forecast rise of 1 percentage point in UK short rates returns the interest rate differential against the world basket to around 4 per cent from its present level of 3 per cent.

Table 3: Foreign and domestic interest rates

	3-month Eurodollar rate	G6 countries' average	UK 3-month LIBOR	Differential vis a vis G6 average	Memo 20-year gilts
1986-87	6.4	6.3	10.5	4.2	9.7
1987-88	7.5	6.6	10.1	3.5	10.1
1988-89	8.6	6.9	11.0	4.1	11.0
1989-90	8.7	6.9	11.0	4.2	11.0

9. The present flat yield curve is projected to persist. The prospect of significant net gilt purchases by the Government might be expected to put downward pressure on long rates but privatisation issues and heavy borrowing by the private sector, particularly companies, are forecast to offset this. Total borrowing relative to GDP remains at a high level. Rising domestic inflation and weakness in international bond markets may also affect sentiment adversely. In these circumstances we have assumed merely that UK long rates do not rise to restore a positive yield curve but remain broadly similar to short rates.

Chart 4: Public and private borrowing



10. Money GDP in the current financial year now seems likely to rise more rapidly than foreseen in the FSBR mainly because real growth is about 1 percentage point higher. The projected rise in interest rates should help to reduce money GDP growth in 1988-89 and 1989-90 but it still seems likely to exceed the MTFS path mainly as a result of higher inflation.

Table 4: Money GDP in the MTFS and forecast
(per cent changes on previous year)

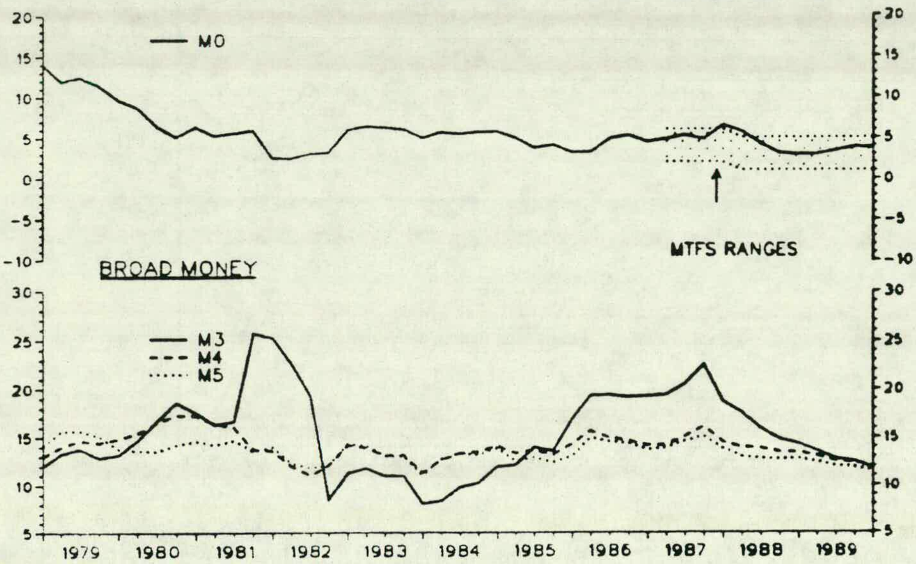
	GDP deflator		Real GDP		Money GDP	
	MTFS	Forecast	MTFS	Forecast	MTFS	Forecast
1986-87	3	3.0	3	3.5	6	6.6
1987-88	4½	4.6	3	4.1	7½	8.9
1988-89	4	5.4	2¼	2.9	6½	8.5
1989-90	3½	5.2	2¼	2.4	6	7.8

MONETARY AGGREGATES

Table 5: Monetary Aggregates
(per cent change over previous year)

	MO		NIBM1	M3	M4	M5
	MTFS Range	Outturn/ Forecast				
1986-87		4.3	11.0	19.0	14.9	14.3
1987-88	2-6	5.1	14.4	20.4	14.9	14.4
1988-89	1-5	4.4	2.7	16.2	13.8	13.0
1989-90	1-5	3.4	1.2	12.7	12.7	12.1

Chart 5: Monetary Aggregates (% change on year earlier)



Narrow money

11. In recent months, M0 has been rising rapidly in response to buoyant consumer spending and the fall in interest rates earlier in the year. In the three months to September, holdings of notes and coin have risen at an annualised rate of 8 per cent although the year on year figures for M0 growth have remained close to 5 per cent. This is in the upper part of the 1987-88 target range and despite some slowing down in the monthly growth rate, it is expected to breach its ceiling in the early months of 1988. Moreover, if the 1988-89 target range for M0 remains as published in the 1987 MTFS, then M0 will still be above its new lower ceiling of 5 per cent in the second quarter of 1988. The lagged effects of the recent rise in interest rates together with the further rise projected in the forecast and the slowdown in real consumer spending and later in consumer prices should bring M0 back within its target range by the middle of 1988.

12. NIBM1 growth is currently unusually high at 13½ per cent a year. Deposits have increased as a result of earlier interest rate cuts and oversubscriptions to capital issues and privatisations and are also possibly being held in anticipation of future issues, notably BP. Year on year growth is forecast to peak above 20 per cent later this year before falling sharply as privatisation effects unwind and the effect of higher interest rates coupled with increased use of interest-bearing current accounts attracts money away from idle balances. Unlike M0 which is a useful contemporaneous indicator, NIBM1 continues to give a noisy message which is difficult to interpret.

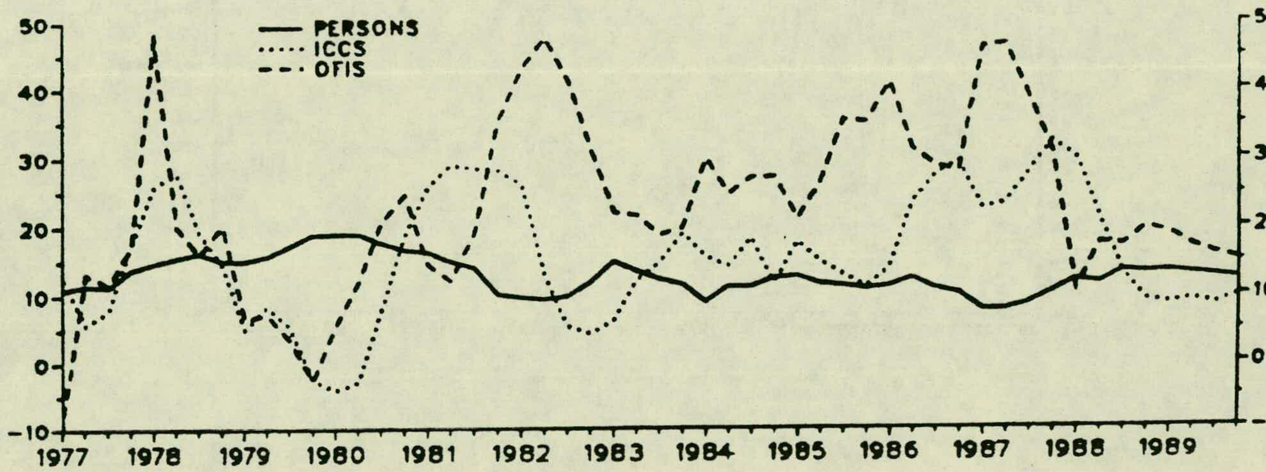
Broad money

13. Growth of the broader aggregate, M4, which includes private sector sterling deposits in both banks and building societies, is forecast to rise from its current level of 15 per cent a year to above 16 per cent a year by the beginning of next year before falling steadily to 12 per cent by the end of 1989-90. This reflects a fall in the growth of companies' and financial institutions' bank deposits. These form a larger proportion of M3 than of M4, and so the gap between M3 and M4 growth closes by 1990.

Table 6: Broad money by sector
(Per cent change on year earlier)

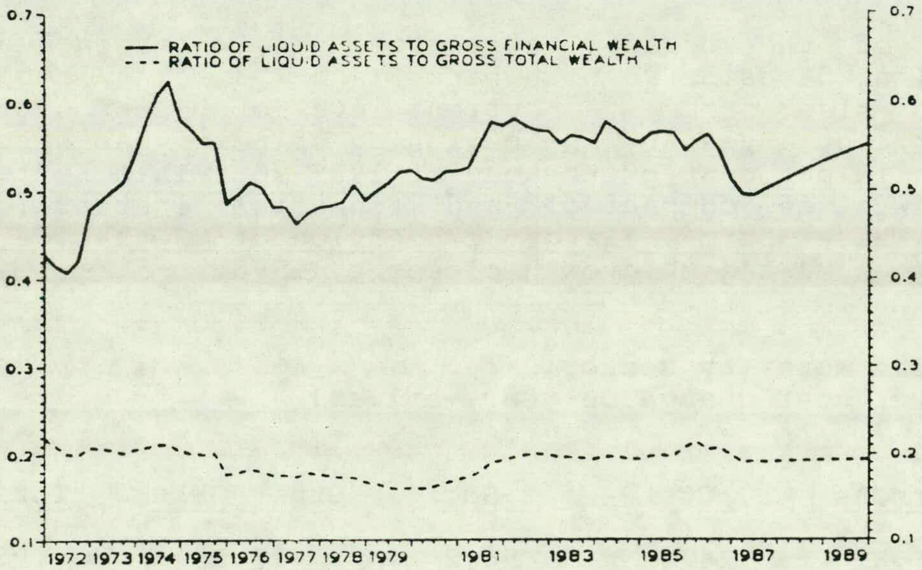
	M3 Persons	ICCs	B-Socs	Other OFIs	M3 Total	M4 Total
1986-87	11.8	24.6	56.2	25.3	19.0	
1987-88	11.3	27.4	47.6	31.0	20.4	14.9
1988-89	16.0	15.7	29.4	11.2	16.2	13.8
1989-90	13.5	9.1	24.6	11.2	13.0	12.7

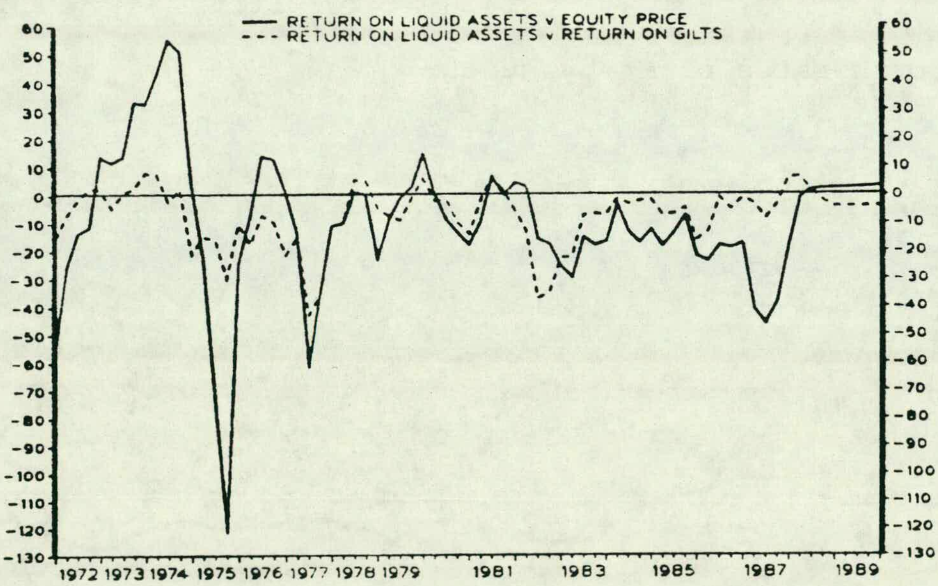
Chart 6: Growth rates of M4 by sector



14. Personal sector liquid assets, which are defined to include bank deposits, building society deposits and national savings, are currently growing at 11 per cent and are expected to increase by more than 12 per cent in 1988-89 as personal disposable income rises strongly and some of the recent capital gains on equities are converted to liquid assets. Thereafter liquid assets grow faster than total financial assets as relative rates of return encourage a move from illiquid to liquid holdings. See Chart 7.

Chart 7: Household liquid asset ratio and relative rates of return

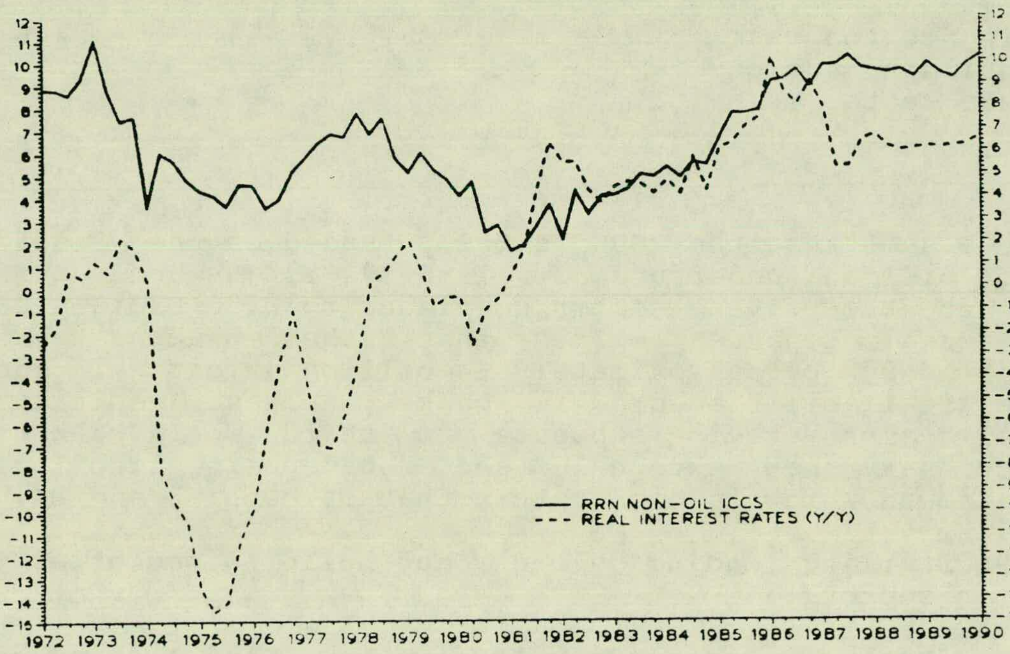




15. Within personal sector liquid assets, both bank and building society deposits gain share at the expense of National Savings, which by assumption attract considerably less funds than in recent years. In the short term, building societies are expected to lose more deposits than banks in the face of the BP issue. Banks are also assumed to gain competitiveness as they provide more high interest cheque accounts. In the medium term, however, building societies are assumed to gain non-price competitiveness with increased provision of 'banking' facilities.

16. The growth of industrial and commercial companies' banks deposits is forecast to fall sharply as growth of their total liquid assets slows. The slowdown in growth of ICCs' liquid assets is mainly explained by the resumption of company investment in real assets which, in contrast with recent years, is now expected to be more profitable relative to the return on liquid assets; see Chart 8.

Chart 8: Relative rates of return on ICCs' real investment and liquid assets



17. Growth of building societies' bank deposits is forecast to slow, but they continue to rise by 20-30 per cent a year as they run down the share of gilts in their liquid assets which grow in line with their balance sheets.

18. In the immediate future, growth of other financial institutions' bank deposits is expected to fall from above 40 per cent to below 10 per cent by the first quarter of next year. This reflects the glut of capital issues and privatisations in the second half of this year which reduces liquidity of institutions, particularly life assurance and pension funds'. Institutions' bank deposits are forecast to continue to grow only slowly as lower net inflows and sluggish equity prices cause their wealth to grow more slowly. The

effect of this on their bank deposit growth is offset only partly by the drastic curtailment of new gilt sales which limits one of the more normal uses of their funds.

Table 7: Counterparts analysis of broad money

£ billion	**1985-86**	**1986-87**	**1987-88**	**1988-89**	**1989-90**
Overfunding (-)	0.4	0.4	-0.4	0	0
£ bank lending to nbps	21.1	30.6	39.8	36.9	35.3
Banking external	0.5	0.8	-4.3	-3.9	-4.1
Increase (-) in net sterling non-deposit liabilities	-2.0	-4.6	-4.6	-5.7	-5.5
Change in M3	25.9	30.1	27.3	25.7	24.0
Memo items:					
Lending to non bank non building society private sector	35.2	48.0	54.2	54.8	55.9
Change in M4	29.7	33.6	39.3	41.6	42.0

19. We assume that the PSBR is fully funded on the M3 definition and the £0.4 billion underfund of 1986-87 is unwound this year. Credit to the private sector continues to rise rapidly but the need for external finance implies that the banking external is contractionary by approximately £4 billion a year. In addition, net non-deposit liabilities grow as banks increase capital issues to provide against their exposure to third world debtors. These contractionary net externals and non-deposit liabilities offset credit growth which is higher than that of both M3 and M4.

