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PART A

Part. A.

SECRET

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Begins : 6/1/88.
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PO -CH /NL/0335
PART A

Chancellor's (Lawson) Papers:

ECONOMIC FORECASTING AND
POLICY ASSUMPTIONS FOR
1988

DD's: 25 Years

8/11/95.

PO -CH /NL/0335
PART A

CABINET OFFICE PAPER

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Reference	Date Of Paper
C(87)2	10 February 1987

SECRET

FROM: P N SEDGWICK
DATE: 6 JANUARY 1988

CHANCELLOR

cc Chief Secretary
PCC
Mr Hawtin
Mr Moore
Mr Odling-Smee
Mr Peretz
Mr Turnbull
Mr Bottrill
Mr Hibberd
Mr Mowl

POLICY ASSUMPTIONS FOR THE FORECAST

I attach a note, which reflects comments at a meeting of PCC yesterday morning, on the policy assumptions that we propose to use for the current forecast. I would be grateful if you could let me know whether you are content with these.

P.N.S
P N SEDGWICK

Ch
OK?
AA

OK. (I v. much endorse yr comments on paras 2 & 6; but these won't greatly need to be done at once, given my dilemmas with Sir T.B.)

110.4 sn 3784/2

POLICY ASSUMPTIONS FOR THE WINTER FORECAST

Note by EA and PSF

This note discusses the assumptions for the internal winter forecast. This will cover the period to end 1989 (to 1989-90 for public finances). The main forecast report will be circulated on Friday 22 January. An updated forecast to be prepared during February, that takes on board Budget decisions and any necessary changes in assumptions, will be the basis of the Industry Act Forecast to be published in the FSBR.

Monetary Policy

2. The forecast will illustrate the implications for money GDP and interest rates of maintaining a constant exchange rate against the Deutschemark to the end of 1988, and possibly for the whole forecast period if the rest of the forecast suggests that this is feasible. Assumptions about intervention will be made in the light of forecast pressures on the exchange rate. A partial rundown of the earlier rise in reserves could be assumed if pressures on the exchange rate seemed likely to be downwards and vice versa in the event of upward pressure. During the forecasting exercise the forecasters will consult Sir Terence Burns and Mr Scholar on the precise implementation of the exchange rate and intervention assumptions and on the implied forecast of interest rates. The level of interest rates will, in so far as the path of the exchange rate permits, also take account of the paths for money GDP, the forecast of MO relative to its target ranges, and other indicators of monetary conditions.

? TB in turn should consult you.

3. It will be assumed that taking 1987-88 and 1988-89 together the PSBR is fully funded through debt sales outside the banking and building society sectors. Underfunding in 1987-88 will be assumed to be offset by overfunding in 1988-89, unless significant foreign exchange market intervention is projected towards the end of 1988-89, in which case some carryover to 1989-90 will be assumed. The contribution assumed from national savings from 1988-89 onwards will depend on the overall level of funding required, but is likely to be £1 billion a year or less.

Fiscal Policy

4. The forecast will assess the likely outturn of the PSBR in 1987-88, taking into account both the latest monthly information on borrowing and fresh information on likely developments in the rest of the financial year.

5. The forecast will reassess the scope for fiscal adjustments in 1988-89 and 1989-90, after making provision for the forecasters' best view of the likely path for public expenditure.

6. The June and October forecasts indicated that a PSBR set at 1 per cent of money GDP, as in the 1987 MTFS, would generate very large fiscal adjustments. If this remains the picture then, as before, the forecast will assume that some of the fiscal adjustment goes to reduce the PSBR (below the 1987 MTFS ratios) and some to reduce personal taxes. The judgement on the allocation of the fiscal adjustment will be reviewed in consultation with Sir Terence Burns during the course of the forecast. In the October forecast it was assumed that in 1988-89 one third of the fiscal adjustment implied by the MTFS PSBR ratio was used to reduce personal taxes and two thirds used to reduce the PSBR. This produced tax cuts of £4 billion and a PSBR surplus of £5 billion, 1 per cent of money GDP. The PSBR ratio in 1989-90 was kept at the same level as 1988-89.

Ditto

Taxation and other government receipts

7. The forecast for pre-fiscal adjustment taxes will assume full revalorisation in 1988 and 1989 Budgets of all the income tax bands and allowances, and of specific duties.

Public Expenditure

8. The forecast of public expenditure will take account of the recently announced plans, changes in economic assumptions implied by the rest of the forecast, and any other pressures on expenditure considered likely to be conceded in-year and, for 1989-90, in the 1988 Survey. As usual detailed public expenditure judgements and assumptions will be discussed during the forecast with the appropriate Treasury divisions.

(i) The forecasters will make their best forecast of public sector pay in consultation with Pay division.

(ii) The outturn percentage of local authorities' Aggregate Exchequer Grant to expenditure in 1988-89 will be forecast from details of the RSG settlements announced on 23 July 1987, the forecast of LA relevant expenditure, and estimates of the associated grant underclaim. The outturn percentage is expected to fall by just over half a percentage point between 1987-88 and 1988-89. It will be assumed to fall by a smaller amount in 1989-90.

Why? (I suppose softening for CC intro following year).

(iii) The forecast of local authority rate income in 1988-89 will be consistent with the forecast of current expenditure, grant income implied by the recent RSG settlement, and assumptions to be discussed with LG about special funds, balances, and rate caps. The forecast of rate income in 1989-90 will be consistent with the expenditure forecast and the assumptions about grant at (ii). It will be discussed with LG, who will also be consulted on the likely effect in the run up period of the introduction of the Community Charge on local authorities' spending decisions and income.

(iv) Privatisation proceeds for 1987-88 will be the best available estimate in the light of the latest information. Total Issue Department purchases of BP shares will be known before the forecast is finalised. For 1988-89 and 1989-90 it is proposed to assume proceeds of £5 billion a year.

(v) The forecast of nationalised industries prices, investment, etc. is being discussed with PE. The forecast of external finance will allow for the transfer to the private sector of newly privatised industries. These will probably have negative EFLs at the time of privatisation.

Privatisation will therefore, other things being equal, increase the aggregate EFL, providing an "EFL offset" to the privatisation proceeds themselves. For this purpose BSC will be assumed to be privatised during the second half of 1988-89 but not to imply a significant "EFL offset" until 1989-90. Part of the water industry will be assumed to be privatised in 1989-90 but the "EFL offsets" will be assumed to be relatively modest. While the first electricity sale could occur in 1989-90, the forecast will assume that it occurs 1990-91.

(vi) As the European Community has not yet agreed a 1988 budget an emergency financing regime (provisional twelfths) will be implemented from 1st January, pushing up the UK's net payments in 1987-88 compared with the Autumn Statement by some £¼ billion, and reducing them by a similar amount in 1988-89. It will be assumed that during the course of 1988 the own resources ceiling will be increased to 1.2 per cent of Community GNP (in place of the existing 1.4 per cent VAT ceiling). The increase will be back-dated to 1st January. This is likely to increase our net payments by around £200 million a year.

(vii) The Treasury supplement to the National Insurance Fund will be assumed to be reduced by 2 percentage points a year. National insurance contribution rates will be assumed to be unchanged from current levels. The lower and upper earnings limits for contributions will be assumed to be as announced for 1988-89 and to be increased in 1989-90 in line with forecast inflation in the year to September 1988.

(viii) Social Security benefit rates will be assumed to be as announced for 1988-89. For 1989-90 all benefit rates will be assumed to be uprated in line with forecast inflation in the year to September 1988, with the exception of child benefit which is assumed to be increased by about 1½ percentage points less than inflation (reflecting a hidden saving in the current public expenditure plans).

Changes Since the October Forecast

9. The main changes from the assumptions used in the October Forecast are:

(i) a full fund is no longer assumed for 1987-88 and it is now assumed that a change in the funding rule will be announced at the time of the 1988 Budget to exclude debt sales to building societies from the definition of funding;

(ii) privatisation proceeds in 1988-89 and 1989-90 have been reduced from £6 billion to £5 billion a year.

(iii) the EC own resources ceiling is now assumed to be increased by the adoption of a 1.2 per cent GNP ceiling rather than a 1.6 per cent VAT ceiling.

pry

FROM: A C S ALLAN

DATE: 7 January 1988

MR SEDGWICK

cc PS/Chief Secretary
Sir P Middleton
Sir T Burns
Mr Odling-Smee
Mr Peretz
Mr Bottrill
Mr Hibberd
Mr Mowl

POLICY ASSUMPTIONS FOR THE FORECAST

The Chancellor was grateful for your minute of 6 January, and is content with the assumptions you propose.

ACSA

A C S ALLAN

MTG
WITH PM

SECRET

Some pretty strange stuff, but I presume it's a reasonably accurate record?? AA

CH/EXCHEQUER

REC.	21 JAN 1988
ACTION	
COPIES TO	SIR P. MIDDLETON SIR T BURNS

21/1

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

20 January 1988

Dear Alex,

The Prime Minister and the Chancellor this morning had a general discussion about economic policy against the background of Sir Terence Burns' note of 18 January. Sir Peter Middleton, Sir Terence Burns and Professor Brian Griffiths were also present.

The Prime Minister said there were a number of features of the economic scene that caused her concern. Inflation remained stubbornly high, particularly in relation to key competitors, and latest figures on earnings and unit labour costs pointed to the dangers of inflation accelerating. Allied to this, the personal savings ratio had fallen to very low levels. The trend of the balance of payments current account was adverse with a significant deficit now emerging; it was essential the UK did not take the place of the United States as a major deficit country. Action to sterilise the large increase in foreign currency reserves had led to large overfunding during 1987. The public finances were at risk if oil prices fell. And the ratio of net public sector debt to GDP remained at very high levels compared with other countries.

?

In discussion the following points were raised:

(i) The political difficulties of the trend in the current account should not be underestimated, and would be exacerbated if there were downward adjustments to the figures for invisibles. On the other hand, recent balance of payments figures had been marked by a large positive balancing item which could lead to favourable corrections. In addition the current size of the deficit was only around half a percent of GDP and, unlike the balance of payments crises of the 1960s and early 1970s, it was associated with a strong underlying economic performance.

(ii) The interpretation of the current account deficit (equivalent to a surplus for the overseas sector) also had to take account of the position in other sectors of the economy. Historically, whenever the public sector had been in the broad balance, there had been no sustained overseas sector surplus. But the present position of the private sector was also unusual, with a move into deficit. To the extent that this private sector deficit reflected strong investment growth, a relatively relaxed view could be taken of its being financed from overseas - in effect the current account deficit had been privatised.

(iii) There had been a small public sector surplus in 1970 but the opportunity that presented had then been wasted by allowing public expenditure to run out of control. It was therefore important to ensure that the present position of broad public sector balance was sustained against a background of rising public expenditure commitments, particularly on the pay front.

(wrong way round)

(iv) Interpretation of the present low savings ratio was particularly difficult. The statistics were bedevilled by a large residual error. It had to be remembered that the savings ratio was measured net and that the reduction in recent years in large part reflected the build up of mortgage borrowing. This was associated with heavy consumer expenditure on items such as kitchens and white goods. One view of the prospect for 1988 was for a substantial slowdown in this type of consumer expenditure, a view supported by recent discussions with the Retail Consortium. On this view it was reasonable to expect some increase in the savings ratio during 1988 which would provide an automatic correction of the pressures on inflation and the trade balance. GDP growth during the course of 1988 might slow to say 2 - 2.5 per cent.

(v) An alternative scenario was one in which consumption-led growth continued at a high rate with no recovery in the savings ratio. On this basis the case for a restrictive fiscal stance was even stronger and would need to be coupled with some tightening of monetary policy.

(vi) There were indeed substantial grounds for considering an early move to raise interest rates by half a percent to tighten the monetary stance. If the circumstances and timing were right this need not necessarily mean upward pressure on the exchange rate. On the other hand, if the exchange rate was pushed up and unsterilised intervention was carried out to hold sterling below DM 3 that would simply offset the desired monetary effect. In those circumstances a tighter monetary stance could only be achieved by allowing the exchange rate to rise.

(vii) Table 6 of Sir Terence Burns' paper pointed to the broadly unchanged ratio of taxes and NICs to GDP in recent years. This single aggregate figure was difficult to interpret as there were different trends for some of the component elements. But a major factor in the continuing strong tax take was the buoyancy of corporation tax as profits rose. In addition, although income tax allowances were indexed for price movements, there was still fiscal drag in the system resulting from real growth. One view of this phenomenon was that 'tax cuts' were no more than returning to taxpayers the additional tax burden generated by growth. There was a related point that, in terms of presentation, the single banner of 'tax cuts' should not be applied to a position in which, although marginal tax rates might be reduced for many taxpayers, the overall tax burden was little changed and was financing a continuing high level of public expenditure.

Summing up the discussion the Prime Minister said it was essential not to take a complacent view of current economic prospects and she felt it was important she should use Question Time and other opportunities to damp down the recent public mood of euphoria about the Budget prospects. She invited the Chancellor to propose some suitable forms of words for this purpose. It would also be helpful if the Treasury could provide a breakdown of the aggregate figures for the ratio of taxes and NICs to GDP.

Yours,
Paul

PAUL GRAY

Alex Allan, Esq.,
H.M. Treasury

WORLD ECONOMIC PROSPECTS

sw64

CONFIDENTIAL

FROM: S W MATTHEWS
DATE: 21 January 1988

CHANCELLOR

cc: Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
PCC Members
Mr Evans
Mr Odling-Smee
Mr Peretz
Mr Sedgwick
Mr Turnbull
Mr Bottrill
Mr S Davies
Mr Hibberd
Mr Mowl
Mr Dolphin
Mr Cropper
Mr Tyrie

[illegible] based on [illegible] forward [illegible] on US - [illegible] shows some [illegible]?

WORLD ECONOMIC PROSPECTS: JANUARY 1988

I attach a report on the latest WEP exercise. It provides the world economic background to the forecast report circulated by Mr Sedgwick and is based on a forecast average North Sea oil price in 1988 of $17 per barrel.

?

2. 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. An annex describing in more detail the forecasts for each of the major countries and for the developing countries is available on request.

SM

S W MATTHEWS

WORLD ECONOMIC PROSPECTS: JANUARY 1988

The forecast is summarised in Table 1.

Table 1: Output, Inflation and Trade

Percentage change on year earlier	1985	1986	1987	1988	1989
Major 7 nominal GNP	7.0	6.2	5.9	6.3	5.9
Major 7 real GNP	3.1	2.7	2.9	2.6	1.9
Major 7 real domestic demand	3.4	3.7	3.0	2.9	1.9
Major 7 industrial production	2.9	1.0	3.2	4.5	2.9
Major 7 consumers' expenditure deflator	3.9	2.1	2.9	3.5	3.9
World trade					
- total	4.0	5.0	4.2	4.8	3.5
- manufactures	4.2	2.0	5.3	6.0	4.2
Major 7 general govt. financial deficit (% of GNP)	3.1	3.0	2.5	2½	2¼
Major 7 real interest rate (%)	4.7	5.0	3.9	3.7	3.9
Real price of industrial materials	-12	-20	-1	7	-
Real price of oil	-5	-56	5	-19	-4

Further detail and the economic analysis underlying the figuring is set out as follows:

KEY ASSUMPTIONS AND RISKS

1. Perhaps the most important assumption made in this forecast is that during the remainder of 1988 government intervention in currency markets to support the dollar will not match the high levels seen in 1987 and the first few weeks of 1988. The continuing large US current account deficits will thus have to be largely financed by private flows. Assuming also a continued reluctance on the part of the US authorities to raise interest rates in a Presidential election year, a substantial further depreciation of the dollar is forecast for the next twelve months. The speed and extent of this depreciation is subject to great uncertainty, and periods of dollar strength - such as seen in the first two weeks of 1988 - followed by further declines seem likely.

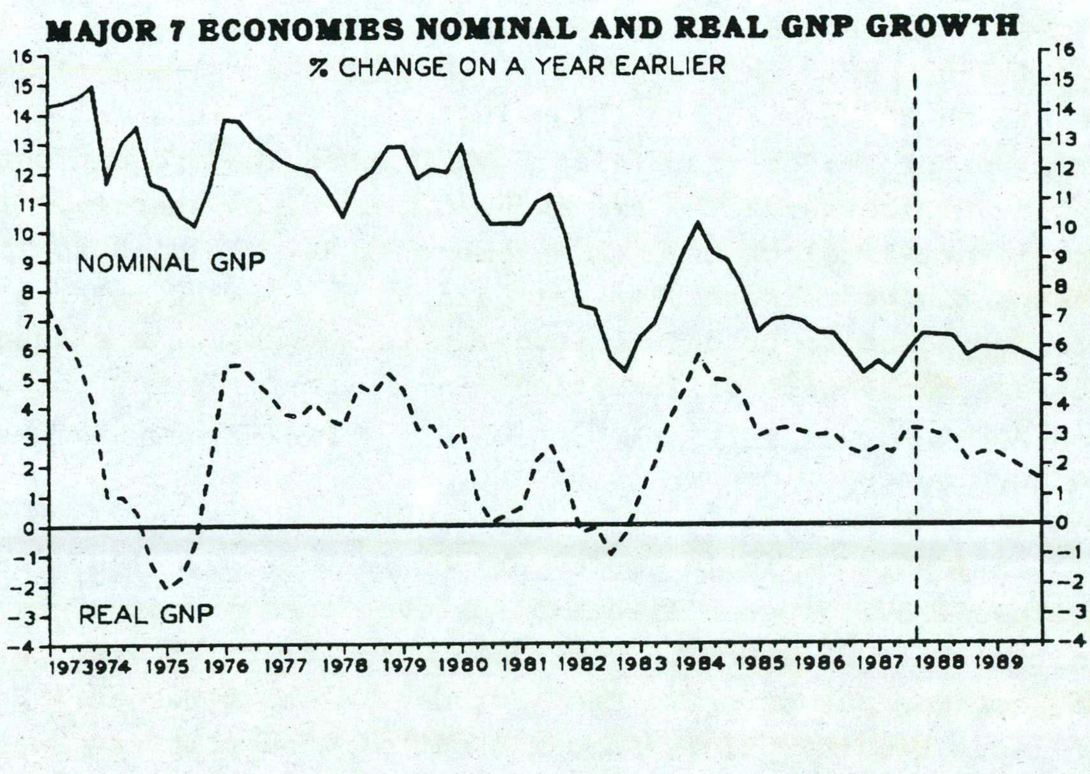
2. By 1989 the US current account deficit is forecast to be declining, but inflation will have risen above 6 per cent. We assume that fears about rising inflation (and continued pressure from other major countries) will then lead to a tightening of policy. Interest rates are assumed to rise sharply after the Presidential election in November 1988. This is followed by a substantial cut in the Federal deficit for FY1990. These measures are forecast to produce a recovery in the dollar's exchange rate. There are obvious difficulties in attempting to forecast the timing and degree of tightening of US policy, and the subsequent policy-induced slowdown in growth.