Table 8: Sterling lending by banks and building societies to private sector

	Bank + B.Soc lending		**Bank lending**		**Bank lending by Sector % growth**			
					Persons			
	£bn	**% growth**	**£bn**	**% growth**	**House purchase**	**Other**	**ICCs**	**OFIs**
1985-86	35.2	17.7	20.8	17.6	20.7	16.3	13.1	29.5
1986-87	48.0	18.5	31.2	19.2	24.1	13.4	11.1	43.4
1987-88	54.2	18.9	40.3	22.3	29.0	18.2	13.3	40.2
1988-89	54.8	17.2	36.9	20.0	22.4	18.9	14.3	28.0
1989-90	55.9	14.8	35.3	15.3	15.3	13.8	11.2	22.0

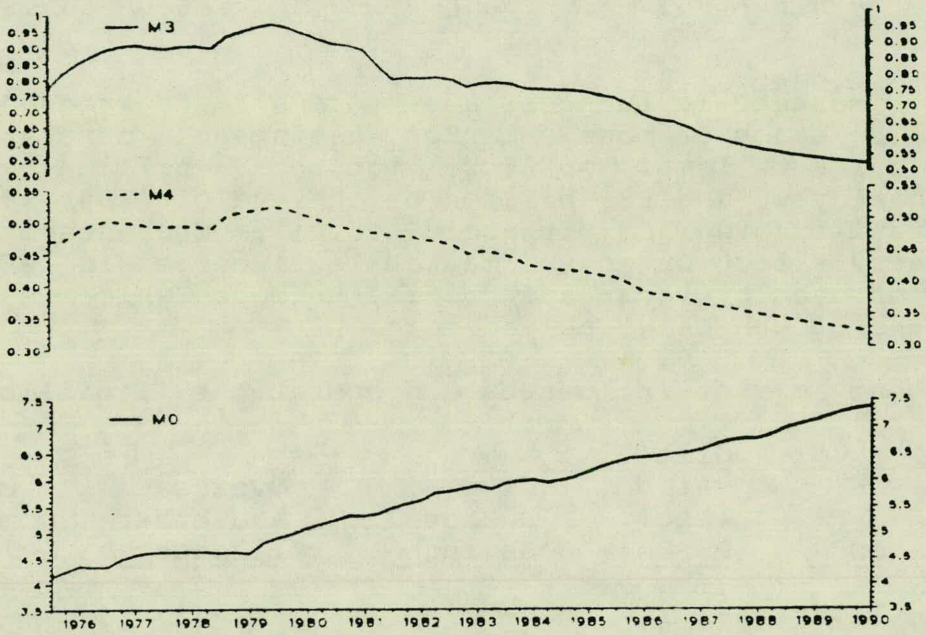
Velocity trends

20. The velocity of M0 rises relative to GDP over the forecast period reflecting higher interest rates and the continuing effects of financial innovation. The velocity of the broad aggregates is forecast to continue to fall - albeit at a slower pace than in the recent past.

Table 9: Income (GDP) velocity of money (per cent changes on previous year

	M0	M3	M4
1986-87	2.3	-10.4	-7.2
1987-88	3.6	-9.5	-5.3
1988-89	3.9	-6.6	-4.7
1989-90	4.3	-4.6	-4.3

Chart 9: Monetary aggregates' velocity



FUNDING AND MONEY MARKET ASSISTANCE

21. In the current financial year, the negative PSBR of £1 billion still implies net gilt sales of £3½ billion to the private and overseas sectors to help offset the £3¾ billion of intervention which is assumed to occur by the end of the year and the £2¼ billion repayment of debt by local authorities. Most of these gilts have been bought by the overseas sector. In 1988-89 and 1989-90 the PSBR is expected to be much lower than previously foreseen at -£5 billion a year. Net Govenment purchases of gilts of £6 billion a year are required. This is assumed to be entirely from the domestic private sector. Gross gilt sales are forecast to fall from £9½ billion in the current financial year to £1¼ billion by 1989-90 despite the prospective large redemptions in the later years.

Table 10: PSBR and overfunding (£ billion)

	PSBR	Gilt sales to NBPS	National Savings	Other debt sales to NBPS	Overseas finance excl. reserves	Reserves	Wide over-funding
1986-87	2.1	1.5	3.4	-3.4	5.3	-3.8	-0.4
1987-88	-0.9	-0.2	2.0	-3.0	4.3	-3.7	0.4
1988-89	-5.0	-6.9	1.0	0.4	2.4	1.0	0.0
1989-90	-5.4	-6.5	1.0	0.4	0.5	0.0	0.0

Table 11: Sectoral gilt purchases (£ billion)

	Net sales							
	Persons	ICCs	OFIs*	Monetary Sector+	Over-seas	Total	Redemp-tions+	Gross sales
1984-85	3.7	-0.2	5.9	0.4	1.3	11.0	4.2	15.2
1985-86	0.4	-0.5	2.9	0.1	2.3	5.2	6.5	11.7
1986-87	2.4	-0.2	-0.7	1.4	2.8	5.8	8.8	14.6
1987-88	0.3	-0.4	0.0	-0.9	3.8	2.6	7.0	9.6
1988-89	-0.7	0.0	-6.2	0.0	0.0	-6.9	10.3	3.4
1989-90	-0.8	0.0	-5.7	0.0	0.0	-6.5	7.8	1.3

22. Money market influences are forecast to reduce the bill mountain. The stock of money market assistance outstanding falls from its current level of £6 billion to £7¾ billion by the end of this financial year and £3½ billion by the end of 1989-90. Under a regime of full funding and with zero net gilt purchases by banks, the contractionary effect of money market influences is explained by repayments of debt by local authorities to banks which is only partly offset by the growth of notes and coin.

Table 12: Money market influences and operations (£ billion)

	CGBR	Gilt sales (excl. REPOs)	CTDs & National Savings	Overseas and other finance	Money market influences
1985-86	11.0	-5.2	-2.3	0.3	3.7
1986-87	10.5	-5.8	-2.4	2.1	4.4
1987-88	3.3	-2.6	-1.3	4.1	3.5
1988-89	-2.3	6.9	-1.0	-1.4	2.3
1989-90	-3.0	6.5	-1.0	-0.4	2.0

	ID and BD commercial bills	REPOs /Other	Money market operations*	Changes in bankers' balances	Total assistance outstanding**
1985-86	-2.0	-1.7	-3.7	0.0	16.9 (12.1)
1986-87	-3.1	-1.2	-4.2	0.2	13.3 (10.1)
1987-88	0.2	-3.8	-3.6	-0.1	9.7 (7.1)
1988-89	-2.3	0.1	-2.2	0.1	7.7 (7.3)
1989-90	-2.0	0.1	-1.9	0.1	5.4 (5.0)

SECTORAL FLOW OF FUNDS

23. To an even greater extent than in recent forecasts, personal and company sector surpluses are forecast to fall from current levels, and this more than offsets the decline in the public sector deficit. As a result, the overseas sector moves into surplus reflecting the emerging balance of payments deficit.

Table 13: Sectoral financial surpluses and deficits (£ billion)

£bn	Private sector					Public	Overseas (1)	Residual
	Persons	Industrial and commercial companies		Financial companies	Total			
		Non-North Sea	North Sea					
1985-86	8.5	7.8	-0.7	1.5	17.1	-8.5	-3.8	4.8
1986-87	4.6	8.0	-0.4	4.7	16.7	-9.4	1.1	8.3
1987-88	2.1	6.9	1.0	3.8	13.8	-4.3	4.0	13.1
1988-89	2.3	3.5	0.4	4.9	11.1	-2.5	4.8	13.4
1989-90	0.8	4.6	0,3	4.4	10.2	-1.6	6.0	14.6

(1) Overseas sector surplus implies current account deficit.

Personal sector

24. Personal sector financial wealth is forecast to fall gradually as a proportion of disposable income mainly because wealth held in pension funds grows much more slowly partly as a result of contributions holidays. Households' gross wealth, however, is projected to grow broadly in line with income as households' saving ratio rises and offsets the fact that existing financial wealth grows only as a result of sluggish securities prices. Total household wealth, which includes the housing stock and consumer durables is also expected to rise in line with personal incomes in contrast to its faster growth of recent years, but remains high by recent standards.

Chart 10: Household wealth relative to income

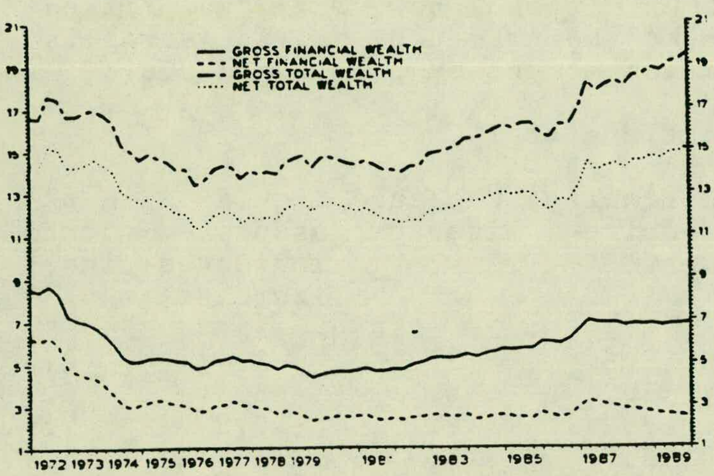
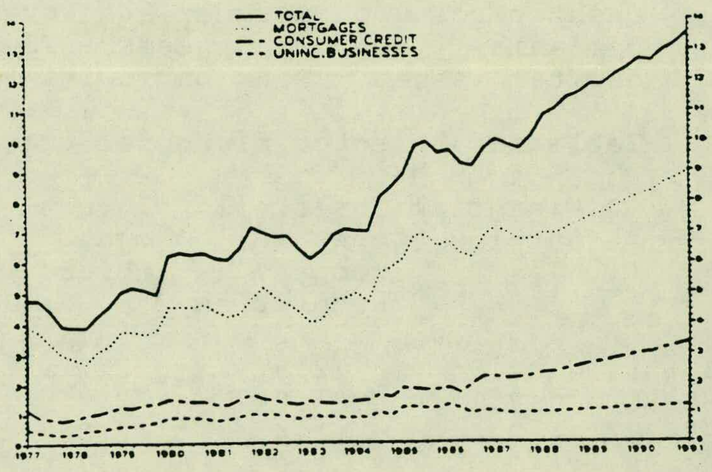


Chart 11: Personal sector income gearing



25. Total personal sector borrowing continues to rise strongly relative to personal incomes, but more than three quarters of this is accounted for by lending for house purchase. Thus, despite steep past and prospective rises in personal sector income gearing, most of this is accounted for by mortgage borrowing which has risen at least partly because of the rise in owner occupation.

Table 14: Flow of non-mortgage credit to personal sector (annual growth in stock outstanding in brackets)

£bn	Banks*	Other OFIs	o/w consumer credit	B.Socs	Total	Memo (Mort. equity withdrawal
1985-86	5.5 (16.3)	1.5 (9.1)	1.0 (13.8)	0.0	7.0 (14.1)	10.5
1986-87	5.0 (13.4)	1.4 (7.4)	1.1 (8.5)	0.1	6.5 (11.7)	15.1
1987-88	10.2 (18.2)	0.4 (9.4)	-0.3 (8.8)	0.5	11.1 (16.2)	14.5
1988-89	8.4 (18.9)	0.9 (4.5)	0.5 (4.6)	0.8	10.1 (16.0)	15.7
1989-90	8.2 (13.8)	0.9 (4.8)	0.5 (5.8)	0.9	10.0 (12.6)	16.5

* includes lending to unincorporated businesses

26. Interest payments on non-mortgage credit relative to personal income is rising to historically high levels but it is possible that these previous peaks will be scaled since credit was rationed in earlier periods. Given the above considerations, net financial wealth of the personal sector is expected to fall slightly.

27. Within personal sector asset portfolios, the fall in investment in life assurance and pension funds is mainly offset by a move into liquid assets. Persons' readiness to continue heavy buying of equities and unit trusts in limited by the forecast sluggish stock market.

Industrial and commercial companies

28. Companies' financial surplus in the present financial year seems likely to be little higher than last year as rising profits are used to finance higher real investment and stockbuilding. A sharp rise in cash spending on mergers and investment abroad, however, has raised companies' borrowing needs. These are being met by a large surge in capital issues. Bank borrowing remains modest by past standards.

Table 15: Selected financial transactions of ICCs

£bn	Financial surplus	Invest-(1) ment in company securities	Invest-ment abroad	Borrowing require-ment	Capital issues	Liquid assets(- indicates increase)	Bank borro-ing
1985-85	7.8	2.5	2.7	3.6	2.7	-2.9	8.0
1985-86	7.1	1.0	2.2	5.7	4.7	-5.3	6.9
1986-87	7.4	1.4	6.5	7.7	8.1	-10.8	5.8
1987-88	7.9	7.0	8.7	15.7	16.9	-11.4	5.9
1988-89	3.9	3.5	3.9	11.2	6.0	-8.5	9.6
1989-90	4.9	3.0	3.4	9.7	5.0	-8.6	8.9

(1) Cash expenditure on domestic mergers

29. The forecast is that companies' financial surplus will be substantially lower in the next two years as profits grow more slowly and investment continues to rise strongly. Merger activity and investment abroad are forecast to be lower but companies' borrowing needs will remain high by the standards of recent years. We have assumed that the absence of gilts will leave some room for corporate bond issues and that companies will also issue short-term securities. In the face of a less buoyant equity market, however, bank borrowing - both in sterling and foreign currencies - may play a larger role again. Companies' gross liquid asset ratio which has been rising steadily is forecast to increase further but the projected growth in bank borrowing and other short-term liabilities implies a small fall in the net liquidity ratio from its present high level.

Monetary sector

30. After a rapid expansion in 1986-87, attributable partly to Big Bang, monetary sector balance sheets seem likely to rise less rapidly this year and a further slowdown is forecast for 1988-89. Banks' claims on other financial institutions in particular are likely to grow more slowly. Overseas claims are also forecast to rise less rapidly reflecting at least partly banks' reluctance to increase exposure to troubled debtors. Lending to companies, however, may grow more rapidly to help meet their large financing needs - although companies' increasing reliance on security issues will push banks towards commission business rather than direct lending. Advances to persons is also forecast to rise rapidly although growth in mortgage lending may slacken from its recent hectic rate.

Table 16: Banks' balance sheet

£bn		Stock 1987Q1	Flows 1986-87	1987-88	1988-89	1989-90
Domestic						
£ assets		186.2	31.2	40.3	36.9	35.3
£ liabilities		153.4	25.9	29.1	26.9	25.1
f.c assets		51.0	13.2	8.2	7.5	9.0
f.c liabilities		28.7	8.1	5.2	5.0	5.0
Net deposit liabilities (1)		-55.1	-10.4	-14.2	-12.5	-14.2
Overseas						
£ assets		33.6	5.3	2.1	3.1	4.1
£ liabilities		42.0	4.2	5.2	5.7	6.6
f.c assets		430.1	52.5	45.1	42.6	47.4
f.c liabilities		438.3	59.9	47.8	45.3	51.6
Net deposit liabilities (1)		16.6	5.6	3.2	3.4	3.9
Net non deposit liabilities	£	38.6	4.7	5.0	5.7	5.5
	fc	38.6	-0.6	3.0	1.6	1.8
Memo item						
Net foreign currency position		14.1	-1.7	-2.6	-1.4	-2.0

(1) - indicates net assets

31. Banks are forecast to rely increasingly on attracting funds from overseas in the light of the slower projected growth of domestic

residents' deposits. Banks' liabilities in foreign currency seem likely to rise relatively rapidly, matched by increased foreign currency lending to domestic companies. Net non-deposit liabilities are projected to rise rapidly during the forecast period reflecting at least partly banks' increased provisions against their exposure to developing country debtors.

Building societies and the mortgage market

32. Building societies have lost share heavily in the market for new mortgages to banks and other lenders recently as slow growth in retail inflows, coupled with constraints on liquidity and wholesale funding, rendered them unable to increase their mortgage lending in line with demand. Over the forecast period, rising economy-wide interest rates and a sluggish equity market help to raise the societies' inflows (which are also aided by increased development of banking services). Mortgage demand also grows more slowly and the societies' market share recovers - albeit to a level well below that of the early 1980s.

Table 17: New mortgage advances by institution

	Building societies			Banks			Others (1)		
	£bn	%growth	share	£bn	%growth	share	£bn	%growth	share
1985-86	15.4	17.9	77.3	4.3	24.7	21.6	0.2	2.3	1.1
1986-87	18.7	18.4	69.3	5.5	25.2	20.3	2.8	29.9	10.4
1987-88	14.8	12.3	52.4	8.2	30.3	29.2	5.2	42.8	18.5
1988-89	19.2	14.2	61.6	6.0	16.9	19.3	6.0	34.3	19.1
1989-90	22.0	14.3	65.6	6.0	14.6	18.0	5.5	23.5	16.4

(1) Other OFIs plus public sector (mainly local authorities)

33. Societies are forecast to maintain the differential between mortgage rates and base rates at its present level of $1\frac{1}{4}$ per cent, and to cope with any shortfall by increasing wholesale funding until, by the end of the forecast period all societies are at or near the current limit. (In the short run there is also a small risk that some societies may rise rates in response to pressures resulting from the BP privatisation, although they can probably take the burden on liquidity, as in the past.)

Table 18: Building societies summary table

	Interest rate differentials			% growth in retail inflows	%growth in mortgage demand	liquidity ratio	whole-sale ratio
	mortgage less gross share rate	mortgage less base rate	net share less net bank deposit rate				
1985-86	1.12	1.20	1.43	15.4	16.3	17.1	4.9
1986-87	1.35	1.17	1.28	10.9	18.5	15.3	8.6
1987-88	1.26	1.47	1.58	10.6	16.3	15.2	10.4
1988-89	1.14	1.25	1.49	12.4	15.3	15.9	12.5
1989-90	1.10	1.25	1.46	12.1	14.2	16.2	14.6

34. Over the medium term, several societies are likely to choose incorporation, either directly or as a prelude to an agreed bank takeover, as a solution to their funding problems. This has not been allowed for in the forecast since to do so would artificially distort the underlying picture. The tendency for mergers between societies is likely to continue, but has little effect on the overall picture.