3. The sharp falls in equity prices in October 1987 have been followed by a stabilisation or even some modest recovery. The initial adverse shock to confidence appears to be dissipating and no confidence effects are included in the forecast. Before the collapse, equity prices appeared out of line with fundamentals and historical experience and the "correction" was notable mainly for its unexpected speed and severity. There remains a risk, though, that the unresolved problems of the US economy could lead to further stockmarket falls at some stage.

DEMAND AND OUTPUT

4. Growth in the major seven in 1986 and the early part of 1987 was held back by the weakness of demand in the rest of the world (following the sharp fall in oil prices and lower prices for many other commodities) and problems in adjusting to the depreciation of the dollar. Data for the third quarter of 1987 show that demand and output in the seven major industrialised countries picked up markedly, particularly in North America and Japan (and the UK). Business investment and industrial production grew particularly strongly.

Chart 1 - Major Seven Nominal and Real GNP Growth



5. The few published data relating to the period since the October stockmarket collapse show no signs of an immediate weakening of activity. In the United States industrial production continued to grow strongly and in November the unemployment rate fell to its lowest level since 1979. In Japan, also, industrial production maintained recent high levels in November. The main pointer to a slowdown in growth is the largely anecdotal evidence of falls in consumer confidence in the US and Europe.

6. Overall real GNP in the major seven is expected to continue to grow strongly in the first half of 1988, before slowing during the second half of the year and in 1989. The present upturn is expected to be shorter and less strong than previous upturns (e.g. in 1982-84) because it was preceded by only a moderate weakening of growth and there is much less spare capacity than in, say, 1982. Also, in 1983 fiscal policy in the US - and thus in the major seven as a whole - was relaxed markedly, whereas, by assumption, during 1988 and 1989 policy is expected to tighten a little.

7. Wealth effects on consumers' expenditure growth following the October collapse are forecast to be significant only in the US, where direct equity holdings are an important component of household wealth and rising equity prices were a factor behind the fall in the household saving ratio from 7 per cent in 1982 to 2.8 per cent in 1987Q3. Some reversal of the earlier wealth effect following the October collapse in equity prices, slower growth of household credit and a squeeze on real personal income as a result of rising import prices are forecast to produce a slowdown in the growth of consumers expenditure. These trends are reinforced in 1989 by the assumed tightening of monetary and fiscal policy (though the latter may not have an effect until 1990).

8. Buoyant consumer spending has been the main factor behind the US upswing from 1983 to 1987 and its slowdown is the key determinant of the forecast deceleration of domestic demand growth.

Table 2: Domestic Demand Growth

Percentage change on year earlier	1986	1987	1988	1989
North America	3.6	2.2	1.6	0.4
Europe* and Japan	3.8	3.9	4.0	3.2
Major 7	3.7	3.0	2.9	1.9

* France, Germany, Italy and the UK.

Although some falls in saving ratios in Japan and Europe are forecast, these are only modest and do not offset the recovery in US saving. More details of the forecasts for individual countries and for the NODCs are given in the annex.

9. The gap between real domestic demand and GNP growth in the major seven was reduced from over 1 per cent in 1986, when they enjoyed large terms of trade gains from the fall in oil and other commodity prices, but also as a consequence weak net exports, to an estimated ¼ per cent in 1987. Further terms of trade gains for the major seven (largely at the expense of oil exporters) produce a substantial gap between the growth rate of their domestic demand and GNP in 1988 as well.

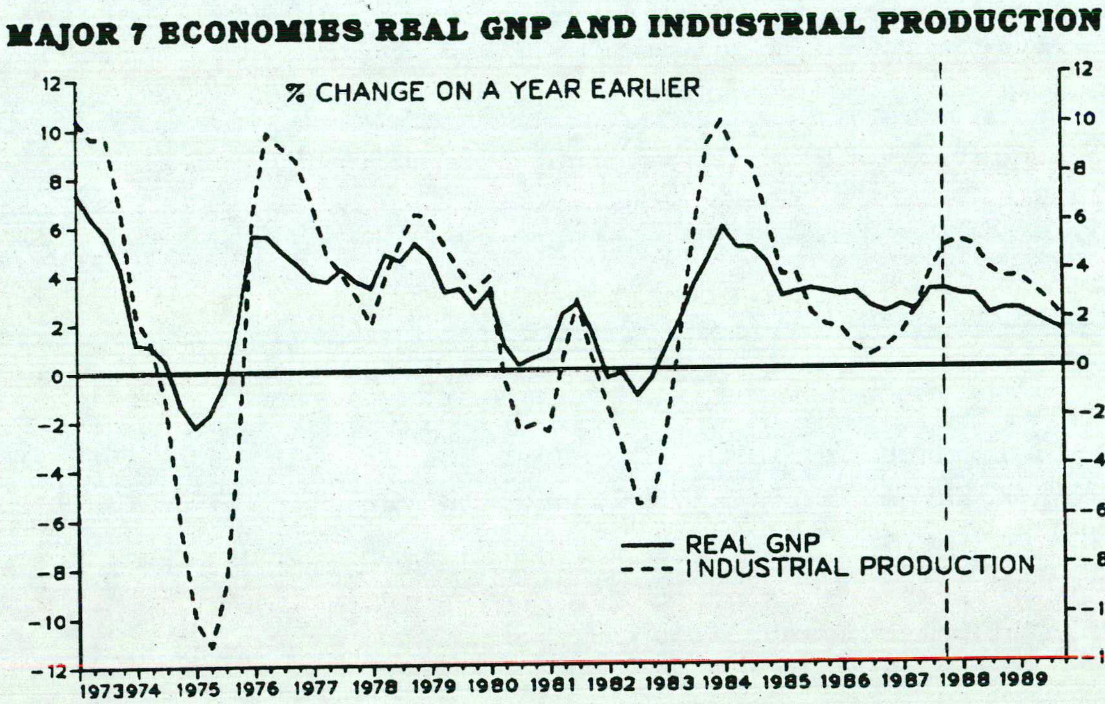
Table 3: Growth of Real GNP and Contribution of Domestic Demand

Percentage change on year earlier	GDP/GNP 1986	GDP/GNP 1987	GDP/GNP 1988	GDP/GNP 1989	Estimated Growth of Productive Potential
US	2.9	2.7	2.3	1.3	2½
Japan	2.5	4.0	3.8	3.2	3½
Germany	2.5	1.6	2.0	1.9	2¼
France	2.0	1.8	1.7	1.7	2¼
Italy	2.7	2.8	2.9	2.6	2½
Canada	3.3	3.8	3.7	2.2	2¾
UK	3.0	4.3	3.1	2.4	2¾
Major 7	2.7	2.9	2.6	1.9	2½

Percentage change on year earlier	Domestic Demand Contribution 1986	1987	1988	1989
US	3.7	2.1	1.3	0.2
Japan	3.9	4.7	5.6	4.6
Germany	3.5	2.6	3.2	2.4
France	3.7	2.9	2.3	2.5
Italy	3.3	4.4	3.2	2.4
Canada	3.7	4.2	5.2	3.3
UK	4.4	4.5	5.0	3.0
Major 7	3.8	3.1	3.0	2.0

10. Industrial production is normally more cyclical than GNP and this is reflected to some extent in the forecast, though in 1989, as the major seven's exports remain fairly strong, industrial production does not slow as much as might normally be expected - see Chart 2.

Chart 2: Real GNP and Industrial Production Growth



WORLD TRADE

11. World import volumes are estimated to have grown by over 4 per cent in 1987, with developed countries' imports growing by about 5 per cent - a little stronger than previously expected reflecting the strength of domestic demand growth. On the other hand, the signs are that OPEC are still cutting back their imports, and the imports of NODCs as a whole are increasing only moderately, although with some individual exceptions - notably the NICs. Nonetheless, trade in manufactures looks to have picked up strongly and probably grew significantly faster than total trade - see Table 4.

Table 4: World Import Growth

Percentage change on year earlier	1985	1986	1987	1988	1989
Total developed economies*	4½	8	5¼	5	3
of which:					
US	4½	12½	4	-½	-2½
Japan	0	13½	7¼	14	9¼
EC(6)**	4¾	6	5¼	5½	3½
OPEC	-16½	-19	-7	-4¼	-2
NODCs	5½	1¼	3½	5½	6¼
Total	4	5	4¼	4¾	3½
World imports of manufactures	4¼	2	5¼	6	4¼

* OECD plus South Africa

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

12. Continued demand growth in developed countries is forecast to produce growth of their imports again around 5 per cent in 1988, with Japanese imports picking up strongly (reflecting strong domestic demand and terms of trade gains from yen appreciation) and US import volumes falling slightly. With imports by the Asian NICs expected to grow faster and the possibility of a little less of a cutback in OPEC imports, world trade growth should be slightly higher in 1988. Trade in manufactures is expected to be buoyant and it could grow by as much as 6 per cent.

FISCAL AND MONETARY POLICIES IN THE MAJOR COUNTRIES

13. The forecasts for general government financial deficits, as a percentage of GNP/GDP, in the major seven countries are set out in Table 5. On this measure fiscal policy for the group as a whole became tighter in 1987, primarily as a result of developments in the United States.

Table 5: General Government Financial Deficits

% of GNP	1980-85	1986	1987	1988	1989
US	2.6	3.5	2.4	2½	2¼
Japan	3.1	0.9	1.2	1¼	1
Germany	2.6	1.2	1.7	2¼	2¼
France	2.2	2.9	2.8	2½	2½
Italy	11.0	11.2	10.3	10	10
Canada	5.1	5.5	4.4	4	4
UK	3.2 3/7	2.6 5/7	1.5 6/7	¾ 7/7	½ 7/7
Major 7	3.4	3.0	2.5	2½	2¼

14. Little change in the aggregate deficit is expected in 1988 or 1989. In the US the Federal budget deficit in fiscal 1988, which ends on 30 September 1988, is forecast to be around $160 billion - a little higher than in FY1987 despite the $30 billion deficit cutting package agreed by the Administration and Congress. In FY1989 also, little progress in cutting the actual deficit is expected, because of slower economic growth and higher interest rates though the structural deficit is expected to fall. Any decision to tighten fiscal policy significantly is unlikely until after the Presidential election, and so will not have significant effects until FY1990.

15. Elsewhere, the forecast assumes that fiscal measures already announced are implemented. The Japanese have announced a "no change" budget for FY1988, which begins in April. For Germany the forecast incorporates the personal tax cuts amounting to DM14 billion which were implemented in January 1988, and the further round of cuts are planned for 1990. The Government is concerned that the budget deficit will rise excessively in 1988 and 1989 and have announced that plans will be made to cut expenditure and increase taxes in 1989. We have decided not to include such measures in the WEP forecast until firmer plans are announced.

16. Paragraphs 1 and 2 set out the assumptions underlying our forecast for a substantial further weakening of the dollar during 1988. The US is unlikely to be able to resist entirely the upward pressures on interest rates coming from rising inflation and a falling dollar and a rise of about 1 per cent during 1988 is forecast. The extent of further dollar depreciation and the timing of any recovery are subject to great uncertainty. Against the background of an improving current account in 1989, the more decisive tightening of monetary policy assumed to take place then seems likely to produce some recovery in the dollar.

<u>**Chart 3: Real Effective Exchange Rates**</u>

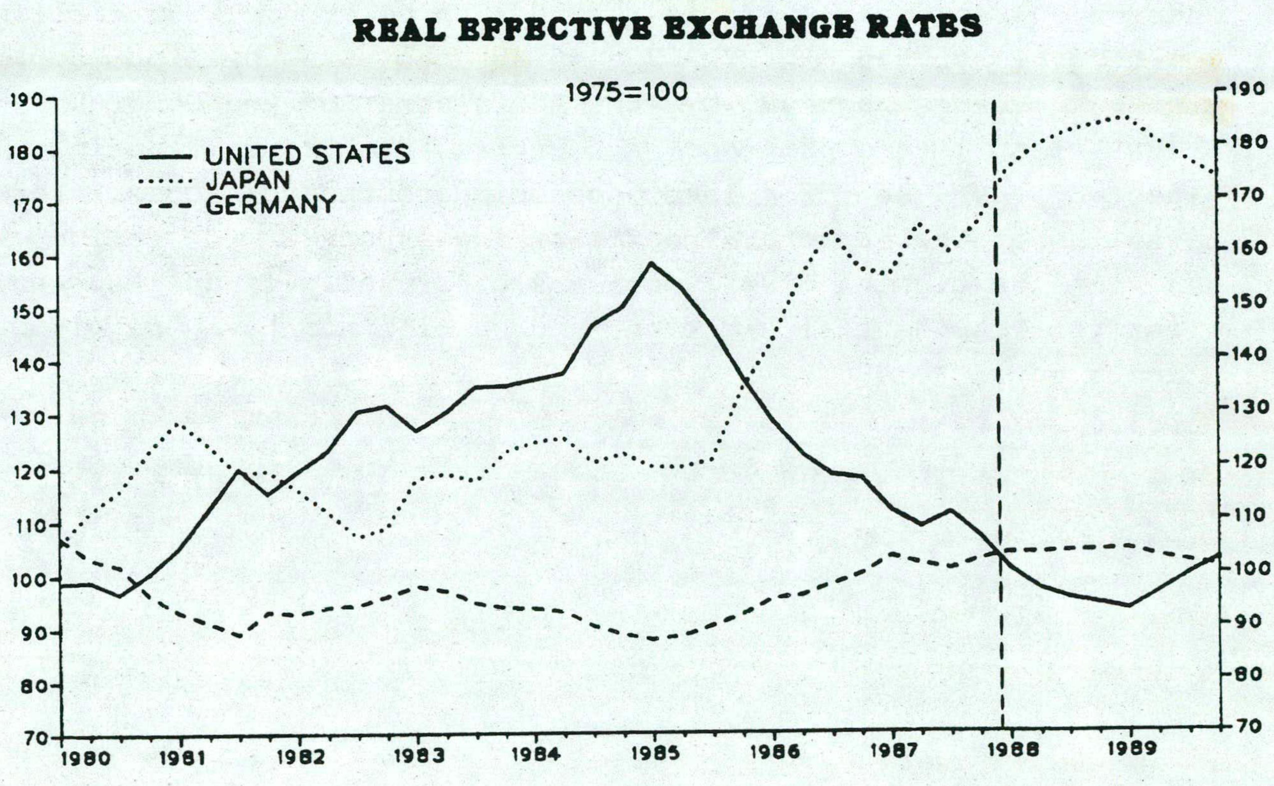


Table 6: Short-Term Interest Rates

%	Nominal 1986	1987	1988	1989	Real* 1986	1987	1988	1989
US	6.5	6.9	8.2	10.1	4.2	2.7	2.8	4.0
Japan	5.0	3.9	3.6	3.5	4.4	3.9	3.5	2.8
Germany	4.6	4.0	3.5	3.5	5.1	3.4	2.8	2.5
France	7.8	8.2	7.8	6.4	5.2	4.9	4.6	3.7
Italy	12.8	11.5	11.0	11.0	6.3	6.3	5.2	4.9
Canada	9.2	8.4	9.0	9.6	4.7	4.6	5.3	5.7
UK	10.9	9.7	9.2	9.5	7.3	6.5	5.5	5.6
Major 7	7.0	6.7	7.0	7.7	5.0	3.9	3.7	3.9

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

17. In Japan and Germany the central banks have cut their discount rate to 2½ per cent, and three-month market interest rates are around 3½ - 4 per cent. Even though inflation in both countries is expected to stay low, further falls in nominal interest rates look unlikely, in view of their monetary authorities concern about above-target money supply growth. On the other hand, there are no strong reasons for expecting rates to rise, even if inflation picks up a little in 1989 as forecast. Consequently, in contrast to US rates, real interest rates in Japan, Germany and France are expected to decline a little over the next two years.

INFLATION

18. During 1987 the average 12-month rate of consumer price inflation in the major seven countries rose from 1 per cent to 3½ per cent as the effect of the oil price fall in 1986 dropped out and as oil and other commodity prices recovered. The forecast is for only a modest further increase in inflation because earnings in most countries continue to grow only slowly.

Table 7: Prices

Percentage change on year earlier	Consumers' Expenditure Deflator			
	1986	1987	1988	1989
US	2.2	4.1	5.2	5.8
Japan	0.6	0.0	0.1	0.7
Germany	-0.5	0.6	0.6	1.0
France	2.5	3.2	3.0	2.6
Italy	6.1	4.8	5.5	5.8
Canada	4.3	3.6	3.5	3.7
UK	3.6	3.2	3.7	3.9
Major 7	2.1	2.9	3.5	3.9

19. The forecast depreciation of the dollar will put upward pressure on inflation in the US. Import prices are forecast to rise by 15 per cent in 1988 and 6 per cent in 1989. This assumes that exporters to the US, who cut their margins drastically in 1985 and 1986 following the initial fall in the dollar, raise their prices to reflect most of the dollar depreciation forecast for 1988. This could lead directly to an increase in US inflation from its present level around 4½ per cent to about 5½ per cent. Whether inflation rises much more depends on wage settlements, which so far continue to be moderate. The risk is that strong output growth could lead to higher wage settlements than forecast - particularly in areas where labour bottlenecks are developing - thus generating higher inflation in the latter part of 1988 and in 1989.