Life assurance and pensions funds (LAPFs)

35. LAPFs inflows fall from £21 billion this year to £18 billion by 1989-90 because of contributions holidays. This reduces the growth of their bank deposits. The dearth of net gilt sales causes them to run down their £70 billion outstanding stock of gilts by £5 billion a year. But take-up of UK company securities including privatisations and overseas securities is at a higher level. Taking these effects together, the growth of their bank deposits is low by recent standards.

Other OFIs

36. Inflows to unit trusts have been extremely buoyant in recent quarters, partly boosted by the increase in take-up of linked life assurance schemes by LAPFs. Over the forecast period, the weakening stock market causes unit trust inflows to fall back below current high levels.

37. **Securities dealers** are assumed to reduce in importance over the immediate future as the shake out from the Big Bang continues and equity markets become more sluggish. Increases in stress lending by banks to this sector may occur.

38. **New mortgage lenders** are forecast to make considerable inroads into the market for new advances, their share increasing to around 20 per cent by the end of 1989-90. These institutions' financing requirements are expected to rely less on bank advances and increasingly on securitised mortgages, although to the extent that these will be bought by banks, recorded bank lending to the sector will remain high.

Capital markets

39. Total issues of domestic securities by all sectors, that is gilts, privatisations and corporate capital issues seem likely to rise from £21 billion last year to £29 billion this before falling sharply in 1989-89 and 1989-90.

Table 19: Issues of domestic securities by all sectors

	Net gilt issues	Capital issues	Privatisation issues	Total	Memo items: Overseas securities	Memo items: Equity price growth
1986-87	1.5	15.8	3.9	21.2	24.6	23.9
1987-88	-0.2	23.7	5.5	29.0	12.9	21.2
1988-89	-6.9	17.5	6.2	16.8	12.0	4.5
1989-90	-6.5	18.8	6.2	18.5	12.3	3.9

40. The main features of the forecast are heavy continued corporate issues. The large fall in issues of gilts is only partly offset by the rise in privatisations. With equity prices sluggish and government fixed term securities in short supply, corporate issues may at least partly take the form of fixed rate bond issues but if international interest rate uncertainties remain then greater reliance may need to be placed on short-term securities.

Overseas sector capital account

41. The need to finance a widening current account deficit and continued investment abroad by companies and financial institutions is forecast to be met by a mixture of corporate capital issues and increased bank borrowing from overseas.

Table 20: Overseas sector capital account

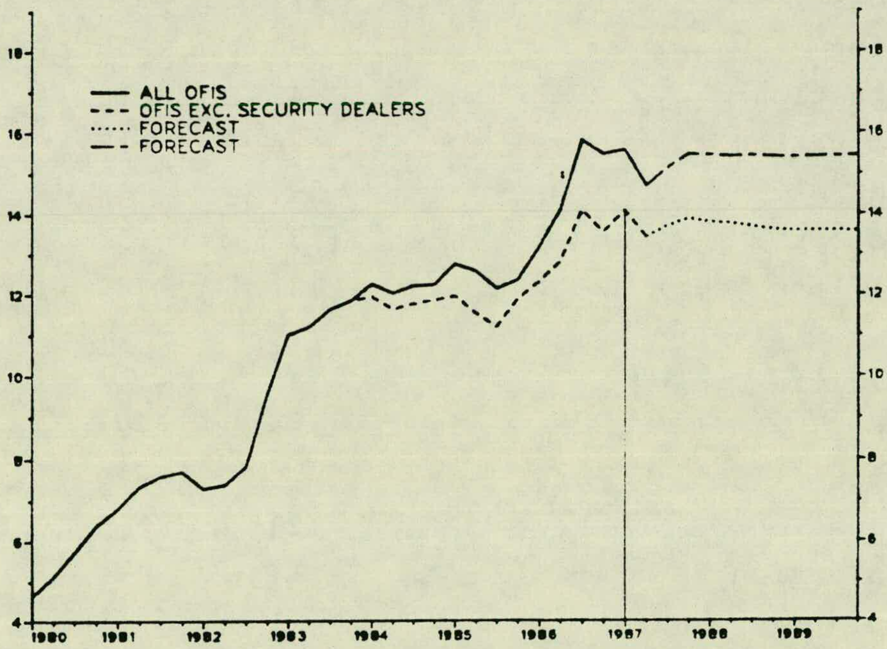
£ BILLION

	1985	1986	1987	1988	1989
DIRECT INVESTMENT					
Inward	4.4	5.4	4.3	5.1	5.2
Outward	-8.8	-11.4	-14.3	-10.4	-10.7
Net	-4.4	-6.0	-10.0	-5.3	-5.5
NON BANK PRIVATE					
Inward	6.8	8.6	12.2	10.2	11.5
Outward	-7.8	-16.0	-6.5	-6.6	-7.4
o.w ofis portfolio	-5.1	-13.8	-2.8	-4.1	-4.6
Net	-1.1	-7.4	5.7	3.6	4.0
BANKS					
Inward					
£	4.1	5.6	6.5	5.2	6.2
f.c	25.3	58.4	46.2	43.2	51.6
Outward					
£	-1.6	-6.0	-2.7	-3.0	-4.0
f.c	-20.4	-47.9	-39.9	-38.0	-44.0
portfolio	-10.1	-7.6	-.1	-3.0	-3.4
Net	-2.7	2.6	10.0	4.4	6.4
GENERAL GOVERNMENT					
Inward	3.4	3.5	4.9	.2	-
o.w gilts	2.9	2.1	4.4	.2	-
Outward	-.7	-.5	-.8	-.7	-.7
Net	2.7	2.9	4.2	-.5	-.7
NET CAPITAL FLOWS	-5.5	-7.8	10.0	2.1	4.3
BALANCING ITEM	4.5	11.7	-1.8	1.0	1.0
RESERVES	-1.8	-2.9	-5.7	1.3	.3
CURRENT ACCOUNT	2.9	-1.0	-2.4	-4.3	-5.6

42. Direct investment abroad by UK companies which has been exceptionally large in 1986 and 1987 partly as a result of take-over activity, is forecast to fall as companies' ability to raise new equity finance is limited and subsidiaries' overseas profits rise less rapidly. Even with steady investment into the UK, however, net direct investment outflows seem likely to be about £5 billion a year.

43. Portfolio investment abroad by UK financial institutions which was boosted in 1986 by an exceptional £9 billion in purchases by securities dealers, has been lower so far in 1987 as this has unwound. In the absence of sharp movements in exchange rates, interest differentials and relative equity prices, security dealers' purchases of overseas assets are forecast to be less erratic. Other UK financial institutions are assumed to invest abroad a slightly higher proportion of their new inflows than in the recent past to keep the share of overseas assets in their total portfolios close to 15 per cent. Total portfolio outflows seem likely to be around £4 billion a year.

Chart 12: OFIs' overseas assets as a share of total assets.



44. Overseas investors seem likely to purchase a significant share of the unprecedented volume of UK companies' capital issues this year, and we forecast that this will continue - albeit at a lower rate. Banks are assumed to increase their net foreign currency borrowing by some £3-4 billion a year for on-lending to domestic companies. The early projected improvement in the sterling interest differential against the world average also allows them to attract net sterling deposits from overseas of about £2 billion a year.

45. Gilt sales to the overseas sector, however, which have been particularly strong in 1987, are projected to fall to zero from mid-1988 onwards given the modest full fund requirements. Around half the £4½ billion build up in reserves recorded in the second quarter of 1987 is expected to be unwound by end 1988-89. Thereafter the conventional zero intervention projection is retained.

Net overseas assets

46. The UK's net overseas assets which rose by £36 billion during 1986 to £114 billion, may show a small further rise this year despite the need to finance the current deficit. The relatively strong rise in securities markets abroad has increased the UK overseas assets more than the pound's appreciation has reduced their value in sterling terms. Valuation effects are forecast to be small in future with UK and overseas securities markets moving broadly in line and the sterling exchange rate constant. The widening current deficit, however, implies a gradual decline in net overseas assets.

Table 21: Changes in UK net overseas assets (£ billion)

Gross assets	**1986**	**1987**	**1988**	**1989**
Capital flows	+92	+70	+60	+70
$ revaluation	-9	-35	-19	-15
Non $ revaluation	+42	-10	+5	+3
Market revaluation	+20	+19	+2	+3
Unexplained	-9	+9	0	0
Change in stock	+136	+53	+48	+61
Stock level (end year)	731	784	832	893
Gross liabilities				
Capital flows	+82	+74	+64	+75
$ revaluation	-8	-29	-15	-12
Non $ revaluation	+23	-5	+2	+2
Market revaluation	+4	+9	+1	+2
Unexplained	-1	-1	0	0
Change in stock	+100	+48	+51	+66
Stock level (end year)	617	665	716	782
Net assets				
Change in net asset position	+36	+5	-3	-5
Net asset position (end year)	114	119	116	111

WORLD ECONOMIC PROSPECTS

CONFIDENTIAL

FROM: S W MATTHEWS

DATE: 8 October 1987

Nigel

thanks

CHANCELLOR

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Mr F E R Butler
Sir T Burns
Sir G Littler
Mr Anson
Mr Byatt
Mr Cassell
Mr Kemp
Mr Lavelle
Mr Monck
Mr Evans
Mr Odling-Smee
Mr Peretz
Mr Sedgwick
Mr Turnbull
Mr Bottrill
Mr S Davies
Mr Mowl
Mr Dolphin
Mr Cropper
Mr Tyrie

WORLD ECONOMIC PROSPECTS: AUTUMN 1987

I attach a report on the latest WEP exercise. It provides the world economic background to the forecast report which Mr Sedgwick is circulating later today. — tomorrow, in fact.

2. The first two pages of the report summarise the forecast. An annex describing in more detail the forecasts for each of the major countries and for the developing countries is available on request.

3. The WEP report includes some figures for the UK consistent with the domestic forecast. These will not be included in any version of the report shown to outside Departments.

SM.

S W MATTHEWS

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WORLD ECONOMIC PROSPECTS: OCTOBER 1987

SUMMARY

- The WEP assumes no major pressures develop in foreign exchange markets over the next year or so. The **dollar's nominal effective exchange rate** remains broadly unchanged over this period, and **US interest rates** rise only modestly. There is a risk though that much greater downward pressure on the dollar could develop, resulting in a combination of greater dollar depreciation and higher US interest rates.

- No major changes in announced **fiscal policies** in the major industrial countries are assumed.

- **Real GNP** in the major seven is picking up after some hesitation around the turn of the year. It is projected to grow by about 2½ per cent in 1987 and at a similar rate over the next few years, broadly in line with potential. Industrial production, which stagnated in several major countries in 1986, is forecast to grow by 3 per cent in 1987 and by over 4 per cent in 1988 and 1989.

- The volume of **World trade** in 1987 is expected to grow by around 3½ per cent, with world trade in manufactures growing slightly faster. In 1988 and 1989 the growth rate of total world trade is forecast to be around 4 per cent per annum.

- **Consumer price inflation** in the major seven has, as expected, risen to around 3 per cent, reflecting the recovery in oil and other commodity prices. Average inflation is forecast to stabilise at around this rate.

- The **oil price** (average North Sea price) is expected to remain around its current level, about $18 per barrel, until the end of 1988, and to remain constant in real terms thereafter. This is roughly consistent with OPEC's current target price.

- **Non-oil commodity prices** have recovered from their trough of last summer. Strengthening world industrial production should produce some further modest increases in the prices of industrial materials but they remain well below their historical average. No increase in real food prices is expected.

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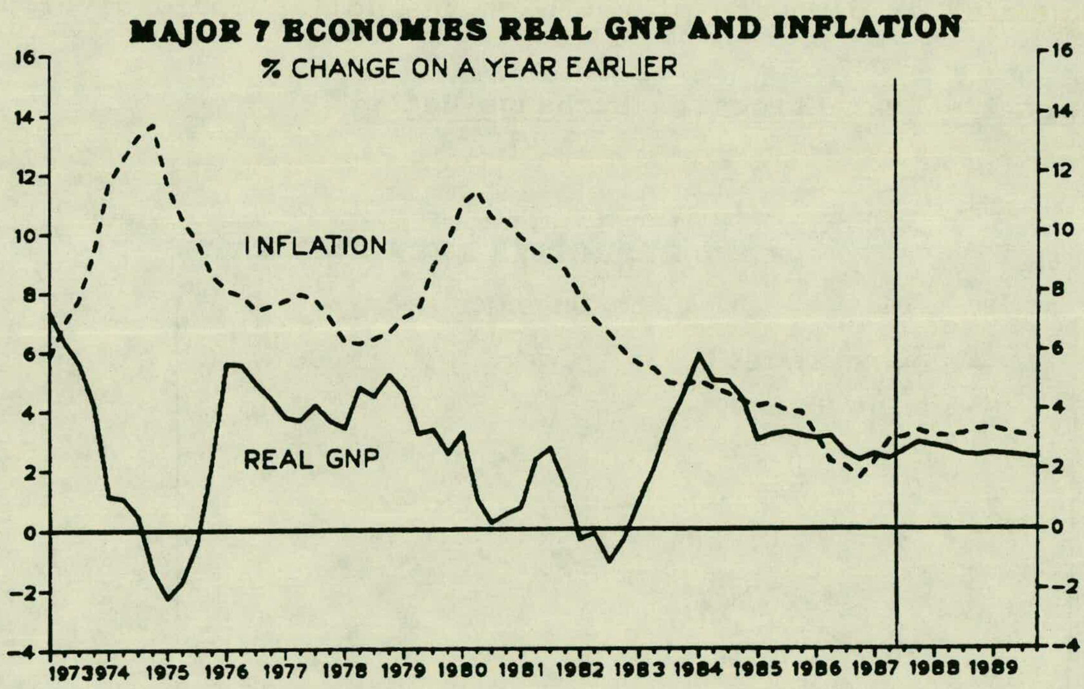
Table 1: Output, Inflation and Trade

Percentage change on year earlier	1985	1986	1987	1988	1989
Major 7 real GNP	3.1	2.7	2.6	2.6	2.4
Major 7 real domestic demand	3.2	3.8	2.7	2.7	2.6
Major 7 industrial production	2.8	0.9	3.0	4.3	4.2
Major 7 consumers' expenditure deflator	3.9	2.1	2.8	3.1	3.0
World trade - total	4.4	4.7	3.5	4.2	4.0
- manufactures	4.6	1.9	3.8	4.9	4.8

Chart 1 - Major Seven Growth and Inflation



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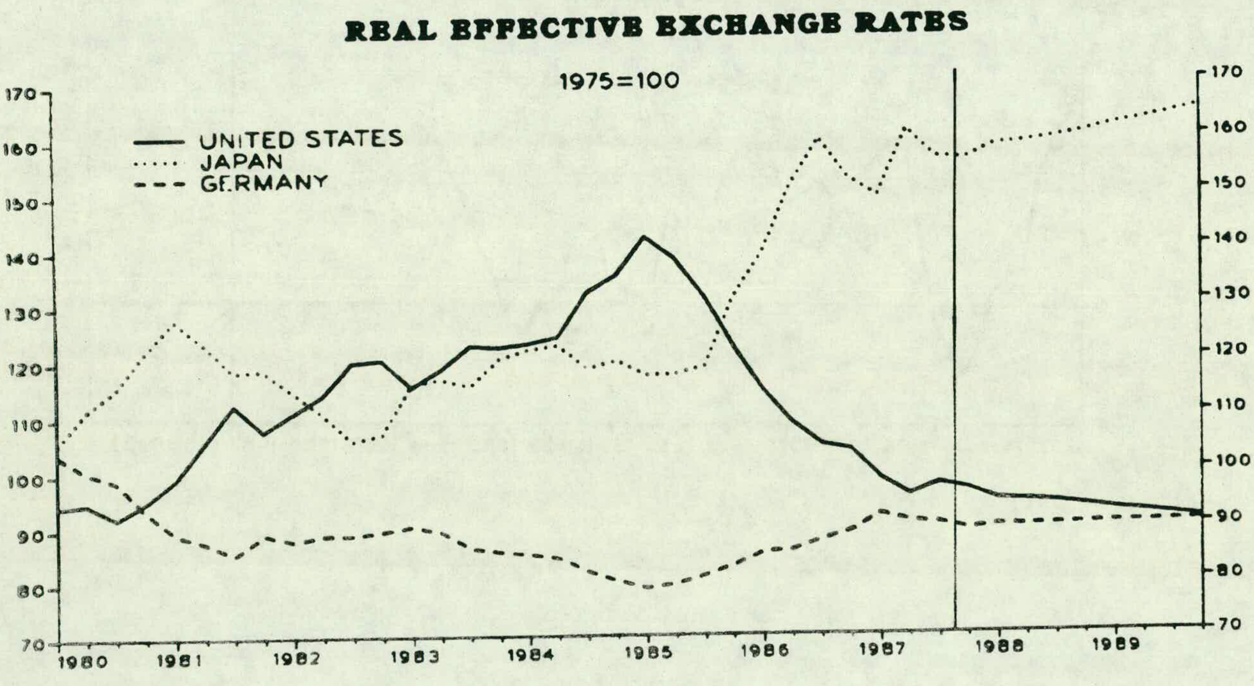
MONETARY AND FISCAL POLICIES IN THE MAJOR COUNTRIES

1. During the first half of 1987 nominal short-term interest rates rose by 1 percentage point in the United States and Canada and fell by ½ percentage point in Japan, Germany and France. These movements will have contributed to the relative stability of exchange rates since the Louvre Accord in February. More recently, interest rates have risen by a further ½ percentage point in the US, and market interest rates in Japan and Germany have also increased slightly.