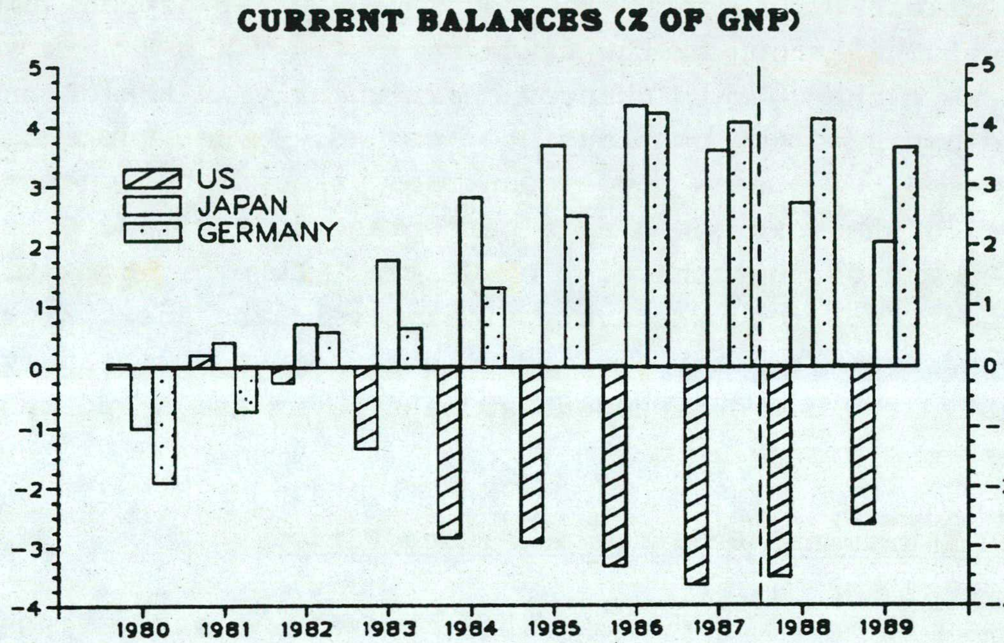
CURRENT BALANCES

20. Table 8 shows the forecast of current account balances. In dollar terms the imbalances of the US, Japan and Germany remain at much the same level in 1988 as in 1987, in part because of the J-curve effects resulting from continued dollar depreciation. But trade volumes, shown by the trade ratios in Table 8, are adjusting to past exchange rate changes, particularly in the US and Japan, and are expected to continue to do so. The current account imbalances of these two countries should be much lower - especially when expressed as a percentage of GNP (see Chart 4) - by the end of the decade. For Germany, however, domestic demand is forecast to grow relatively slowly over the next few years, with the result that trade volumes adjust more slowly and the decline in the current account surplus (even as a percentage of GNP) is more gradual.

Table 8: External Balances and Trade Ratios

	1986	1987	1988	1989	1990
Current balance ($bn)					
US	-141	-164	-169	-135	-96
Japan	86	85	85	70	57
Germany	38	46	59	57	48
UK	-1	-4	-9	-11	-8
NODCs	-2	-6	-5	-7	-16
OPEC	-34	-21	-21	-17	-18
World imbalance	-61	-75	-67	-91	-90
Trade balance ($bn)					
US	-144	-157	-151	-113	-70
Japan	83	81	80	63	48
Germany	53	65	73	71	62
UK	-12	-15	-23	-25	-24
Trade ratio (exports/imports, volumes, 1980=100					
US	57	62	73	83	90
Japan	113	103	88	79	74
Germany	111	108	103	100	97

Chart 4: Current Account Balances



21. The forecast developments in current account imbalances may be sufficient to ensure that the net external asset positions of the US, Japan and Germany begin to stabilise as a proportion of GNP around 1990. But estimates of external assets are subject to a large error margin, and some experts think official figures may overstate US net liabilities. Protectionist pressures in the US should be controllable in 1988 because of continued strong industrial output and employment growth. Like its predecessors, this forecast assumes no more than a continuation of the recent trend of creeping protectionism in the world economy.

THE OIL MARKET

22. The OPEC Ministerial meeting in December 1987 agreed to roll-over production quotas and crude oil target prices from 1987 into the first six months of 1988 (though Iraq was excluded from the agreement). The immediate reaction of the markets was to mark down prices in the expectation that total production would exceed both the quotas and demand. Prices are now rather volatile reflecting conflicting reports about production levels and price-discounting.

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	47.6	48.2	48.6	49.2
Stockbuilding	0.6	1.1	-0.2	0.0	0.1
Supply					
Non-OPEC	22.8	28.7	28.8	29.1	29.3
OPEC	27.6	20.0	19.2	19.5	20.0
Oil pricc* ($ pb)	30.3	14.3	17.3	16.5	16.8
Real oil price**	100	45.5	47.6	38.8	37.4
North sea oil price ($ pb)	34.7	14.3	17.8	17.0	17.4

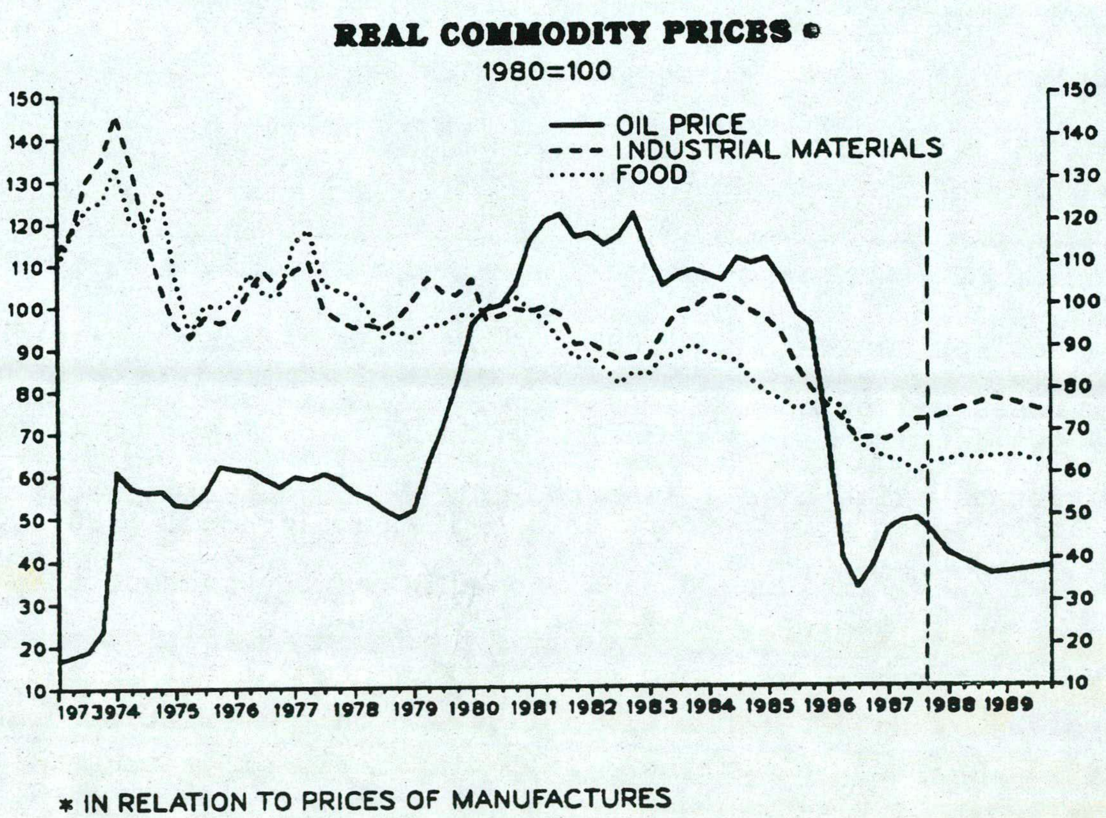
* Average price of oil imported into OECD countries (fob).
** Relative to world export prices of manufactures, 1980=100

23. Trends in demand and non-OPEC supply suggest only modest increases in demand for OPEC oil (see Table 9). Prices look likely to remain weak and the WEP projects the oil price (of OECD imports) at $16½ per barrel in 1988 and only a little higher in 1989, implying a further fall in real oil prices. This is consistent with an average North Sea oil price of about $17 per barrel. This projection is subject to some uncertainty. Prices could fall sharply if OPEC's production agreement collapses completely, but there is also a possibility of higher prices if other producers (particularly Iraq) are brought into line and/or Saudi Arabia agrees to become a swing producer again.

NON-OIL COMMODITY PRICES

24. Non-food commodity prices rose strongly during 1987 from the exceptionally low levels reached in late 1986. By the end of the year spot prices measured in SDRs were over 25 per cent up on a year earlier. Some further increases in real non-food commodity prices are expected in 1988 because industrial production in the major OECD countries is forecast to be relatively buoyant, but these rises are likely to be more modest than during 1987. On the other hand, the continuing over-supply of many foodstuffs - encouraged by high levels of support in many OECD countries - points to continued weakness in food prices, which are expected, at best, to level off in real terms.

Chart 5: Real Commodity Prices



NON-OPEC DEVELOPING COUNTRIES

25. Non-OPEC developing country trade prospects are summarised in Table 10. The aggregate forecast is for continued fast growth in export volumes followed by more moderate growth in 1989. Import volumes in aggregate are also expected to increase rapidly, as the Asian NICs' domestic demand increases in response to previous export growth.