2. One of the most important judgements made in this forecast is that the dollar does not come under significant downward pressure during the rest of the decade. We assume that the dollar's nominal depreciation is slightly more than the inflation differential between the US and Japan and Germany, and that US interest rates need to rise by only a further 1 per cent. This may be unduly optimistic in view of the prospects, on present policies, for current balances and net external asset positions of the three largest countries. There remains a significant risk that markets may become impatient with the speed of adjustment and much greater downward pressure on the dollar could develop.

<u>**Chart 2 - Real Effective Exchange Rates**</u>



3. As well as the desire not to see the dollar fall sharply, the Federal Reserve Board faces a number of conflicting domestic pressures in setting US monetary policy: continuing large Federal deficits, an inflation rate which has been creeping up, and political pressure not to raise interest rates to such an extent that real growth is weakened. On balance domestic considerations point to the trend in US interest rates remaining upward.

4. In Japan and Germany the monetary authorities are concerned about the rapid growth of their monetary aggregates and have only accepted this as a necessary price to prevent their currencies appreciating even more. They will be reluctant to let their interest rates fall while their exchange rates are not subject to strong upward pressure.

Table 2: Short-Term Interest Rates

	Nominal				Real*			
%	1986	1987	1988	1989	1986	1987	1988	1989
US	6.5	6.8	8.2	8.5	4.2	2.9	4.2	4.4
Japan	5.0	3.9	3.8	3.8	4.3	3.7	3.1	3.1
Germany	4.6	4.0	4.0	4.0	5.1	3.2	2.7	3.1
France	7.8	8.0	7.4	7.1	5.2	4.4	5.0	4.8
Italy	12.8	11.7	12.1	11.8	6.3	7.3	6.4	5.5
Canada	9.2	8.6	9.6	9.3	4.7	4.1	5.1	4.9
UK	11.0	10.0	11.0	11.0	7.4	7.3	6.5	6.7
Major 7 (excluding UK)	6.7	6.4	6.8	6.9	4.5	3.6	3.8	3.8

* Average annual three month interest rate less change in consumers' expenditure deflator over the previous year.

5. The forecasts for general government financial deficits, as a percentage of GNP, in the major seven countries are set out in Table 3. On this measure fiscal policy for the group as a whole has become tighter in 1987, as reductions in deficits in the US, Canada, and to a lesser extent France, have more than offset the increase in the Japanese deficit.

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Table 3: General Government Financial Deficits

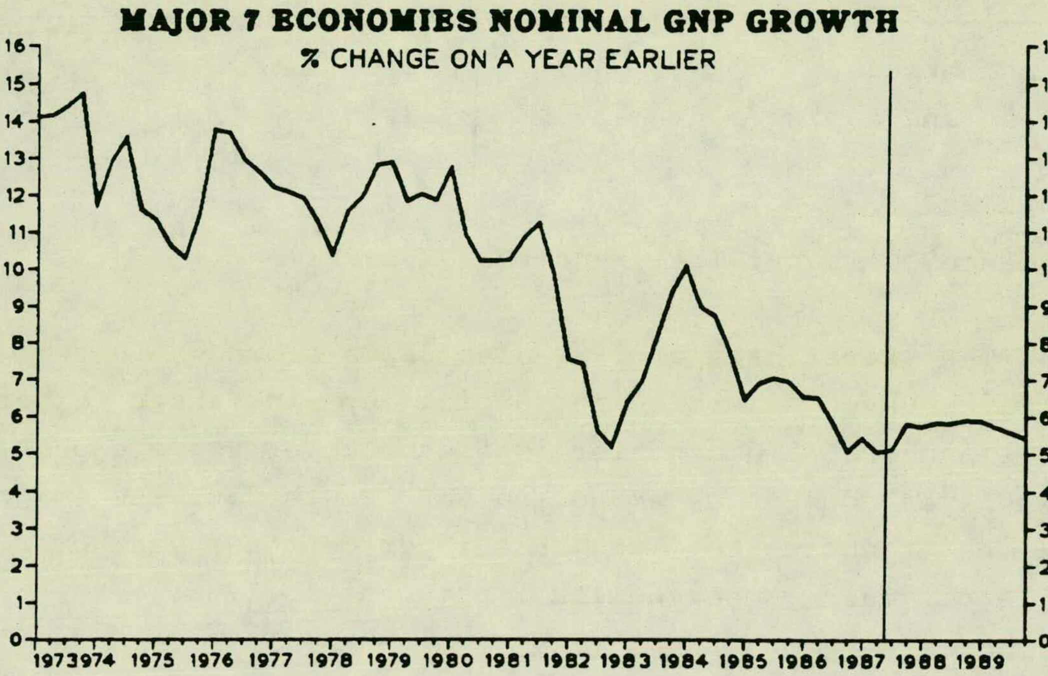
% of GNP	1980-85	1986	1987	1988	1989
US	2.6	3.5	2½	2½	2¼
Japan	3.2	0.6	1½	1½	1
Germany	2.6	1.2	1½	1¾	1½
France	2.2	2.9	2¼	2¼	2
Italy	11.9	11.2	11½	11	11
Canada	5.0	5.5	4½	4½	4½
UK	3.1	2.6	1	1	½
Major 7	3.3	3.3	2¾	2¾	2½

6. The US Federal budget deficit in fiscal 1987, which ended on 30 September 1987, is likely to have been about $160 billion (3½ per cent of GNP). This represents a reduction of $60 billion on the previous year, partly reflecting one-off gains from the tax reform package. The Congressional Budget Office estimate that, on a "current services" basis, the deficit will rise to over $180 billion in FY1988 and over $190 billion in FY1989. Despite the revamped Gramm-Rudman legislation, only modest reductions in the deficit from this baseline are likely until after next year's election, giving deficits of around $170 billion in both FY1988 and FY1989. This assessment is broadly in line with that of most other forecasters.

7. Elsewhere, the forecast assumes that fiscal measures already announced are implemented - in particular the Japanese package and cuts in tax rates in Germany from January 1988. Only about half of the Japanese package is assumed to be genuinely additional, but the fiscal stimulus nevertheless amounts to 1 per cent of GNP. After 1988 the Japanese Government is assumed to return to a policy of gradual fiscal consolidation. In Germany a further round of tax cuts is planned for 1990, but no changes are expected in 1989.

8. These policy assumptions are forecast to produce continued growth in aggregate money GDP in the major seven of around 5½ per cent a year - see chart 3.

Chart 3 - Nominal GNP in Major Seven



DEMAND AND OUTPUT

9. Data for the first half of 1987 show that domestic demand in the major seven as a whole slowed following rapid growth in 1986, when these countries experienced a large terms of trade gain. There are also signs that private investment was affected by exchange rate uncertainty around the turn of the year. Stockbuilding was particularly strong in the first half. The reasons for this are as yet unclear, but it was probably partly involuntary, and subsequent destocking could depress growth in the remainder of the year. However, other factors point to a modest recovery in domestic demand growth outside the United States and, on balance, domestic demand growth in the major seven is projected to grow at just over 2½ per cent per annum over the next few years.

Table 4: Domestic Demand Growth

Percentage change on year earlier	1986	1987	1988	1989
North America	3.9	2.0	1.8	1.6
Europe* and Japan	3.8	3.4	3.5	3.4
Major 7	3.8	2.7	2.7	2.5

* France, Germany, Italy and the UK.

10. The first half of 1987 also saw a slowdown in the growth of the major seven's imports and a pick up in their exports. If NODC's and OPEC's demand for imports recover as we expect, the gap between real domestic demand and GNP growth in the major seven will be reduced to less than ½ per cent per year over the next couple of years compared with 1 per cent in 1986.

Chart 4 - Real GNP Growth in the Major Seven

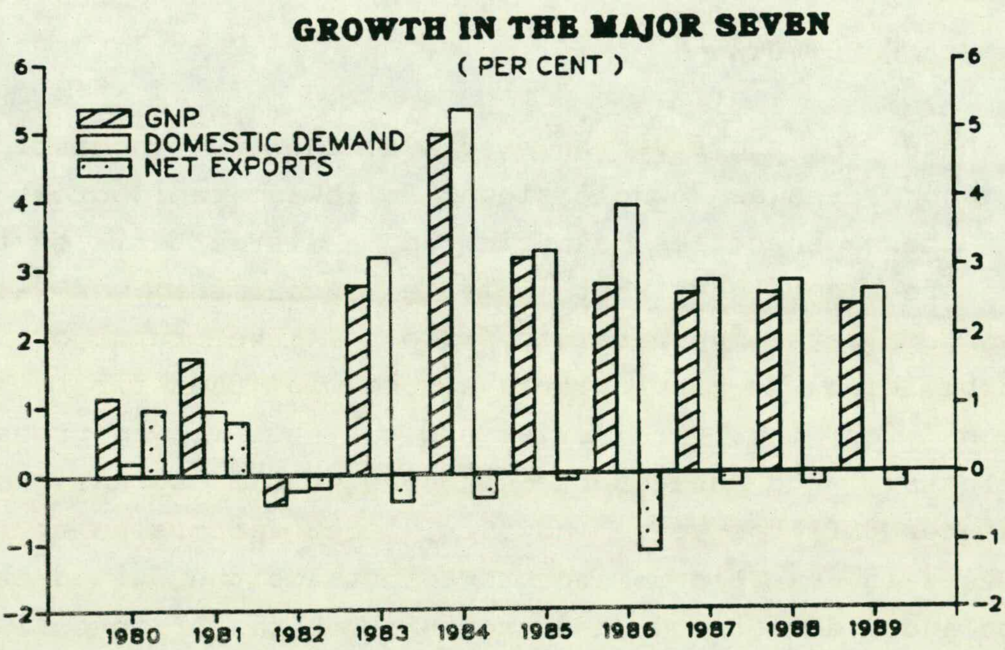


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Table 5: Growth of Real GNP and Contribution of Domestic Demand

Percentage change on year earlier	GDP/GNP 1986	1987	1988	1989	Estimated Growth of Productive Potential
US	2.9	2.5	2.5	2.0	2½
Japan	2.5	3.2	3.5	3.6	3½
Germany	2.5	1.5	2.2	2.4	2¼
France	2.1	1.5	2.1	2.3	2¼
Italy	2.7	3.1	2.3	2.7	2½
Canada	3.3	3.4	2.4	2.1	2¾
UK	3.1	4.1	3.1	2.4	2½
Major 7	2.7	2.6	2.6	2.4	2½

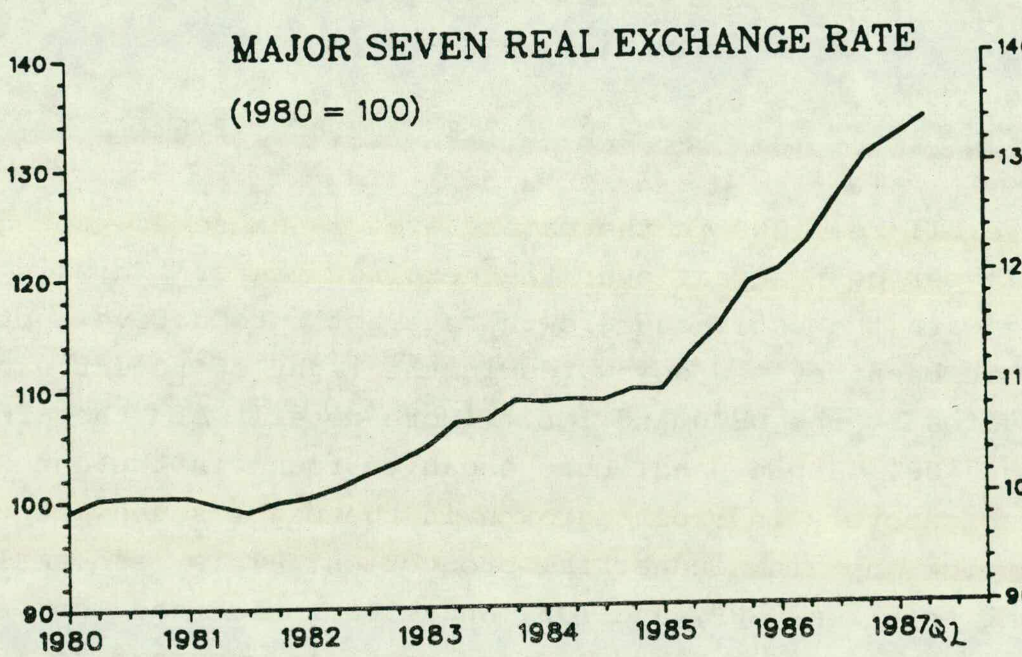
Percentage change on year earlier	Domestic Demand Contribution 1986	1987	1988	1989
US	4.0	1.9	1.7	1.6
Japan	3.9	4.2	4.8	4.3
Germany	3.5	2.4	2.7	2.9
France	3.7	2.2	2.3	2.5
Italy	3.3	3.7	3.1	3.3
Canada	3.7	3.4	3.6	2.5
UK	4.3	4.5	4.7	3.4
Major 7	3.9	2.8	2.8	2.6

11. Overall real GNP in the major seven is expected to grow at about 2½ per cent a year over the next few years. This is broadly in line with the estimated growth rate of productive potential, which has been revised downwards in the light of recent experience and studies by the OECD and IMF. (More detail of the forecasts for the US, Japan and Europe can be found in the annex). The forecast recovery in export growth in the major seven contributes to a pick up in industrial production. This is normally more cyclical than real GNP, and 1987 and 1988 could see quite rapid growth perhaps averaging 4 per cent; in contrast to 1986 when production rose by less than 1 per cent.

13. The real exchange rate of the major seven as a gro[up] appreciated sharply from the beginning of 1985 because many developing countries depreciated their currencies in line with the dollar. (See Chart 5). This will have contributed to the rapid growth in developing countries' - particularly the NICs' - exports (and in major seven imports) last year and this. The appreciation of the G7 real effective exchange rate index has slowed since the Louvre Accord, but the pressure being put on the Pacific rim NICs to allow their exchange rates to rise to more realistic levels has not yet produced any reversal of the earlier rise in the index.

14. There is already evidence that an end to oil stockbuilding and a slowdown in domestic demand growth in industrial countries (particularly the United States) are producing slower growth in total world trade in 1987 - a rise of about 3½ per cent is expected. However, imports of manufactures should grow faster in 1987 than in 1986 helped by a recovery in NODCs' imports, and less of a cutback in OPEC imports. OPEC countries still account for a greater proportion of UK exports of manufactures than of world trade as a whole, so the continued cutbacks in OPEC imports mean that UK-weighted world trade in manufactures continue to grow more slowly than the total shown in Table 6.

Chart 5 - Major Seven Real Effective Exchange Rate



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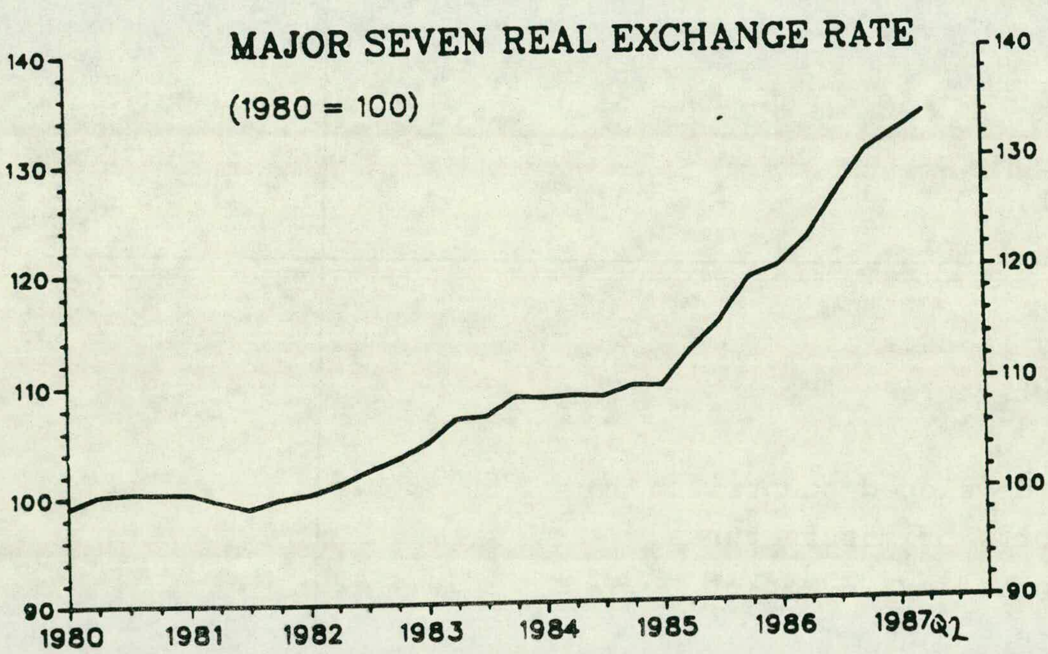

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WORLD TRADE

12. World import volumes grew by over 4½ per cent in 1986, with developed countries' imports rising by about 8 per cent. Much of this strong growth was caused by increased demand for oil (reflecting its low price in 1986) and strong domestic demand growth in the major industrial countries. On the other hand, OPEC imports are estimated to have fallen sharply and NODC's imports increased only slightly. Non-oil trade is estimated to have grown by less than 3 per cent, and trade in manufactures by only 2 per cent.

Table 6: World Import Growth

Percentage change on year earlier	1985	1986	1987	1988	1989
Total developed economies*	4½	8	4½	4	3½
of which:					
US	4½	12½	3½	-1	-½
Japan	0	13½	7	11½	8½
EC(6)**	5	6	5	4½	4
OPEC	-11	-20½	-10	0	2½
NODCs	5½	1	3½	5½	6
Total	4½	4½	3½	4	4
World imports of manufactures	4½	2	4	5	5
Main developed countries' exports of manufactures, weighted by UK market share	4	1½	2½	3½	4

* OECD plus South Africa

** Belgium, France, Germany, Italy, Netherlands and UK.

INFLATION

15. The average 12-month rate of inflation in the major seven countries has risen to 3 per cent as the effect of the oil price fall in 1986 has dropped out and as oil and other commodity prices have recovered. The forecast is for no further pick up in inflation. Earnings growth in many countries has slowed down, thereby reducing domestically-generated inflation and the appreciation of their effective exchange rates will keep import price rises low in Europe and Japan.

Table 7: Prices

Percentage change on year earlier	Consumers' Expenditure Deflator 1986	1987	1988	1989
US	2.2	3.8	3.8	3.9
Japan	0.6	0.1	0.7	0.7
Germany	-0.5	0.8	1.3	0.9
France	2.5	3.5	2.3	2.1
Italy	6.2	4.1	5.4	5.9
Canada	4.3	4.3	4.2	4.1
UK	3.6	2.7	4.5	4.3
Major 7	2.1	2.8	3.1	3.0

16. The main inflation risk is in the United States if the dollar falls sharply. Unemployment there has fallen below 6 per cent, around most people's estimates of the NAIRU and there is evidence of labour shortages in more prosperous areas. Higher import prices could be reflected in higher wage settlements. In any case, the differential between inflation in the United States and in Japan and Germany remains wide.

CURRENT BALANCES

17. Table 8 and Chart 6 show the forecast of current account balances. There is some evidence from monthly data that the

surpluses of Japan and Germany are already beginning gradually to decline as changes in trade volumes, shown by the trade ratios in Table 8, begin to offset improvements in terms of trade following the depreciation of the dollar. Our assumption of little further change in exchange rates allows some short-term reductions in imbalances, but - given our assumptions about macroeconomic policies and forecast of relative growth rates of domestic demand - limits adjustment in the long-term. However, as discrepancies produce a world current account deficit of $70 billion, which the IMF have been unable to allocate between countries, the magnitudes of present imbalances must be judged with care.

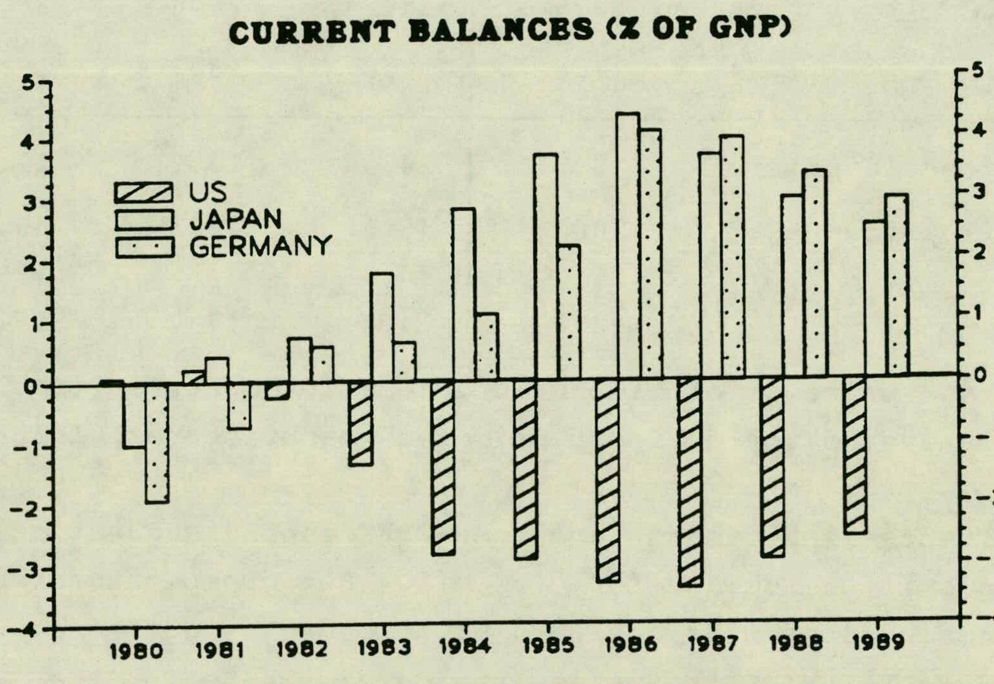
Table 8: External Balances, Trade Ratios and Net External Assets

	1986	1987	1988	1989	1990
Current balance ($bn)					
US	-141	-153	-140	-130	-121
Japan	85	85	77	73	68
Germany	37	44	40	39	37
NODCs	-2	-1	0	0	4
OPEC	-39	-30	-25	-21	-17
World imbalance	-70	-73	-74	-80	-77
Trade balance ($bn)					
US	-144	-153	-137	-125	-116
Japan	82	82	74	69	64
Germany	53	61	60	60	49
Trade ratio (exports/imports, volumes, 1980=100					
US	57	61	68	73	78
Japan	113	103	93	88	84
Germany	111	108	105	103	101
Net external assets ($bn, end of year)					
US	-264	-417	-557	-687	-808
Japan	180	265	342	415	483
Germany	94	138	178	217	254
Net external assets (% of GNP)					
US	-6	-9½	-11½	-13½	-15
Japan	9	11½	13	14½	15
Germany	10½	12½	15	16½	17½

18. Table 8 also shows estimates of the implications of these forecast current account balances for the net asset positions of the three largest economies. These figures are subject to a substantial margin of error - for instance, an attempt by Goldman Sachs, New York to adjust the official Department of Commerce figures to make the valuation of US assets less conservative gives an estimate of net external assets for the US at the end of 1986 of $200 billion, rather than net liabilities of $265 billion. Nonetheless, it is clear that if current account balances develop as expected the net external position of the United States will continue to deteriorate. There is a danger of a dollar "overhang" building up which could reinforce the risk of market impatience with the speed at which current imbalances were being reduced. This could point to much greater dollar weakness and/or higher US interest rates than assumed in the forecast.

19. Large current account imbalances are likely to mean that protectionist pressures remain strong in the US, though the recent recovery in industrial production and exports and continued employment growth should all strengthen the Administration's hand in resisting these pressures. Like its predecessors, this forecast assumes no more than a continuation of the recent trend of creeping protectionism in the world economy.

Chart 6 - Current Account Balances



THE OIL MARKET

20. OPEC have re-established some control over the oil market and Saudi Arabia is again in the position where it can, if it wishes, act as a swing producer. In the first half of 1987, total OPEC output was close to its agreed aggregate production limit - thanks to under production by Saudi Arabia - and oil prices were close to OPEC's target price, with the average OECD import price (fob) just under $17 per barrel. In the summer prices rose to over $20 per barrel for a short time (partly because of fears about an escalation of the Gulf War) before falling back again to around $17 per barrel following reports that several OPEC Members were breaching their production limits, and that Saudi Arabia was not making offsetting cuts in its production.

Table 9: The Oil Market

Millions of barrels per day	1980	1986	1987	1988	1989
Demand					
Consumption in OECD, OPEC and developing countries	49.8	46.9	47.4	48.1	49.0
Stockbuilding	0.6	1.1	0.0	0.3	0.4
Supply					
Non-OPEC	22.8	28.2	28.6	28.5	28.7
OPEC	27.6	19.8	18.8	19.9	20.7
Oil price* ($ pb)	30.3	14.3	17.2	17.5	18.1
Real oil price**	100	45.5	48.2	46.5	45.5
North sea oil price ($pb)	34.7	14.2	17.7	18.0	18.8

* Average price of oil imported into OECD countries (fob).

** (relative to world export prices of manufactures, 1980=100)

21. Trends in demand and non-OPEC supply suggest only modest increases in the demand for OPEC oil. But prospects for prices in the remainder of 1987 and 1988 are clouded by doubts about OPEC's ability to restrict production and developments in the Iran-Iraq

conflict. The forecast attempts to strike a balance by projecting the oil price (of OECD imports) remains around $17½ per barrel until the end of 1988. This is consistent with an average North Sea oil price of about $18 per barrel.

COMMODITY PRICES

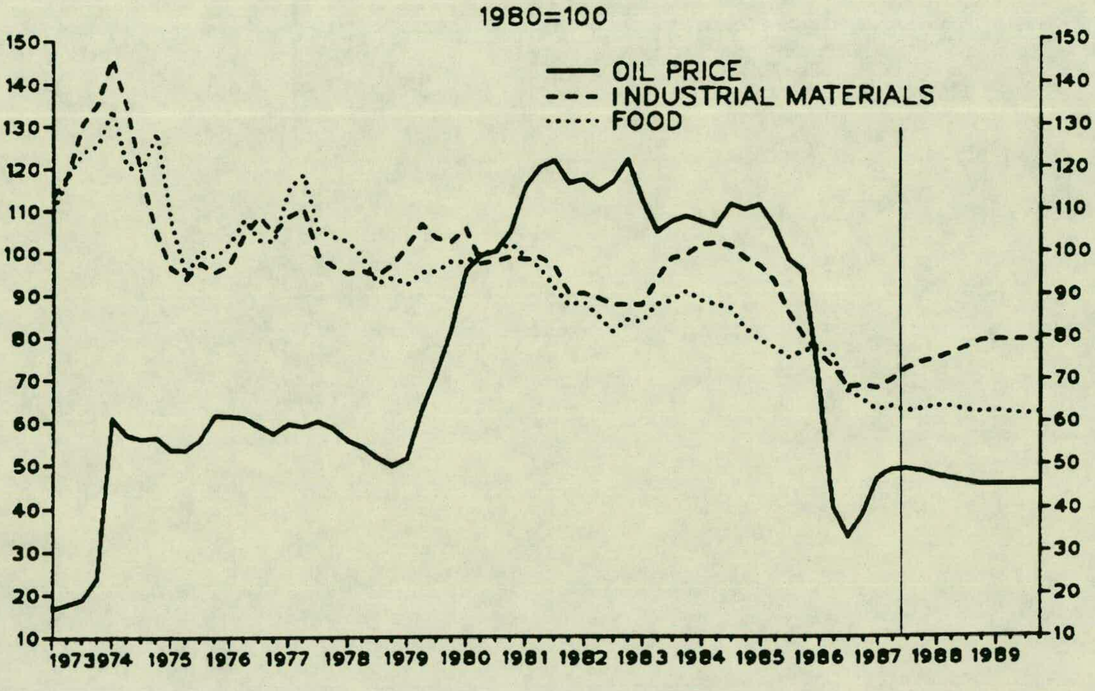
22. Non-food commodity prices were driven to unsustainably low levels in 1986 by speculative influences in a general climate of low inflation and falling oil prices. Spot prices of non-food commodities rose sharply in the first seven or eight months of 1987, falling back slightly in recent weeks. Despite this reversal, average prices (in SDRs) are still about 30 per cent higher than a year ago.

23. Some further increases in real non-food commodity prices are possible over the next year or so, especially if industrial production in the major OECD countries grows reasonably strongly. But for most commodities relatively abundant supply points to only a modest rise. The continuing over-supply of many foodstuffs and lack of any real progress in cutting back production point to continued weakness in food prices, which are expected, at best, to level off in real terms.

<u>**Chart 7 - Real Commodity Prices**</u>

REAL COMMODITY PRICES *

1980=100



* IN RELATION TO PRICES OF MANUFACTURES

NON-OPEC DEVELOPING COUNTRIES

24. The forecast for non-OPEC developing countries is summarised in Table 10 (further detail is contained in the annex.) NODC exports are expected to continue to grow 1½ - 2 percentage points per year faster than their markets, allowing import growth to pick up and the reserve: import ratio to remain broadly unchanged. Within this overall picture, though, the performance of the NICs is much better than that of the major debtors.

Table 10: NODCs Current Account

	1985	1986	1987	1988	1989
Export markets growth (%)	3½	6	4	4½	4½
Export volume growth (%)	3½	7½	6	6	6
Import volume growth (%)	5½	1	3½	5½	6
Terms of trade (% change)	-1½	-1	-2	½	0
Current account ($bn)	-23	-2	-1	0	0
of which:					
Trade*	-2	13	18	25	27
Invisibles	-21	-15	-19	-25	-28
Capital flows ($bn)	22	18	23	22	22
Change in reserves ($bn)	2	15	27	22	21
Reserve/import ratio (%)	32	37	40	40	40

* fob/fob

TEF - PUBLIC FINANCES

ps2/26R

SECRET

B/F 13/10

FROM: CATHY RYDING
DATE: 12 October 1987

CR TO MOWL 12/10

MR C MOWL

cc Sir P Middleton
Sir T Burns
Mr Sedgwick
Mr Odling-Smee
Mr Turnbull
Miss Peirson
Mr S Davies
Mr Cropper

TREASURY ECONOMIC FORECAST, OCTOBER 1987: PUBLIC FINANCES

The Chancellor was grateful for your minute of 9 October.

2. The Chancellor has noted in your paragraph 9 that there is some uncertainty over the CYMS forecast for 1987-88 in the light of recent outturn data for certain types of benefit. He would be grateful for a note on this.

3. The Chancellor has also noted the RPI figure for September 1988 (Table V) which affects Social Security uprating in 1989-90. He wonders if a figure of 5.4 per cent is sensible or desirable.

CR

CATHY RYDING

SECRET COPY NO. 1

Poor show

Would never have happened in my day.

FROM: COLIN MOWL
DATE: 12 OCTOBER 1987

PPS/CHANCELLOR

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
PCC
MEG
Mr Hawtin
Mr Luce
Mr Moore
Miss Peirson
Mr Grice
Mr Matthews
Mr Melliss
Miss O'Mara
Mr Riley
Mr Cropper
Mr Tyrie
Mr Call

(marked on forecast report)

TREASURY ECONOMIC FORECAST: CORRIGENDA

There were some mistakes in the forecast reports circulated on 9 October.

Main Report

("Treasury Economic Forecast" - Mr Sedgwick's minute of 9 October)

P.5 Table 2 - the figures for the UK General Government Fiscal Deficit in 1987 and 1988 were wrong. The table should have read as follows:

TABLE 2 : GENERAL GOVERNMENT FISCAL DEFICITS AS A SHARE OF GDP (%)

	1979-85	1986	1987	1988	1989
UK	3.1	2.6	1.8	1.1	0.6
G7 (less UK)	3.1	3.1	2.8	2.7	2.7

P.24 Table 18 - the figure published last week for the increase in the RPI excluding mortgage interest payments was 3.5 per cent not 3.4 per cent.

P.34 Table 31 - the two columns of figures for the 4th and 6th rows (ie NICs and stamp duty) should be transposed as follows:

	Changes since	
	FSBR	**June**
- higher NICs........	-½	-
- higher stamp duty	-½	-

Annex I - in para 2(i) the AEG percentage in 1988-89 should be 45 not 45¼.

Public Finances Report

("Treasury Economic Forecast, October 1987 : Public Finances - Mr Mowl's minute of 9 October).

P.2 Table II - the average increase in private sector average earnings in 1989-90 pay round is 7½ per cent not 8½ per cent.

P.5 Table V - the ROSSI uprating in the October Forecast for 1988-89 is 3.2 per cent not 3.6 per cent.

Colin Mowl

C MOWL

FIXED £/DM VARIANT

SECRET

Not what I asked for, & some pretty suspect assumptions [illegible]

FROM: A BOTTRILL

DATE: 12 October 1987

CHANCELLOR

cc: Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
PCC
MEG
Mr Hawtin
Mr Luce
Mr Moore
Miss Peirson
Mr Sedgwick
Mr Grice
Mr Matthews
Mr Melliss
Mr Mowl
Miss O'Mara
Mr Riley
Mr Cropper
Mr Tyrie
Mr Call

TREASURY ECONOMIC FORECAST: FIXED £/DM VARIANT

You asked for a variant on the main forecast reported by Mr Sedgwick on 8 October which would assess the effects of assuming that the US dollar falls by 10 per cent over the next year and the DM/£ rate remains constant. This note discusses both the world and UK effects.

World economy

2. The variant assumes weaker confidence leads to a larger depreciation of the dollar and higher US interest rates.

(i) By the end of 1988 the dollar effective exchange rate is 10 per cent lower than in the past month and 6½ per cent lower than in the main forecast.

(ii) US interest rates rise by 2 percentage points over the next year, compared to 1 percentage point in the main forecast. Interest rates in other countries, which are broadly constant in the main forecast, fall by ½ percentage point in the variant, so the average world interest rate is unchanged.

(iii) The weaker EMS currencies which were assumed in the main forecast to realign against the DM and the Dutch guilder to maintain constant real bilateral exchange rates, depreciate in the variant by an additional 3 per cent.

3. The assumption that as US interest rates rise other countries' rates fall helps to ensure that growth and inflation in the major seven

economies as a whole remain broadly unchanged. World trade is also unchanged in 1988 but slightly lower in 1989. Within the G7 real GNP is lower and inflation higher in the US while the opposite is true after a lag for Germany and Japan. Lower US domestic demand reduces American imports by more than imports rise elsewhere helping to explain the decline in world trade. J-curve effects, however, delay any substantial benefits to the US current balance until 1990.

Table 1: Growth, inflation and trade
(Differences from base levels

	1988	1989	1990
Real GNP (%)			
Major 7	-0.1	-0.2	-0.1
US	-0.1	-0.2	-0.2
Japan	-0.2	-0.1	0.3
Germany	-0.1	0.0	0.1
Consumer prices (%)			
Major 7	-0.1	0.1	0.2
US	0.1	0.4	0.5
Japan	-0.2	-0.4	-0.3
Germany	-0.2	-0.4	-0.6
Current balances ($bn)			
US	-1	+4	+13
Japan	3	6	-2
Germany	5	4	-2
World trade volume (%)	-0.1	-0.4	-0.4

UK economy

4. The pressure on sterling against the DM might well be similar to that experienced by the weaker EMS currencies. This would tend to push the DM/£ rate, which was already projected in the main forecast to decline by around 2½ per cent a year, well below the bottom of the Louvre range by 1989. We have assumed instead, however, that the DM/£ rate remains at its recent average of 2.99.