Table 10: NODCs Current Account

Percentage change on a year earlier	1985	1986	1987	1988	1989
Export markets growth	3.1	6.3	4.5	5.4	3.9
Export volume growth	3.7	7.3	5.1	5.6	4.3
Import volume growth	5.4	1.2	3.4	5.6	6.2
Terms of trade	-1.7	-1.1	-2.1	0.6	1.5
Current account ($bn) of which:	-23	-2	-6	-5	-7
Trade*	-2	13	14	19	20
Invisibles	-21	-16	-19	-25	-28

* fob/fob

26. This overall picture conceals wide divergences in experience. Most of the expansion of both exports and imports is accounted for by continued strong growth in the Asian NICs which take about 30 per cent of NODC imports. The major primary producers which account for 35 per cent of NODC imports and include 10 of the Baker 15 are likely to do less well with only a modest pick-up in export growth in the short term. Non-OPEC oil producers such as Mexico will have to make further substantial import adjustments to the fall in real oil prices.

OPEC

27. The trade forecast for the OPEC countries is summarised in Table 11. The projected fall in the real oil price (which arises in large part from the depreciation of the dollar) will necessitate further adjustment in OPEC import volumes. Continued large current account deficits around $20 billion may prove unsustainable and import compression may thus have to be greater than forecast. On the other hand the current balance data for many OPEC countries are unreliable (part of the global current account discrepancy could belong here) and Saudi Arabia and many Gulf producers continue to have a substantial cushion of financial assets.

Table 11: OPEC Current Account

Percentage change on a year earlier	1985	1986	1987	1988	1989
Export volumes	-7	16	-4	2	2
Import volumes	-17	-19	-7	-4	-2
Real oil price	-5	-56	5	-19	-4
Trade Balance ($ bn)	61	9	28	30	37
Current Balance ($ bn)	6	-34	-21	-21	-17

TREASURY ECONOMIC FORECAST

SECRET COPY NO. 1

FROM: P N SEDGWICK
DATE: 21 JANUARY 1988

pmp

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Financial Secretary
Paymaster General
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PCC
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Mr Hawtin
Mrs Lomax
Mr Moore
Miss Peirson
Mr R I G Allen
Mr Bottrill
Mr Grice
Mr S Davies
Mr Hibberd
Mr Matthews
Mr Melliss
Mr Mowl
Mr Pickford
Mr Riley
Mr Cropper
Mr Tyrie
Mr Call

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.

2. The other details reports on this exercise are

World Economic Prospects	(Mr Matthews, IF2)
Public Finances	(Mr Mowl, PSF)
The Financial Prospect	(Mr Bottrill, EA2).

P.N.S

P N SEDGWICK

TREASURY ECONOMIC FORECASTING EXERCISE

WINTER 1988 REPORT

Contents

TREASURY ECONOMIC FORECASTING EXERCISE

(1) SUMMARY

The forecast covers the period to the end of 1989 (1989-90 for public finances). Table 1 summarises the results.

(i) Main results

The World economy

2 After some hesitation in the second half of 1986 and early 1987 growth in the world economy picked up more strongly than expected in the third quarter of 1987 (particularly in North America and Japan). Major 7 GNP probably rose by just under 3 per cent in 1987, while industrial production in October was 5 per cent higher than a year earlier.

3 Activity is likely to remain strong in the first half of 1988 with only modest effects from the collapse in equity prices and the subsequent disturbances in foreign exchange markets. The US authorities continue to give priority to avoiding recession rather than stabilising the dollar. There are likely to be further falls in the dollar during 1988 until adverse effects lead to tighter monetary policy. The underlying balance of payments problem is unlikely to be solved until further fiscal action is taken. Weakening of activity in the US during 1988 will contribute to moderation in the growth of Major 7 GNP. This may be a little lower than in 1987, at just over 2½ per cent in 1988 and just under 2 per cent in 1989.

?? 4 Growth of world trade in manufactures, which may have been about 5 per cent in 1987, is forecast to rise to 6 per cent in 1988 before falling to 4 per cent in 1989. Continuing strong activity in the early part of 1988 is likely to lead to a further rise in real commodity prices in 1988. The ?? average North Sea oil price is forecast to be $17 in 1988 and to rise slightly in 1989.

UK Activity

5 Last year GDP and domestic demand grew significantly faster in the UK than in the rest of the Major 7. The CSO may revise up the current estimates for growth of domestic demand (3¾ per cent higher than a year earlier in the first three quarters of 1987) and GDP (5 per cent up over the same period.)

6 Growth in consumers' expenditure should be lower in 1988, though at 4½ per cent it will still be buoyant. It will be boosted by the assumed

large tax cut in the 1988 budget and, for a time, by lower short term interest rates. The fall in equity prices should do no more than offset the effects of the rise during the first part of 1987. Business confidence seems largely unimpaired by the stock market crash, and investment growth should pick up in 1988 and 1989. Total domestic demand is therefore expected to grow more strongly in 1988 than in 1987. But the Why? decline in net exports that began during 1987 will probably continue. As a result GDP growth is likely to fall from 4¼ in 1987 to about 3 per cent in 1988 and 2½ per cent in 1989. Growth in 1988 and 1989 taken together would be close to the post 1981 average.

The balance of payments

7 Despite the strong growth of demand the current account deficit seems to have widened only modestly, from £1b. in 1986 to £2½b. in 1987 - as forecast in the FSBR and Autumn Statement. A larger deficit on trade in manufactures and increased transfers abroad more than account for this worsening. During 1987 the competitiveness gains achieved in 1986 were partly eroded. If the dollar falls as forecast and sterling by assumption falls only slightly against the DM, the sterling index will rise further. This is likely to contribute to a further worsening of competitiveness, with adverse effects on non-oil trade in 1988 and 1989. Falling North Sea production and lower oil prices will reduce the surplus on oil trade by £1½b. in 1988 and £½b. in 1989. These developments taken together could increase the current account deficit to £4½b. in 1988 (a monthly rate of just under £400m.), or 1 per cent of GDP. Continuing current account deficits and a reduction in the sterling value of the UK's dollar assets imply that the UK's net stock of foreign assets, which probably fell to about £90b. at the end of 1987, will fall further to about £80b.

8 The growing current account deficit coupled with continued net direct investment outflows by companies and further portfolio investment abroad by financial institutions implies the need for substantial offsetting capital inflows. The forecast is that UK companies and banks will be able to attract much of the necessary finance at the projected interest rates, but sterling may eventually come under some downward pressure against non dollar currencies. Official intervention, however, is assumed to prevent the sterling/DM rate falling much below 2.90. The sterling index is projected to ease as the dollar rebounds in 1989.

Don't like all this XR prediction

Inflation and money GDP

9 The prospects for RPI inflation in the short term will depend critically on fluctuations in the exchange rate and the mortgage interest rate. The sterling index is now higher than assumed at the time of the

TABLE 1 : SUMMARY OF FORECAST

	FSBR 1987	OCTOBER INTERNAL 1987 (pre stock mkt fall)	AUTUMN STATEMENT 1987	WINTER 1988
A THE WORLD ECONOMY				
1. GNP (MAJOR 7 EXCLUDING UK) (per cent change on a year earlier)				
1986	2.6	2.7	2¾	2.7
1987	2.6	2.5	2½	2.8
1988	3.0	2.6	2	2.6
1989	2.9	2.4		1.9
2. DOMESTIC DEMAND (MAJOR 7 EXCLUDING UK) (per cent change on a year earlier)				
1986	3.8	3.8	3¾	3.7
1987	3.0	2.6	2¾	3.0
1988	3.2	2.6	2	2.8
1989	3.0	2.5		1.8
3. WORLD TRADE IN MANUFACTURES (per cent change on a year earlier)				
1986		1.9	2	2.0
1987		3.8	3¾	5.3
1988		4.9	4	6.0
1989		4.8		4.2
B UK ACTIVITY AND DEMAND				
4. GDP VOLUME (non-North Sea in brackets) (per cent change on a year earlier)				
1986	2.6(2.7)	3.1(3.2)	3(3)	3.0(3.1)
1987	3.0(3.1)	4.1(4.5)	4(4½)	4.3(4.7)
1988	2.4(2.9)	3.0(3.5)	2½(3)	3.1(3.6)
1989	2.4(2.9)	2.4(2.8)		2.4(2.7)
5. VOLUME OF DOMESTIC DEMAND (per cent change on a year earlier)				
1986	3.2	3.8	4	3.8
1987	3.5	3.9	4	3.9
1988	2.4	4.1	3½	4.3
1989	2.2	2.9		2.6
6. UNEMPLOYMENT (UK S.A. EXCLUDING SCHOOL LEAVERS million)				
1986 Q4	3.14	3.14	3.14	3.14
1987 Q4	2.88	2.74	2.73	2.66
1988 Q4	3.01	2.52	2.71	2.41
1989 Q4	2.94	2.54		2.34
C INFLATION AND MONEY GDP				
7. MONEY GDP (MARKET PRICES) (per cent change on a year earlier)				
1986-87	6.1	6.6	6.6	6.7
1987-88	7.5	8.9	8½	9.9
1988-89	6.4	8.5	7¼	7.6
1989-90	6.1	7.8		7.0

	FSBR 1987	OCTOBER INTERNAL 1987	AUTUMN STATEMENT 1987	WINTER 1988
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)	3.4(3.4)
1987 Q4	3.9(3.4)	3.9(3.7)	4(3.6)	4.1(4.0)
1988 Q4	3.3(3.0)	5.3(4.6)	4½(4.4)	4.0(3.8)
1989 Q4	3.3(3.2)	4.3(3.9)		4.4(4.2)
9. GDP market price deflator (per cent change on a year earlier)				
1986-87	3.2	3.0	3.0	3.2
1987-88	4.4	4.6	4¼	5.0
1988-89	4.0	5.4	4½	4.8
1989-90	3.6	5.2		4.6
D PUBLIC FINANCES				
10. PSBR - £ billion				
1986-87	4.1	3.5	3.4	3.4
1987-88	3.9	-1.2	1.0	-2.8
1988-89	4.4	-5.0		-3.4
1989-90	4.9	-5.4		-3.7
11. PSBR - % OF GDP				
1986-87	1.1	0.9	1	0.9
1987-88	1.0	-0.3	¼	-0.7
1988-89	1.0	-1.1		-0.8
1989-90	1.0	-1.1		-0.8
12. ANNUAL FISCAL ADJUSTMENT - £ billion				
1988-89	3.2*	13.6*		12.0*
1989-90	1.5*	2.8*		2.9*
allocated to				
(a) reducing personal taxes				
1988-89	3.2	4.1**		4.0
1989-90	1.7	2.0		2.4
(b) reducing PSBR				
1988-89	0.0	9.5		8.0
1989-90	-0.2	0.8		0.5

*Assuming PSBR ratio of 1 per cent as in 1987 MTFS.
**This was one third of the fiscal adjustment remaining after the higher (by £lb.) than previously assumed level of privatisation receipts had been used to reduce the PSBR.

	FSBR 1987	OCTOBER INTERNAL 1987	AUTUMN STATEMENT 1987	WINTER 1988
E MONETARY CONDITIONS				
13. SHORT TERM INTEREST RATES (per cent))				
1986 Q4	11.2	11.2	11.2	11.2
1987 Q4	10.3	10.5	9.5	9.2
1988 Q4	10.1	11.0	9.5	9.5
1989 Q4	9.7	11.0		9.5

	FSBR 1987	OCTOBER INTERNAL 1987	AUTUMN STATEMENT 1987	WINTER 1988
14. MO				
(per cent change on a year earlier)				
1986-87	4.3	4.3	4.3	4.3
1987-88	4.0	5.1	4.9	5.1
1988-89	3.4	4.4	4.3	5.0
1989-90	3.0	3.4		3.0
15. STERLING INDEX (1975=100)				
1986	72.8	72.8	72.8	72.8
1987	70.3	72.0	72.0	72.6
1988	69.3	72.5	72.5	77.1
1989	67.3	72.5		76.5
16. £/DM EXCHANGE RATE				
1986	3.19	3.19	3.19	3.19
1987	2.78	2.95	2.95	2.94
1988	2.67	2.94	2.94	2.96
1989	2.52	2.87	2.87	2.88
17. RELATIVE UNIT LABOUR COSTS (1980=100)				
1986	77.6	77.3	77.3	78.0
1987	74.0	74.8	75.1	75.5
1988	73.5	76.7	75.4	79.8
1989	70.1	76.9		80.5

I thought it showed falling £? (is this low variant)

F TRADE AND CURRENT ACCOUNT

	FSBR 1987	OCTOBER INTERNAL 1987	AUTUMN STATEMENT 1987	WINTER 1988
18. VOLUME OF NON-OIL EXPORTS OF GOODS				
(per cent change on a year earlier)				
1986	4.2	4.2	4	4.0
1987	5.2	6.2	7	7.2
1988	4.0	2.6	3½	5.2
1989	4.9	3.3		4.3
19. VOLUME OF NON-OIL IMPORTS OF GOODS				
(per cent change on a year earlier)				
1986	5.6	5.6	5½	5.7
1987	8.0	8.1	8	8.2
1988	1.7	4.7	5	6.9
1989	3.1	2.9		3.3
20. CURRENT BALANCE £ billion				
1986	-1.1	-1.0	-1.0	-0.9
1987	-2.7	-2.4	-2½	-2.5
1988	-1.7	-4.3	-3½	-4.6
1989	-0.4	-5.6		-5.3

Autumn Statement and expected to be rising through 1988 . The forecast is for RPI inflation in 1988Q4 of a little over 4 per cent - below the 4½ per cent in the Autumn Statement.

10 The return of GDP growth to more normal levels will probably lead to somewhat lower recorded (though not underlying) productivity growth. This in turn will lead to faster growth in labour costs than recent exceptionally favourable rates. The impact of this on prices will probably be offset by some squeeze on profit margins as a result of less buoyant domestic activity and increased competition from foreign producers as sterling rises. Most measures of inflation are likely to be fairly stable between 4 and 5 per cent in the period until end 1989.

11 Money GDP growth during 1987-88 appears to be turning out well above the forecasts in the FSBR (7½ per cent) and the Autumn Statement (8½ per cent). Figures for the GDP deflator in the first half of the year have been revised up and with real growth of 4 per cent or more money GDP growth could be 10 per cent. Over the forecast period money GDP growth falls, though the path will still be above that in the 1987 MTFS; the reduction in growth reflects lower growth in real GDP.

__Public finances__

12 The performance of public finances continues to be astonishingly strong. The PSBR in 1987-88 is now forecast to be in surplus by nearly £3b., compared with a forecast surplus of £1b. expected in the internal October forecast. Receipts have continued to run above earlier profiles, with VAT, corporation tax in particular, and more recently income tax contributing significantly to the overshoot. Central government expenditure (on a cash basis) is well below the levels expected at budget time. 1987-88 is likely to be the first year since 1982-83 in which public expenditure undershoots the planning total in the previous PEWP. (Expenditure in 1987-88 could also undershoot the total in the 1988 PEWP.)

discuss

13 This strength of public finances should continue during 1988-89, though not quite on the scale expected in the October forecast because a downward revision to the forecast for receipts more than offsets one for expenditure. With profits in 1987 having once again grown very strongly, and forecast economic growth in 1988 revised up, CT receipts in 1988-89 and 1989-90 should be higher than previously expected. But lower oil prices have reduced forecast North Sea revenues by £1b. in each year; the stock market crash will reduce receipts of Stamp Duty (by £¾b. in 1988-89) and, with increasing effect over the forecast period, capital taxes (by £¼ in 1989-90).

Look high?

From what to what?

14 Although public expenditure is likely to undershoot plans in 1987-88 the forecast is for a small overshoot of the existing plans in 1988-89 and a rather larger one in 1989-90. These forecast overshoots are, however, more modest than in some earlier forecasts, mainly because lower inflation in 1988 and lower unemployment throughout have led to lower forecasts for social security spending (by £1½b. in 1989-90 compared with the October estimate). The forecast does allow for increases in public sector pay that are some way above those consistent with the plans, and has central government procurement (the main constituents of which are health and defence) rising significantly more in real terms than the current plans envisage.

15 Adopting the convention used in October the forecast arbitrarily allocates one third of any fiscal adjustment in 1988-89 to cuts in personal taxes and two thirds to reducing the PSBR (taking the 1987 MTFS assumption of a PSBR of 1 per cent of GDP as the starting point). This convention yields a slightly lower PSBR surplus of £3½b., ¾ per cent of GDP, than in the October (internal) forecast and an assumed tax cut in the 1988 budget of £4 billion. (The October forecast had higher privatisation receipts - of £6b. - than the £5b. now assumed. The assumed extra receipts were allowed to increase the PSBR surplus.) There is scope for a tax cut in the 1989 budget of £2½b. if the PSBR is held at a surplus of ¾ per cent of GDP.

16 The *ex post* fiscal stance - as measured by the general government deficit, the only comparable measure for G7 countries - is already tighter in the UK than on average in the rest of the G7, and becomes relatively tighter over the forecast period. No other G7 economy is likely on present plans to have a lower general government deficit as a share of GDP in 1988 and 1989.

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

	1979-85	1985	1986	1987	1988	1989
UK	3.1	2.8	2.6	1.5	0.8	0.6
G7 (less UK)	3.2	3.1	3.1	2.6	2.8	2.5

(ii) **Risks**

The world economy

17 The behaviour of the dollar together with its effects on the world

economy are particular uncertainties in the forecast. The WEP has made no specific allowance for adverse effects from uncertainties associated with exchange rates and equity markets on world trade and activity. Nevertheless it is difficult to see how effects could be anything but adverse.

18. If the dollar fell less than assumed, it would - with sterling linked to the DM - ease the upward pressures on the sterling index and mitigate both the forecast loss of competitiveness and downward pressure on inflation.

The personal sector

19 Considerable uncertainty surrounds the past and likely future behaviour of the personal sector. The latest CSO figures show the saving ratio down to 5 per cent by 1987 Q3, and the sector's net acquisitions of financial assets negative for the last year. The forecast shows (small) personal sector deficits in 1988 and 1989 even though the saving ratio rises - particularly in 1988 following the large assumed tax cut.