Table 2: Exchange rates and interest rates

	Sterling exchange rate index			DM/£			3-month LIBOR	
	Oct	Variant	% change	Oct	Variant	% change	Oct	Variant
1987Q4	72.5	72.5	-	2.99	2.99	-	10.5	10.5
1988 av.	72.5	74.5	2.8	2.94	2.99	1.7	11.0	11.4
1989 av.	72.5	77.1	6.3	2.87	2.99	4.2	11.0	12.0

?

Why not?

5. In order to maintain the DM/£ rate constant at this level, the effective exchange rate would therefore need to rise by almost 3 per cent in 1988 and 6 per cent in 1989 compared to the constant projected rate of 72½ in the main forecast. Even against a background of small reductions in other non dollar interest rates, the variant assumes that UK short rates would need to rise by ½ percentage point in 1988 to average 11½ per cent and by a further ½ percentage point in 1989 to average 12 per cent. These apparently steep interest rate increases reflect of course the arbitrary assumption that sterling remains at the top of its Louvre range against the DM and that none of any downward pressure on the pound is absorbed by a move within the Louvre margins.

Table 3: Money GDP, output and prices

(per cent change on previous year)

	Money GDP			Real GDP		GDP deflator	
	Oct	Variant	MTFS	Oct	Variant	Oct	Variant
1987-88	8.9	8.9	7½	4.2	4.2	4.6	4.6
1988-89	8.5	8.0	6½	2.8	2.4	5.4	5.4
1989-90	7.8	6.1	6	2.4	1.8	5.2	4.3

6. The tightening of monetary policy would reduce money GDP growth in 1988-89 by around ½ per cent compared to the October forecast and in 1989-90 the growth rate would be almost 2 per cent lower and close to the MTFS path. Most of the reduction in money GDP growth would reflect initially slower real GDP growth. Higher interest rates would tend to reduce domestic expenditure while the appreciation of sterling and slowdown in world trade would depress net exports. Output growth would slow from 4 per cent this year to 2½ per cent in 1988-89 and less than 2 per cent in 1989-90. The GDP deflator would still rise to around 5½ per cent next year, but would fall sharply to just over 4 per cent in 1989-90 in response to lower import costs and weaker demand.

Table 4: Earnings, competitiveness and the current balance

	Average earnings (per cent change on previous year)		Relative unit labour costs (1980=100)			Current balance (£ billion)	
	Oct	Variant	Oct	Variant	%change	Oct	Variant
1987	8.0	8.0	74.8	74.8	-	-2.4	-2.4
1988	8.0	8.0	76.7	78.6	2.5	-4.3	-3.7
1989	8.0	7.2	76.9	80.9	5.2	-5.6	-4.8

7. The reduction in domestic inflation would tend to reduce earnings growth in 1989 but this would offset only partly the effect of the

higher exchange rate on competitiveness. The current balance, however, would probably deteriorate less rapidly over the next two years than in the October forecast, as sterling's appreciation improves the terms of trade and tighter policies reduce domestic demand. This improvement in the current balance would probably not be sustained in later years once trade volumes responded more fully to the loss of competitiveness.

8. The effects of the variant on the PSBR are negligible in 1988-89, but by 1989-90 lower GDP and higher interest rates leads to an ex ante rise of around £1 billion in borrowing. This is assumed to reduce the scope for tax reductions in that year, with the PSBR ratio held constant at its projected 1988-89 level, as in the October forecast.

9. The variant shows that, in the absence of greater confidence in sterling, an attempt to maintain a fixed DM/£ rate could require higher interest rates and a fairly sharp slowdown in GDP growth. However inflation gains would in time be substantial. These results differ from the £/DM variant that we did in June mainly because then we assumed that improved confidence allowed the UK to have both a higher exchange rate and lower interest rates. This avoided the reduction in real GDP growth seen in the present variant. Inflation also benefited more. [illegible]

It shows what happens
Sic! if one makes the assumption.

A Bottrill

A BOTTRILL

psl/15A

SECRET

COPY NO. OF .

FROM: A C S ALLAN
DATE: 12 October 1987

MR SEDGWICK

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
PCC
MEG
Mr Grice
Mr Matthews
Mr Melliss
Mr Mowl
Miss O'Mara
Mr Riley
Mr Cropper
Mr Tyrie
Mr Call

TREASURY ECONOMIC FORECAST

The Chancellor was most grateful for your minute of 9 October covering the main report of the recent forecasting exercise.

2. This is to be discussed at a meeting on Thursday, but the Chancellor would be grateful before then for further information on a few points:

(i) when was there last a year-on-year change in the PSBR of 1.2 per cent of GDP? (which is what is forecast for 1987-88 on 1986-87, as the PSBR moves from a deficit of 0.9 per cent of GDP to a surplus of 0.3 per cent);

Ans: in 1985-86!

(ii) Table 2 gives aggregate G7 figures for General Government Fiscal Deficits as a share of GDP over a run of years. The Chancellor would be grateful for the figures for the individual G5 countries;

(iii) what is the average margin of error on forecasts of the current balance?

(iv) Table 8 in paragraph 10 shows a breakdown of the invisibles balance. The Chancellor would be grateful for a further breakdown of the services balance, in particular to distinguish financial services (to the extent that is possible);

(v) Table 29 in paragraph 63 shows figures for net external capital flows, including changes in official reserves. The Chancellor would be grateful for the figure for the change in official reserves for 1987 to date;

(vi) paragraph 64 says that the average absolute error in PSBR forecasts made at this time of year is around 0.8 per cent of GDP (£3 billion). The Chancellor wondered whether this was still true?;

(vii) he would be grateful for figures showing the real growth in GGE for each year between 1984-85 and 1987-88, both including and excluding privatisation proceeds?

(viii) The Chancellor would be grateful for some more explanation about what has led to the large upward revision in the forecast of domestic demand for 1988 (from 3.3 per cent in the summer forecast to 4.1 per cent in this forecast).

(ix) The forecast continues to stress the likely impact of the construction boom on the GDP deflator. But does the (perhaps surprisingly) gloomy outlook for housing have any offsetting effect?

(x) What are the year-by-year forecast increases in manufacturing productivity (from 1986 to 1989)? Is there any reason why productivity growth should revert quickly to its "estimated underlying rate of increase"?

(xii) The Chancellor was puzzled by the different figures for increases in nationalised industry prices in the main forecast and in the Public Finances forecast. The main forecast has nationalised industry prices rising 2.3 per cent in the year to 1987 Q4, and by 6.3 per cent in the year to 1988 Q4. The Public Finances forecast has nationalised industry prices growing in real terms by -1.2 per cent in 1987-88 and -0.6 per cent in 1988-89. How are these reconciled?

(xiii) The Chancellor noted that in paragraph 46 the forecast assumes that pay settlements will rise when the RPI rises in mid-1988, but fall back as price inflation falls. How does this compare with experience in 1985, when there was a blip in the RPI?

(xiv) The Chancellor would be grateful for the 1984-85 figures for the ratio of GGE excluding privatisation proceeds to money GDP (as in table 34).

ACSA

A C S ALLAN

RA3.4

FROM: A C S ALLAN
DATE: 12 October 1987

CHANCELLOR

FORECAST

I have minuted out lots of queries, but we won't get the answers in time for your meeting with Peter and Terry.

- below

2. We now have a fixed £/DM variant. But it is not quite what you wanted, since it also incorporates the separate assumption of a 10 per cent dollar devaluation. The forecasters have the fixed £/DM exchange rate requiring yet higher interest rates, which deflate the economy quite considerably (and the net effect is to improve rather than worsen the current balance).

3. The other points you mentioned but which did not raise questions suitable for minuting out were:

(i) How does the model cope with large cuts in personal tax combined with large cuts in the PSBR?

(ii) On interest and exchange rate assumptions, you probably need a variant which has a constant £/DM exchange rate; a constant $/DM exchange rate; and no change in UK interest rates (or conceivably a rise before the Budget ~~for~~ and a fall afterwards). It will be very tricky to explain to the TCSC anything other than a pretty steady dollar exchange rate.

(iii) You thought the outlook for the world in the forecast was rather too gloomy, with GNP revised <u>down</u> for 1988.

(iv) You noted that the RPI figures did not include the income tax effect of the tax package.

(v) On figures to publish, the main potential problems are on the PSBR (£2 billion?); the RPI (almost certainly $4\frac{3}{4}$ per cent); and public expenditure (a smaller undershoot than £1 billion).

AA

A C S ALLAN

NOTE OF A MEETING IN THE CHANCELLOR'S ROOM
HM TREASURY AT 6.15 PM ON TUESDAY, 13 OCTOBER

Present

Chancellor
Sir P Middleton
Sir T Burns

AUTUMN FORECAST

The Chancellor felt that the economy had, inevitably, not turned out as we had earlier expected: in some ways it was better, in some ways worse. But the overall picture seemed encouraging. His general conclusion was that, even though we were not on the track we had expected, "if it ain't broke, don't fix it".

NOTE OF MTG 13/10

2. Sir T Burns said he thought it was helpful to start by looking at what the main changes had been. For 1987, the policy stance was as tight or tighter than we had expected: interest rates were as expected; the exchange rate higher; and the PSBR much lower. GDP growth was significantly faster, with better export performance being the main factor. The inflation rate was only a fraction higher. Earnings growth had been faster, but the rapid growth in productivity had held down the growth in unit labour costs. The balance of payments was much as expected.

3. Domestic demand was continuing to grow fast, with the increases coming mainly in consumption, though some also in investment. There were some severe data problems here, and it was quite likely the final figures would show even faster growth in consumption. Private sector savings were coming down rapidly, as buoyant financial markets increased wealth and that in turn influenced consumer spending. The Chancellor thought there was a lag between inflation coming down and people believing that low

inflation was here to stay; we had only recently got to the second stage and that might explain some of the buoyancy in consumption.

4. For 1988, Sir T Burns saw the difficulty as deciding how many of these trends would continue. The forecast was pretty cautious: it had productivity growth falling back towards trend; and it had only moderate growth in domestic demand. He thought that the forecasters might have overdone this, and the consumption figures might be too low. It was perfectly possible that we could have faster productivity growth, higher exports and a faster rise in domestic demand, leading to a growth rate of 4 per cent again next year.

5. The Chancellor noted that the public finance forecasts were also cautious: he thought it was quite likely that revenues would be higher than forecast, and (though with less confidence) that expenditure could be lower.

6. Sir T Burns thought that if the economy did indeed grow faster than forecast, two areas became vulnerable: the first, and much the most important, was the pressure on wages and prices; the second was the balance of payments. There were some pressures on the labour market, but he thought that the firm exchange rate continued to play an important part in limiting price rises. If we had another year of growth at 4 per cent then we might be beginning to push against what was safe. But the message from this year was that, although there were some signs of capacity difficulties, there were no general signs of shortages in the materials or labour markets.

7. The Chancellor felt that a steady exchange rate should act as a firm discipline. It was important to make sure that business recognised the change from the previous six years, when the exchange rate had depreciated steadily. He also noted that it was necessary to grow slightly above trend in order to get unemployment

down; the worry would be if we were too much above trend. Sir T Burns felt it was in any case very difficult to do much about it. He thought it was important to retain a medium-term perspective: it was just as wrong to try to fine tune growth downwards as it was to try to fine tune it upwards.

8. Sir P Middleton agreed with most of this analysis. He felt we should certainly not try to fine tune the economy, especially via fiscal policy. But he was concerned about the medium-term framework: the picture emerging was certainly not the one we had expected or planned. We now had stable (rather than declining) inflation, though coupled with a very considerable supply side improvement and a much better investment performance.

9. He felt that pegging the £/DM rate must at some stage produce the right sort of discipline. So even though money GDP would rise faster than planned we did have the mechanisms to deal with it eventually. The problems came more in the short-term: heavy intervention might create a larger monetary expansion and stimulate the economy more than was desirable. He was worried that the head of steam which was building up could push us off our long-term objectives.

10. The Chancellor noted that although growth was higher, it seemed that growth potential was higher as well. And getting a boom in high quality investment was a considerable prize. Even though inflation had remained flat, this was over a period of sustained and vigourous growth, which was a major achievement. He agreed with the concerns about the head of steam in the economy, and would himself like to calm things down a little. But it was very difficult to see exactly how that could be done. It was imposible to turn the economy on a sixpence without massive disruption. Whereas a shock was needed in 1979-80, he did not feel one would be justified now.

11. The Chancellor said that one of the essential objectives of the MTFS was to pledge that there would be consistency of policy. This was very important. Until we had demonstrated that we were achieving that, all we could do was map out an illustration of what we planned. But we now had a period of years when we had not merely maintained consistency, but had got people to realise that we could do this without necessarily following a particular path. Sir T Burns accepted this, but thought we should still present a money GDP path in the MTFS. Its status should be changed so that it was more an expectation of what we thought would happen in the medium-term. Sir P Middleton agreed. It seemed both sensible and simpler to move to an exchange rate based policy.

Assumptions for Autumn Statement

12. There was some discussion about the main numbers to be published in the Autumn Statement.

(i) On the PSBR for 1987-88, the choice was between (plus) £1 billion and £2 billion. This depended to some extent on the published undershoot on the planning total. The Chancellor inclined to £2 billion, Sir T Burns to £1 billion.

(ii) On the planning total for 1987-88, the best figure to publish seemed to be one where the shortfall was equal to the known increase in privatisation proceeds plus other receipts, though this might need to be reconsidered if it produced a shortfall of more than £½ billion.

(iii) On inflation, the best assumptions seemed to be 4¼ per cent for the RPI in the year to 1988 QIV, and 4½ per cent for the GDP deflator in 1988-89.

(iv) For the current account, the choice was between deficits for 1987 and 1988 of 2/3 or 2½/3½. On balance, the latter seemed preferable.

(v) For GDP growth, there seemed no reason to depart from the forecast of 4 per cent and 3 per cent in 1987 and 1988.

13. There was also some discussion about earlier comments by "pundits". It was clear that many commentators who had expressed disbelief about the forecast in last year's Autumn Statement had been proved badly wrong. It would be worth assembling a list of such comments, which could usefully be publicised in some way, for example in a speech or in the EPR. There was an important objective here: if doubt could be cast on the credibility of comments like these it would help to stop them moving the market in future.

ACSA

A C S ALLAN

14 October 1987

Circulation
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SECRET & PERSONAL

SCORECARD
Copy No 1 of 16 Copies

FROM: A TURNBULL
DATE: 13 OCTOBER 1987

1. MR F E R BUTLER

2. CHANCELLOR +1

Copies attached for:

Chief Secretary +1
Sir P Middleton
Sir T Burns

cc Mr Anson
Mr Monck
Mr Sedgwick
Mr Luce
Mr Gieve

you agreed with Peter & Terry to go for 4½%

ECONOMIC ASSUMPTIONS

The forecasters have put recommendations to you that the assumption for the GDP deflator in 1988-89 should be raised from 4 to 5 per cent and that the increase in the RPI to Q4 1988 (used in the April 1989 uprating) should also be raised from 4 to 5 per cent.

4½/4¾%.

2. You will naturally be considering the implications of this, both for the presentation of financial policy and for the credibility of the Treasury Forecast. You may also like to consider the implications for the Survey arithmetic and for the Survey negotiations.

TURNBULL → CH/EX 13/10

3. There are three effects for the Survey:

i. the increase to cash plans for social security resulting from the RPI increase, and to the cost of export credit and housing subsidies resulting from the interest rate increase;

ii. the real terms figures produced by modifying the cash figures as in (i) and then applying the revised deflator;

iii. the impact on Survey bids and settlements.

4. To some extent (i) and (ii) offset one another. The average real growth rates are lower, the higher the inflation assumption

chosen despite the cash increases in social security. But for 1989-90 the opposite is true, ie the higher the 1988 inflation assumption the higher the real growth rate in 1989-90 - see Annex A. The contrast between the growth rates in 1989-90 and the other years is also more marked. Last month you discussed the possibility of revising all the forward years but concluded that it would be wrong to revise the inflation path in isolation from the other features of the MTFS. The discontinuity between Forecast years and MTFS years, with its corresponding impact on the real terms path, is an unavoidable consequence of that.

5. But it is the impact on settlements and outstanding bids which is most troublesome. Wherever possible we are avoiding being drawn into settlements which are explicitly expressed in real terms and we are stressing, as far as possible, that settlements are in cash terms. Nevertheless, in some cases departments have framed their bids explicitly in terms of the GDP deflator. We may want to resist those bids or argue that, once settled, the deal is in cash. But if we not even allow them to reformulate their bids, when we know the inflation assumption is going to be changed we can, with some justice, be accused of negotiating in bad faith.

6. Difficulties could arise in the following areas:

i. With Defence, the position may not be too troublesome as implicit in a two-stage approach as now envisaged is an opportunity for MOD to revise their bids in the light of further information.

But only for 1989-90 and 1990-91 in next year's Survey.

ii. With ODA, we are likely to offer something sufficiently in excess of flat real terms as presently measured so that it will cover any higher assumptions.

iii. There could be a reaction from colleagues on the RSG settlement where Ministers are on record as saying that provision will allow non-rate capped authorities to hold their spending totals constant in real terms.

iv. Although the running costs settlements for 1988-89 are not explicitly related to the GDP deflator, many of the bids and settlements were conditioned by it, and departments may well argue that if they had known earlier about the revised inflation propsects they would not have settled as they did.

v. Health is the most troublesome case as Mr Moore's bid to compensate for movements in the GDP deflator over the past year (a bid he argues has always been conceded) is at the centre of the remaining dispute. Star Chamber, as well as the Treasury, could find itself in a difficult position if it urged Mr Moore to accept a recommendation on the grounds that it would provide 1 per cent real to cover demography plus a bit more, and later found that the figures to be published in the Autumn Statement did not validate that.

7. We have looked at the precedents for revisions in the inflation assumptions between the MTFS and the Autumn Statement.

i. In 1982 and 1983, there were downward revisions to the current year and year 1. The movement in the GDP deflator was not covered in the submission to Treasury Ministers and no reference to it was made in the subsequent letters to Departments.

ii. In 1984 there was an upward revision of ¼ per cent in year 1 from 4¼ per cent in the MTFS to 4½ per cent to be used in the Autumn Statement. DHSS was informed of this in October. However, the debate in Star Chamber took a different form. There the comparison was with the 4¾ per cent assumed in the previous White Paper and the issue was whether the fall of ¼ per cent should be clawed back.

iii. In 1985 there were no changes.

iv. In 1986 there was a ¾ per cent downward revision to the current year but no changes to year 1. DHSS were aware of this from October but no adjustments were sought, though the better inflation prospect in the current year was put forward as one reason for limiting the in-year addition for Review Bodies' pay.

Thus there are no exact precedents. Downward revisions have been more common and in the case of the one upward revision, it was very much smaller than the change under consideration now, and the nature of the argument was completely different.

8. Despite the problem, we think it would be a mistake to inform all departments of the forthcoming change as this would be an invitation to them to reopen settlements, particularly for running costs. There are also difficulties in informing departments selectively. However, in the case of DHSS it is virtually impossible to avoid informing them as they receive the RPI assumptions for recasting the social security programme and the GDP deflator assumptions for costing parts of the FPS programme.

9. Given these considerations, we conclude that we have no alternative but to press on with a revision of which no warning is given other than to DHSS who need the information to cost their programme and to stick to the "cash is cash is cash" principle. But the public sector side do believe there is a case for making the smallest adjustment now that can plausibly be presented, with a further adjustment in the Budget.

AT

A TURNBULL

2131/5

ANNEX A

All examples assume an undershoot of £1 billion in 1987-88 for the planning total and £700 million for programmes excluding privatisation proceeds. Other assumptions are:

£ billion

	1987-88	1988-89	1989-90	1990-91
Reserves	-	4	7	10
Privatisation	5.3	5.5	5.5	5.5
Debt Interest) Other adjustments)	25.5	26	26	26

	1988-89	1989-90	1990-91	Average
A. GDP deflator 4/3½/3				
RPI 1988 Q4 4				
Increase in programes £bn	4.6	5.8	7.6	
Increase in Planning Total £bn	2.6	4.9	-	
PT real growth %	2.1	2.5	2.2	2.3
GGE ex pp real growth %	1.5	1.4	1.4	1.4
B. GDP deflator 4½/3½/3				
RPI 1988 Q4 4½				
Increase in programmes £bn	4.7	6.1	7.9	
Increase in Planning Total £bn	2.7	5.2	-	
PT real growth %	1.7	2.6	2.2	2.2
GGE ex pp real growth %	1.1	1.6	1.4	1.4
C. GDP deflator 4¾/3½/3	This is closest			
RPI 1988 Q4 4¾				
Increase in programmes £bn	4.7	6.2	8.0	
Increase in Planning Total £bn	2.7	5.2	-	
PT real growth %	1.5	2.6	2.2	2.1
GGE ex pp real growth %	0.8	1.6	1.4	1.3
D. GDP deflator 5/3½/3				
RPI 1988 Q4 5				
Increase in programmes £bn	4.7	6.3	8.1	
Increase in Planning Total £bn	2.7	5.3		
PT real growth %	1.2	2.7	2.2	2.0
GGE excl pp real growth %	0.6	1.7	1.4	1.2

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See also notes by FERB
& Andrew Turnbull
below

Ch
Relevant papers are the
forecast itself, plus papers on
economic assumptions (and
note of meeting with Peter & Terry)
AA

FROM: **P N SEDGWICK**
DATE: 13 OCTOBER 1987

PPS

cc Chief Secretary
Sir P Middleton
Sir T Burns
Mr F E R Butler
Mr Turnbull

SEDGWICK → PPS 13/10

DECISIONS ON INDUSTRY ACT FORECAST AND ECONOMIC ASSUMPTIONS

1. We are to discuss the October forecast with the Chancellor at 4 pm on Thursday 15. Following discussion of the forecast it would be helpful to agree

(i) the more important figures to be published in the Industry Act Forecast (IAF),

and (ii) the outstanding economic assumptions for public expenditure (Mr Davies' submission of October 2).

This note lists these.

Need also to decide what to publish for planning total for 1987-88 (or do that @ separate meeting?)

RPI

2. In the Industry Act Forecast, figures will be published for 1987 Q4 and 1988 Q4. 4¾%

Forecast is 3.9, so 3¾ or 4?

— 4¾ — 3¼ (ie no change) — see SJ Davies of 20ct para 15

Assumptions for September 1988 and September 1989 will also be published in the Autumn Statement (part 2) and PEWP.

GDP deflator

4½ (as in MTFS) 4½ (to help PX)

3. The Industry Act Forecast will include figures for the increase in the GDP deflator for 1987-88 and 1988-89. Assumptions for the following two years will also be published in the Autumn Statement, but these will be (as already agreed) the same as those in the 1987 MTFS.

Current account

−2½ −3½

4. Current account forecasts for calendar years 1987 and 1988 will be published in the IAF.

O.? Chart?

Output and activity

5. The Autumn Statement will show growth of GDP and manufacturing output for 1987 and 1988. It would be helpful to know if the Chancellor is content to publish the numbers in the current forecast. GDP 4 3 (Table 14)
Manuf 5¼ 3

Note that some numbers for 1987 may change; eg the figure for consumers' expenditure in 1987 Q3 will be available next week, and there may be revisions to back numbers. There will be half yearly growth figures in the final Industry Act forecast table (table 1.15 last year); these numbers will be worked out in the light of the latest data and the decisions on growth for calendar years.

PSBR

+£2bn or £1 bn

6. A figure for the PSBR in 1987-88 will be published in the IAF.

We also need to think about the assumption for 1988-89. In the last two Autumn Statements there has been no forecast of the PSBR (or fiscal adjustment) for the following financial year. Instead there has been explicit reference at the beginning of the Industry Act forecast to the PSBR ratio for the following year being assumed to be as in the previous MTFS. This will not obviously be sensible if the forecast for the PSBR in the current year shows an undershoot on the MTFS figure. One option would be to make a stylised assumption of no change in the PSBR between 1987-88 and 1988-89. The PSBR assumption for 1988-89 will have implications for the debt interest figures in part 2 of the AS.

? (rather)

Interest rates

7. The interest rate assumptions underlying the IAF are not published, although the decisions on the RPI forecast will come close to implying an assumption about short term interest rates over the yearto 1988(4). The assumptions on interest rates for public expenditure calculations (not published) need to be decided. No change?

P.N.S

P N SEDGWICK

Forecast folder
PSO.

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FROM: S P JUDGE
DATE: 14 October 1987

cc PS/Chancellor (for info)
Mr Scholar
Mrs Hamill - C&E

PAYMASTER GENERAL

TREASURY ECONOMIC FORECAST

I thought you might like a little more background information to paragraph 66 of Mr Sedgwick's submission of 9 October, which is being discussed at a meeting you are attending tomorrow.

Originally, the Keith reforms were forecast to bring in a total of £600 million, in a profile spread over several years.

The following table shows changes in VAT yield, compared with the FSBR forecast at the start of the year in question, apportioning them to:

i. yield from Keith, over and above the afore-mentioned profile; and

ii. yield caused by buoyancy of consumers' expenditure, and an unexpected shift within that to standard-rated goods.

Changes since FSBR	1986-87	£million 1987-88
Total	+800	+700
o/w Keith*	200	100
Consumers	600	600

(* excess over profile in FSBR)

Customs say that it is still too early to tell whether the eventual total yield from Keith will be more than £600 million, or whether it is just the original profile that is wrong.

JUDGE → PMG 14/10

S P JUDGE
Private Secretary

PS None of the forecasts take any account of the changes to the Keith regime proposed in Mr Finlinson's submission of 9 October.

EA

SECRET AND PERSONAL

SCORECARD
Copy No. 1 of 16 Copies

FROM: F. E. R. BUTLER
14th October, 1987.

CHANCELLOR OF THE EXCHEQUER +1

Ch
I think GE would be pretty happy with 4½% for GDP deflator in 1988-89 & 4¾% for RPI to Sept 88
AA

c.c. Chief Secretary
Sir P. Middleton
Sir T. Burns
Mr. Anson
Mr. Monck
Mr. Sedgwick
Mr. Luce
Mr. Gieve

ECONOMIC ASSUMPTIONS

I attach a note by Mr. Turnbull about the public expenditure aspects of the economic assumptions published with the Autumn Statement. This is relevant to the discussion you are holding on 15th October.

2. Our particular problem is with the increase in the GDP deflator. In general it is in our interest to have realistic figures. But a sharp increase in the GDP deflator in the final stage of the public expenditure round causes problems which, surprisingly, we have not previously faced since adopting cash planning.

3. The Annex to Mr. Turnbull's minute shows that the effect of increasing the GDP deflator in 1988-89 but not the subsequent years produces a net reduction in average real growth over the period, but an uneven pattern - reflecting the uneven pattern of the GDP deflator itself.

FERB → CH/EX 14/10

4. Our main concern is with the effect of a sharp increase in the GDP deflator on the public expenditure settlements. As Mr. Turnbull's note shows, there is no precedent for an increase in the GDP deflator in the Autumn Statement of more than ¼ per cent, and that was merely a partial reversal of a larger previous reduction.

5. We have emphasised in all the public expenditure negotiations that the settlement is in cash. But there are some Ministers for whom the real terms line is important - notably health, defence and aid.

6. If there is to be a sharp increase in the GDP deflator in the Autumn Statement, we have considered three options:-

(i) Telling all departments - but this would simply invite them to re-open the settlements;

(ii) telling just those departments which have drawn attention to the real terms line in the public expenditure negotiations; but this is partly open to the objection to (i) and would also be difficult to defend to other departments;

(iii) acting as normal, ie only giving the change in assumption to those departments needing it for recalculating Survey figures (which include DHSS) and justifying not giving it to other departments, after the event, by pointing out that the Survey is conducted in cash and that there are swings as well as roundabouts on inflation assumptions.

Of these courses, I think that (iii) is the best. But it is uncomfortable, and there is the possibility of a row at the public expenditure Cabinet, with an outside risk of the public expenditure settlements becoming unstitched. From this point of view, the greater the increase in the assumption about the GDP deflator, the greater the risk - ½ per cent on inflation is worth £100 million to defence, for example. If we can establish a precedent this time for increasing the inflation assumptions <u>without</u> undoing the settlements, that would be helpful for the future; but, given that we are setting a precedent, we do not want to push our luck with the size of the increase.

F.E.R.B.

F. E. R. BUTLER

CONFIDENTIAL

FROM: P N SEDGWICK
DATE: 14 OCTOBER 1987

CHANCELLOR

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
PCC
MEG
Mr Bottrill
Mr S J Davies
Mr Grice
Mr Matthews
Mr Melliss
Mr Mowl
Miss O'Mara
Mr Riley
Mr Cropper
Mr Tyrie
Mr Call

TREASURY ECONOMIC FORECAST

Mr Allan's minute to me of October 12 passed on your request for further information on a number of points on the forecast which I circulated on 9 October. These points are covered in order below. Ms Ryding's note to Mr Mowl of October 12 asked whether the RPI figure for September 1988 which affects social security uprating was sensible or desirable. This note deals with this point at the end. (The Chancellor's question on CYMS and the reserves are dealt with in separate submissions.) I am indebted to Messrs Davies, Bottrill, Mowl and Dolphin for the material below.

(i) Changes in the PSBR

You asked when there was last a year-on-year change in the PSBR of 1.2 per cent of GDP. The table below gives the figures since the early 1970s. The PSBR fell by 1.5 per cent in 1985-86 but this was largely due to the recovery from the coal strike. Prior to that it fell by 2.1 per cent in 1981-82. There were however very large year to year changes in the 1970s.

	Changes in PSBR from previous year (% of money GDP)
1970-71	+2.7
1971-72	+0.1
1972-73	+2.0
1973-74	+2.2
1974-75	+3.2
1975-76	+0.3
1976-77	-2.9
1977-78	-2.8
1978-79	+1.7
1979-80	-0.5
1980-81	+0.6
1981-82	-2.1
1982-83	-0.2
1983-84	+0.1
1984-85	-0.1
1985-86	-1.5
1986-87	-0.7
1987-88 (Forecast)	-1.2

" - 1988-89 5th successive [illegible]. When last achieved?

(ii) General Government deficits in the G5

You asked for individual countries' general government fiscal deficits as a share of GNP. These are shown below.

SEDGWICK TO CH/EX 14/10

	General government fiscal deficit(per cent of GDP) 1979-85	1986	1987	1988	1989
US	2.1	3.5	2.5	2.5	2.3
Japan	3.4	0.6	1.5	1.5	1.0
Germany	2.6	1.2	1.6	1.8	1.5
France	2.0	2.9	2.7	2.3	2.1
UK	3.1	2.6	1.8	1.1	0.6

(iii) Errors on forecasts of the current balance

You asked about the average margin of error on forecasts of the current balance. The average absolute error on forecasts for the following year made in the autumn has been ¾ per cent of GDP, which is equivalent to £3bn. in 1988.

(iv) The outlook for trade in financial services

You asked for additional information on the outlook for financial services so far this year. It is not possible to provide a breakdown of the forecast for trade in services to distinguish financial services, although we look at recent developments in individual components in forming a judgment about the prospects for services earnings as a whole. The financial sector's net earnings rose by more than 20 per cent in 1986 to almost £5 billion or a fifth of the UK's total exports of services. In the first half of 1987, growth is estimated to have been slower with net earnings about 10 per cent higher than a year earlier.

The Bank of England estimates that earnings of foreign exchange dealers rose strongly in the first half-year, but that banks' earnings were estimated to be flat reflecting pressure on margins and the weakness in international bond markets. No information on securities dealers' earnings is available. Lloyds underwriters reported no further growth in earnings after last year's very steep rise when premium income increased sharply. Insurance brokers reported modest earnings growth.

The increased internationalisation of capital markets should offer increased opportunities for London-based financial institutions, but greater competition is likely to continue to pare margins and fees. The projected fall in bond markets as long rates rise and slower rise in equity markets, however, could also limit the growth in activity and earnings growth. Anecdotal evidence of the profits squeeze on a number of securities dealers and banks could be consistent with this. We expect insurance earnings to be constrained as claims rise to match the recent increase in premium income. On balance, the financial sector's earnings should continue to grow, but not at the same hectic pace as the last two years.

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(v) **Errors in PSBR forecasts**

You wondered whether it is still true that the average absolute error in PSBR forecasts made at this time of year is around 0.8 per cent of GDP (£3 billion). This is the average error made in forecasts over the last eleven years. The first forecast included, that made in autumn 1976,had an extremely large error of over 2 per cent of money GDP. If this is excluded by looking at the last ten years only - the period we now quote in published forecasts - the average error drops to 0.7 per cent, and errors made over the last five years are lower still at 0.6 per cent (£2½ billion). Table A show further detail both for internal and published Autumn Forecasts.

TABLE A : ERRORS IN PSBR FORECASTS

(i) INTERNAL AUTUMN FORECASTS FOR PSBR (£bn)

Year		Forecast	Outturn	Error	Error as % of GDP
1976-77		11.2	8.5	-2.7	-2.1
1977-78		7.1	5.6	-1.5	-1.0
1978-79		8.1	9.2	1.1	0.7
1979-80		8.7	10.1	1.5	0.7
1980-81		10.7	13.3	2.7	1.1
1981-82		10.7	9.0	-1.7	-0.7
1982-83		8.0	9.4	1.3	0.5
1983-84		10.9	10.2	-0.7	-0.2
1984-85		9.7	10.2	0.5	0.2
1985-86		8.4	5.8	-2.6	-0.7
1986-87		8.4	3.5	-5.0	-1.3
AVERAGE ABSOLUTE ERRORS	WHOLE PERIOD			1.9	0.8
	LAST 10 YEARS			1.9	0.7
	LAST 5 YEARS			2.0	0.6
BIAS	WHOLE PERIOD			-0.6	-0.3
	LAST 10 YEARS			-0.4	0.2
	LAST 5 YEARS			-1.3	-0.3

(ii) PUBLISHED AUTUMN FORECASTS OF PSBR (£bn)

Year		Forecast	Outturn	Error	Error as % of GDP
1976-77		11.0	8.5	-2.5	-1.9
1977-78		7.5	5.6	-1.9	-1.3
1978-79		8.0	9.2	1.2	0.7
1979-80		8.3	10.1	1.8	0.8
1980-81		11.5	13.3	1.8	0.7
1981-82		10.5	9.0	-1.5	-0.7
1982-83		9.0	9.4	0.4	0.1
1983-84		10.0	10.2	0.2	-
1984-85		8.5	10.2	1.7	0.5
1985-86		8.0	5.8	-2.2	-0.6
1986-87		7.1	3.5	-3.6	-0.9
AVERAGE ABSOLUTE ERRORS	WHOLE PERIOD			1.7	0.7
	LAST 10 YEARS			1.6	0.6
	LAST 5 YEARS			1.6	0.4
BIAS	WHOLE PERIOD			-0.4	-0.2
	LAST 10 YEARS			-0.2	-0.1
	LAST 5 YEARS			-0.7	-0.2

(vi) Growth in GGE

You asked for figures showing the real growth in GGE for each year between 1984-85 and 1987-88.

GGE IN REAL TERMS per cent change

	1984-85	1985-86	1986-87	1987-88
Including privatisation proceeds	2.7	-0.6	1.3	-0.2
Excluding privatisation proceeds	3.3	-0.3	2.2	0.2

(vii) Domestic demand in 1988

You asked for an explanation of the upward revision in the forecast for domestic demand in 1988.

Growth in consumers' expenditure, fixed investment, and stockbuilding have all been revised up for 1988 since the June forecast. Consumers' expenditure growth has been revised up by about ½ percentage point since June. This reflects higher forecast growth in real personal disposable income over 1987 and 1988 (an upward revision since June of around 1½ percentage points in total over the two years). This higher growth in real personal disposable income is in turn attributable to:

(a) faster growth in output and productivity (the forecast for non-North Sea productivity growth has been revised up by about ½ percentage point in 1988, partly because we have reconsidered the evidence of recent productivity performance);

(b) lower than expected consumer price inflation so far in 1987;

(c) a slightly bigger tax cut in the 1988 Budget than assumed in June (the increase is worth about an extra 0.1 per cent on personal disposable income in 1988).

We now think that manufacturing investment will rise significantly faster than in the June DTI survey: the latest quarterly investment figures, the responses in the last CBI quarterly survey, recent fast growth in manufacturing output, and the relatively high level of capacity utilisation in manufacturing all suggest that a big upward swing in manufacturing investment could be underway.

Since June the forecast for the increase in stockbuilding between 1987 and 1988 has changed for two main reasons:

(a) stockbuilding has been more negative in 1987 so far than expected;

(b) firms have stopped telling the CBI that (on balance) they hold more than adequate stocks - for the first time this decade.

These developments mean that it is more likely that stockbuilding will make a small positive contribution to growth in 1988 - something we did not allow for in June.

(viii) Construction output and prices

You asked about prospects for housing and construction output and prices. It is perhaps a little disappointing that housing starts have fallen back since the start of 1987, though with housing investment still likely to rise by about 10 per cent this year and 6 per cent next year, the immediate prospects are not particularly gloomy. Total construction output is forecast to rise by 7 per cent this year and 4½ per cent next year, with growth probably concentrated on the south east (this concentration being exacerbated by the Channel Tunnel and Canary Wharf projects).

There has in the past been a lag of a year or so between sharp movements in construction output and in national accounts construction output prices (because demand conditions first affect tender prices, and then output prices later on). There is now some evidence of tender prices rising fast in the south east (see Financial Times, 12 October, front page - copy attached). These price increases will probably show up in the GDP deflator next year rather than this. The effect on prices of any subsequent slowing in construction output will probably not show up in the GDP deflator until 1989.

(ix) Manufacturing productivity

You asked for year-by year forecast increases in manufacturing productivity. These are:

1986	3.2
1987	6.7
1988	3.9
1989	4.5

Following two years of growth at just over 3 per cent, manufacturing productivity has grown twice as fast this year. While we have raised (again) our estimate of underlying productivity growth -

from [illegible]4 to 4¾ per cent - much of this year's acceleration in productivity is attributable to the acceleration in manufacturing output (up from growth of 1 per cent last year to 5 per cent this). As manufacturing output growth reverts in 1988 and 1989 to close to its post 1981 trend, so we would expect productivity growth to revert to a note closer to its recent trend. Should we get another year of 5 per cent growth in manufacturing output, we would expect a continuation of an above trend rise in productivity. Note also that the reduction in productivity growth does not feed fully through into faster growth in unit labour costs as the forecast allows for an offset to the lower productivity growth in the form of lower wage drift.

(x) Nationalised industry prices

You were puzzled by the different figures for increases in nationalised industry prices in the main forecast and in the Public Finances Forecast. The figures were as follows

REAL NI PRICES - ANNUAL % INCREASES

	Main Report	Public Finances Report		
			As circulated	Corrected
1987 Q4	-1.6	1987-88	-1.2	-2.3
1988 Q4	+1.0	1988-89	-0.6	-0.6

The figure for 1987-88 in Table XII of the public finances report for <u>total</u> NIs was unfortunately wrong. The correct figure of -2.3 per cent was in fact in Table XIII. The correct figure is shown above along with the figure as circulated.

The differences between the two sets of figures arise for two reasons:

(a) they refer to different time periods - Q4 in the main report as part of the explanation of changes in the RPI to the fourth quarter of each year, and financial year averages in the public finances report as part of the explanation of PCs trading surpluses and borrowing in financial years;

(b) the main report refers only to those prices which are in the RPI and the public finances report relates to all NI prices, ie industrial as well as consumer prices. For 1988-89, we are forecasting a substantial gap between average domestic NI price increases (+6 per cent in nominal terms) and average industrial NI price increases (+3¾ per cent).

(xi) The RPI and pay

You asked for a comparison of the effect of the RPI path on pay settlements in 1985 with that postulated for 1988. Chart E on page 25 of the forecast report suggests some relationship between fluctuations in RPI inflation and private sector wage settlements since the end of 1984. Settlements reached a temporary trough at the end of 1984 and then picked up until around May 1985 (as inflation rose from under 5 per cent to 7 per cent). From around October 1985 to the beginning of 1987 pay settlements were either flat or declining (as RPI inflation declined almost without a break from July 1985 to August 1986); since the beginning of 1987 the pick up in RPI inflation has been accompanied by a renewed rise in pay settlements.

(xi) GGE ratios

You asked for the 1984-85 figure for the ratio of GGE excluding privatisation proceeds to money GDP. This is given in the revised version of table 34 below.

TABLE 34 : RATIO OF GGE EXCLUDING PRIVATISATION PROCEEDS TO MONEY GDP

per cent

	1984-85	1985-86	1986-87	1987-88	1988-89	1989-90
1987 PEWP	46¼	44¾	44½	44	42¾	42¼
1987 FSBR	46¼	44¾	44¼	43½	42½	41¾
Oct forecast	46¼	44½	44	42½	41¾	41¼

(xii) The 1988 uprating factor

You also asked (Ms Ryding's minute to Mr Mowl of 12 October) whether the 5½ per cent RPI increase forecast for the year to September 1988 (the period relevant to the 1989 uprating) was "sensible or desirable". For the purpose of the published public expenditure assumptions, Mr Davies in his minute of 2 October proposed adopting a 5 per cent figure - which is what would be obtained by taking out the mortgage interest increase assumed in the forecast. The increase in the RPI over the year to September reflects the full impact of the main factors pushing up inflation next year: the rise in rates and specific duties (effective from April), the rise in electricity prices (feeding through to the RPI during the second quarter) and the rise in gas prices (feeding through to the RPI during the third quarter).

SJO p.p.

P N SEDGWICK

Construction costs gap widens

BY ANDREW TAYLOR

PRICES CHARGED by building contractors in the surging private construction market of south-east England, now Western Europe's busiest, are rising five times faster than in the rest of the UK.

Figures from the Building Cost Information Service of the Royal Institution of Chartered Surveyors show construction tender prices rose by 20 per cent in the south-east in the two years to March, compared with a 4 per cent rise in the rest of the country over the period.

The gap has widened as order-books in the south-east have continued to grow. For example, building prices in the region rose by 15 per cent in the 12 months to March, compared with a rise of 5 per cent in the preceding 12 months.

The survey covered tender prices accepted from contractors for about 150 different building types. It defined the south-east as an area enclosed by the counties of Norfolk, Cambridgeshire, Bedfordshire, Buckinghamshire, Oxfordshire, Wiltshire, Avon and Hampshire, easily the most prosperous region in the British Isles.

Order-books in the region have been fuelled by a massive rise in office building, particularly in the City of London, which accompanied the Big Bang deregulation of the London securities markets a year ago.

Demand for new sites for out-of-town shopping centres, encouraged by completion of the M25 orbital motorway around London, also boosted order-books in the region, as has a surge in private housebuilding in the last 18 months.

The number of new private homes started by developers in England and Wales this year is expected to be the highest for 15 years.

The pace of new building is such that many contractors in the south-east fear the market may be in danger of overheating. Skilled tradesmen remain scarce following the fall in construction which took place in the second half of the 1970s and early-1980s.

Some skilled tradesmen in central London are earning more than £100 a shift. Some were recruited from other regions where the construction recovery has been more limited or has still to bite.

Contractors also say construction specialists from the Irish Republic, where the building market is depressed, have established offices in London and the south-east, to take advantage of the upsurge.

The pace seems unlikely to slacken in the near future. Big projects under way or planned in the south-east include the Channel tunnel; a new Dartford crossing on the River Thames; completion of a large, new international terminal at London's third airport at Stansted, Essex; the massive Canary Wharf development in London's docklands; and further plans for the City and other parts of the docklands.

British and French contractors have established a skills-training centre at Ashford, Kent.

Figures available quarterly at £30, or by £100 annual subscription; Building Cost Information Service, 85-87 Clarence Street, Kingston upon Thames, Surrey.

SECRET

FROM: A BOTTRILL

DATE: 14 October 1987

CHANCELLOR

cc: Sir P Middleton
Sir T Burns
Mr Cassell

TREASURY ECONOMIC FORECAST

You asked Mr Sedgwick about the change in official reserves this year. The underlying rise in official reserves between January and end-September was $10 billion, equivalent to £6.3 billion. Market intervention this month up 13 October has been $3¾ billion, equivalent to £2½ billion.

A Bottrill

A BOTTRILL

BOTTRILL TO CH/EX 14/10

CONFIDENTIAL

FROM: **COLIN MOWL**
DATE: 15 OCTOBER 1987

PPS/CHANCELLOR

cc	PS/Chief Secretary	Mr Grice
	PS/Financial Secretary	Mr Matthews
	PS/Paymaster General	Mr Melliss
	PS/Economic Secretary	Miss O'Mara
	PCC	Mr Riley
	MEG	Mr Cropper
	Mr Bottrill	Mr Tyrie
	Mr S J Davies	Mr Call

TREASURY ECONOMIC FORECAST: CORRIGENDUM

Mr Sedgwick's minute of 12 October (Treasury Economic Forecast).

2. I regret that there was a mistake in table A(ii) which formed part of the answer to question (v) - "Errors in PSBR forecasts". The error for the published autumn forecast of the PSBR in 1985-86 as a percentage of GDP should have been minus not plus 0.6. This does not affect calculation of the average absolute errors but the bias should be as follows:

	% of GDP
Whole Period	-0.2
Last 10 years	-0.1
Last 5 years	-0.2

Colin Mowl

C MOWL

GDP H/Wat- GDP
Mr
Rosovin

MINUTES OF A MEETING HELD AT 5.00 PM ON THURSDAY 15 OCTOBER, IN CHANCELLOR'S ROOM, HM TREASURY

Those present

Chancellor	Mr Odling-Smee
Chief Secretary	Mr Peretz
Paymaster General	Mr Scholar
Economic Secretary	Mr Sedgwick
Sir P Middleton	Mr Turnbull
Sir T Burns	Mr R I G Allen
Mr F E R Butler	Mr Bottrill
Mr Anson	Mr S J Davies
Mr Byatt	Mr Mowl
Mr Cassell	Mr Tyrie
Mr Kemp	

INDUSTRY ACT AND ECONOMIC ASSUMPTIONS

Sir T Burns said that for the most part, 1987 looked to be turning out rather better than had been expected, although inflation and earnings growth were perhaps a touch higher and the balance of payments a little worse. But in the main, the picture was reasonably satisfactory. There was a worry that domestic demand was increasing rather strongly relative to other countries and that this could lead to problems of over-heating and leakages overseas. The policy stance through 1987 was not easy to disentangle, but both fiscal and monetary policy had probably been tighter than expected. The difficult issue was the extent to which these features would follow into 1988. In the main, the forecast was cautious, but there was a possibility that growth would be more rapid in 1988. The worry was that if this happened, the pressure would become more intense on inflation, the labour market and the balance of payments. It was difficult to know what the policy response to this should be. Fiscal policy had been tightening during the year and would probably tighten further into 1988. It was difficult to make the case for tightening it further still. On monetary policy, the exchange rate was pushing the top of its limit, though if higher interest rates could be achieved with a given exchange rate that would be helpful. His conclusion was that the forecast showed a relatively favourable background. Many of the pressures were temporary and at some stage the grip of policy would tighten.

2. Sir P Middleton said that his main concern was the inflationary prospect. The primary objective of policy was a deutschemark-based system and the question was whether the risks with this were sufficiently large to warrant a change in policy. In his view, they were not. Policy was bound to be counter-inflationary in the longer run, though there could be problems in the short run. It was important to maintain policy - any of the pressures were more likely to be contained by maintaining policy than changing it. There were aspects of the the economy that were going particularly well - there were genuine improvements in the supply side and the prospects for investment were very encouraging.

3. Mr Butler said that the public expenditure figures for next year were if anything likely to be lower than the forecasters were suggesting. In particular, there were now the first signs of social security growth slowing down, and he would give rather more weight to the restraining influence of cash limits and running cost limits.

4. The Chancellor said the most worrying prospect was the resurgence of inflation. The most remarkable feature of the forecast was the fiscal prospect and the PSBR. In his view the forecasters had been rather cautious in their forecast of revenue receipts. It was striking that the forecast for the next two years showed the UK with the smallest GGFD and highest interest rates of any country in the G5. He thought there was no case for a change in policy. The precise posture of policy needed to be decided, but he was content to go ahead on the assumptions that underlay the

forecast. He was sceptical about the higher interest rates contained in the forecast. He accepted that there might be periods of high interest rates, but he found it difficult to believe that the average would be as high as suggested by the forecast.

5. Mr Kemp expressed concern that a perceived worsening of inflationary prospects would feed into pay. There were signs of settlements and earnings picking up. The Chancellor agreed, but commented that there were also signs of a growing consciousness in business that for competitive reasons they could not implement large price increases.

Public expenditure assumptions

RPI

6. It was agreed that the Industry Act forecast should show figures of 4 per cent for 1987 Q4 and $4\frac{3}{4}$ per cent for 1988 Q4.

GDP deflator

7. The Chancellor and Chief Secretary noted that there were very real public expenditure problems with publishing a GDP deflator of $4\frac{3}{4}$ per cent for 1988-89. Not only was there a significant risk of public expenditure settlements being re-opened, but there was a risk that the Public Expenditure Cabinet itself would be very difficult indeed. They would prefer a figure of $4\frac{1}{2}$ per cent. Mr Butler noted that there was no precedent for the Autumn Statement showing a net increase in the GDP deflator compared to the previous White Paper. Mr Anson noted there was still a residual danger of problems with an assumption of $4\frac{1}{2}$ per cent.

8. Sir T Burns said that he appreciated the public expenditure problems, but was concerned that the other components of the forecast consistent with a GDP deflator of $4\frac{1}{2}$ per cent would themselves look very unrealistic. This would open up another difficult area. Work on this had not been completed, but it looked as though the implied unit cost figures necessary to achieve a

GDP deflator of 4½ per cent would be very difficult to defend as realistic.

9. It was agreed to postpone a decision on the GDP deflator until Sir T Burns had completed his further work. A meeting would be arranged for the following day.

Current account

10. It was agreed to publish a deficit of £2½ billion for calendar 1987 and a deficit of £3½ billion for calendar 1988. It was recognised that it might be necessary to review again the figure for 1988 in the run-up to the FSBR.

Output and activity

11. It was agreed that the Autumn Statement would show figures of 4 and 3 per cent growth in GDP for 1987 and 1988 respectively and 5 and 3 per cent for manufacturing.

PSBR and public expenditure

12. Mr Turnbull noted that for the planning total in the current financial year an undershoot on the White Paper of £1.6 billion was now forecast. £1¼ billion of this was accounted for by asset sales, and this figure was in the public domain. It would be possible to show an undershoot of £1¼ billion in the Autumn Statement, but anything smaller than this would be extremely difficult. It was agreed to show a £1¼ billion undershoot on the planning total for this financial year.

13. Sir T Burns said that in the light of the decision on the 1987-88 planning total, it would be possible to adjust the revenue forecast so as to achieve a PSBR of £1 billion, but it would be very difficult indeed to show a PSBR higher than this - say £2 billion. Adjusting the revenue forecast in this way would result in figures which looked rather cautious compared to the first half of the year, but commentators were unlikely to believe that the Treasury

had biased the figures down.

14. Continuing, Sir T Burns said that the 1988-89 PSBR presented much more of a problem. In previous years the assumption had always been that the Autumn Statement showed the same PSBR as in the MTFS. The problem was that the current forecast was for a PSBR surplus of £4 billion compared to an MTFS figure of a deficit of £4 billion. It was almost impossible to square these two numbers. Mr Sedgwick had suggested the introduction of a new stylised assumption - ie that the PSBR in 1988-89 should be the same as in the previous year. The Chancellor agreed. He thought this should not be too difficult presentationally - we would simply say that the convention had been changed in a way which seemed sensible in the circumstances. The PSBR assumption would be the lower of the MTFS assumption and the estimated outturn for the previous year.

Interest rate assumptions

15. Figures of 10, 9½, 9 were agreed for 1988-89 to 1990-91.

Reserves and privatisation proceeds

16. It was agreed to defer decisions on the Reserves and privatisation proceeds.

CR

CATHY RYDING

15 October 1987

Circulation

Those present