20 A number of factors may have contributed to the large fall in saving and the emergence of a personal sector deficit. The strong rise in asset values throughout the 1980s has boosted financial wealth. Contribution holidays for companies' pension funds are one result of this, but it may also have led to some discretionary dissaving by households. A higher rate of equity withdrawal by owner occupiers may have followed the rapid growth of house prices. This implies that it is the private sector's management of its finances, not overloose macro policies, that is producing strong consumption growth, the current account deficit and the associated reduction in net foreign assets.

21 There are large risks either way to the forecast. The recent low saving and personal sector deficit may be reversed. On its own this would produce lower consumers' expenditure growth, a better current account, and a higher path for net overseas assets. On the other hand it is possible that the very low level of saving could persist, which would lead to a continued rapid growth of consumers' expenditure, a greater worsening of the current account, and a larger rundown in net foreign assets.

Public finances

22 One of the main uncertainties is the extent to which the amazing strength of public finances will survive a return of growth to a more normal rate. In particular the growth of profits is likely to revert to a rate close to the growth of money GDP following very high growth for a

number of years. But this forecast shows stronger GDP growth than earlier exercises, and there is not too dramatic a reduction in the growth of profits and, subsequently, corporation tax. A less favourable prospect for growth could would produce a lower fiscal adjustment for the 1988 and 1989 budgets.

(2) THE WORLD ECONOMY

23 Output in the major 7 grew faster in 1987 than was previously expected, particularly in North America and Japan (and the UK). Exports of the major 7 as a whole, which were broadly unchanged in 1986, picked up, while import growth slowed. Consequently business investment and **industrial production** grew strongly.

24 There are few indications yet of the extent to which October's stock market collapse will affect activity. In the US and Japan the recent strong growth of industrial production was maintained in November, and the unemployment rate in the US fell to its lowest level since 1979. The forecast assumes equity prices remain broadly at current levels. The October collapse is expected to have only modest effects on confidence and activity, except in the US, where significant wealth effects on consumers' expenditure are likely.

TABLE 3 : G7 (EXCLUDING UK) GROWTH AND INFLATION

Percentage changes on a year earlier	1986	1987	1988	1989
Real GNP	2.7	2.8(3.0)	2.6(2.6)	1.9(2.7)
Domestic demand	3.7	3.0(3.1)	2.8(2.7)	1.8(2.7)
Industrial production	1.0	3.0	4.5	2.9
Consumer prices	1.8	2.5	3.4	3.9

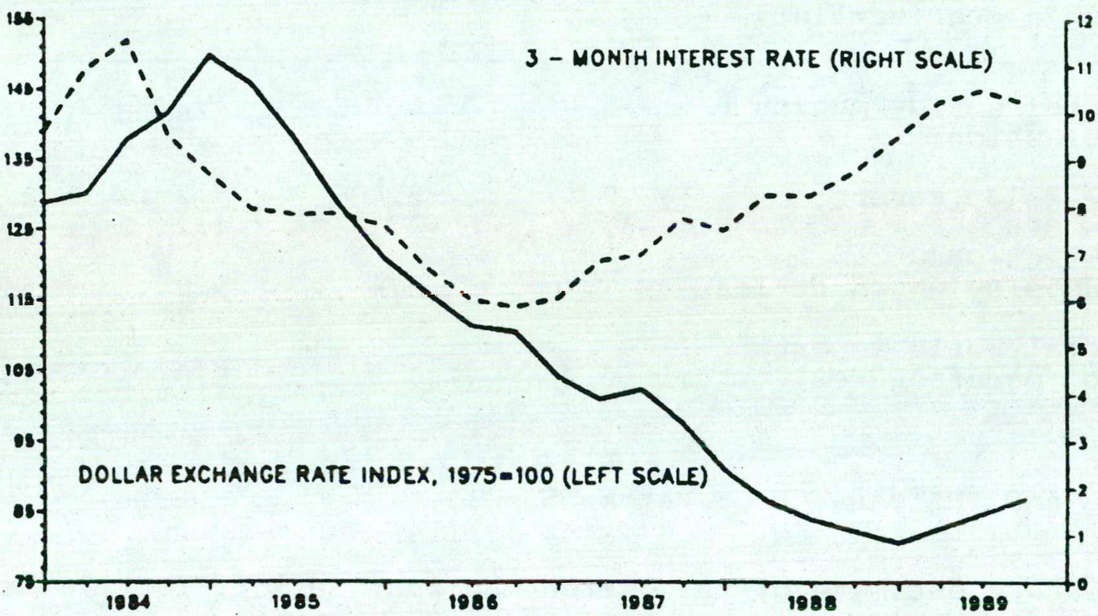
Note: Figures in brackets are IMF Staff's December estimates for G7 <u>including</u> UK.

25 Prospects for world activity, inflation, and trade will depend crucially on policy responses to the turbulence in stockmarkets and currency markets. **Fiscal policy** plans for 1988 suggest that the average budget deficit of G7 countries will be about the same proportion of GNP as in 1987 (Table 2). There may be a small rise in the federal deficit in the US, little change in the Japanese government's budget deficit, but some widening of the budget deficit in Germany.

26 It is harder to assess prospects for **interest rates** and **exchange rates**. The forecast assumes that official foreign exchange market intervention will not be maintained at the high levels seen in 1987 and early 1988, and that private flows will therefore have to be attracted to finance the continuing large US current account deficits. This will probably involve some combination of higher US interest rates and a still lower dollar. Given the reluctance of the US authorities to raise interest rates in a Presidential election year, a substantial further weakening of the dollar seems probable over the next twelve months or so. In 1989 a tightening of monetary policy followed by more determined action to reduce the federal deficit point to a sharp slowdown in US domestic demand and some recovery in the dollar.

27 This exchange rate profile is obviously subject to considerable uncertainty on both the timing and extent of further dollar depreciation, but until there is a credible US commitment to stabilise the dollar and concrete signs of a falling current account deficit periodic downward pressure on the dollar looks inevitable.

CHART A : US EXCHANGE RATE AND SHORT RATES



28 **Non-oil commodity prices** rose strongly in real terms during 1987. The forecast is for a further rise in real prices of industrial materials during 1988, as world industrial production strengthens further, though food prices will probably remain weak. Prospects for **oil prices** depend on OPEC's ability to restrict production. The forecast is that the oil price (North Sea average) will be around $17 per barrel in 1988, but the margin

of error around this could be +/- $5 per barrel. (A separate note considers the implications of a lower world oil price.) (not yet received)

29 **Consumer price inflation** in countries with appreciating exchange rates, particularly Japan and Germany, is forecast to remain low. The depreciation of the dollar and falling margin of unused resources have so far had only a modest effect on inflation in the US, but inflation there could be running at around 6 per cent by the end of 1988.

30 **Total world imports** of goods are estimated to have grown by over 4 per cent in 1987, when, as expected, trade in manufactures picked up strongly and grew significantly faster than total trade. In 1988 **trade in manufactures** is again expected to be buoyant - it could grow by as much as 6 per cent - as imports by Asian NICs continue to expand, and cutbacks in OPEC's imports are reduced. But in 1989, the projected slowdown in world activity is expected to be accompanied by slower growth in world trade.

TABLE 4 : THE VOLUME OF WORLD TRADE IN GOODS

Percentage changes on a year earlier	1986	1987	1988	1989
Total world imports of which:	5.0	4.2	4.8	3.5
- Major seven	9.1	5.4	5.2	2.8
- OPEC	-19.1	-7.1	-4.2	-2.0
- Non-OPEC developing countries	1.2	3.4	5.6	6.2
Total world imports of manufactures	2.0	5.3	6.0	4.2

(3) TRADE AND THE BALANCE OF PAYMENTS

31 The latest estimate of the current account deficit for 1987 is close to the £2½ billion forecast in both the FSBR and the Autumn Statement. The widening in the deficit from the £1 billion recorded in 1986 reflected an increased deficit on manufactured trade and a reduced surplus on invisibles. The current account deficit seems likely to widen further to about £4½ billion in 1988 as sterling's strength continues to reverse the competitiveness gains of 1986, domestic spending grows rapidly and the oil surplus declines.

TABLE 5 : UK CURRENT ACCOUNT (£bn)

	Visible trade balances			Net invisibles			Current balance
	Manufactures	Oil	Other	Services	IPD	Transfers	
1986	-5.3	4.1	-7.2	5.1	4.6	-2.2	-0.9
1987	-6.7	4.2	-6.9	5.4	5.0	-3.5	-2.5
1988	-8.1	2.7	-6.0	5.3	5.0	-3.4	-4.6
1989	-8.3	2.1	-6.0	5.2	5.7	-4.0	-5.3

Non-oil visible trade

32 The deficit on trade in manufactures is forecast to increase from £6½ billion in 1987 to £8 billion in 1988. The UK's domestic demand growth and the effects of deteriorating competitiveness are likely to cause import volumes to continue to grow more quickly than exports. Sterling's appreciation, coupled with domestic unit labour costs rising a little faster than abroad, is forecast to reverse all but about 4 per cent of the competitiveness gains since 1985. The pound's strength, however, may initially improve the terms of trade and help to offset at least partly the deterioration in trade volumes.

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33 The deficit in manufactures should level off from the end of 1988 as slower UK demand growth brings the rise in imports more closely into line with export growth during 1989. The level of the deficit in 1989, however, may still be rather higher than in 1988 reflecting the projected deterioration in the course of the current year.

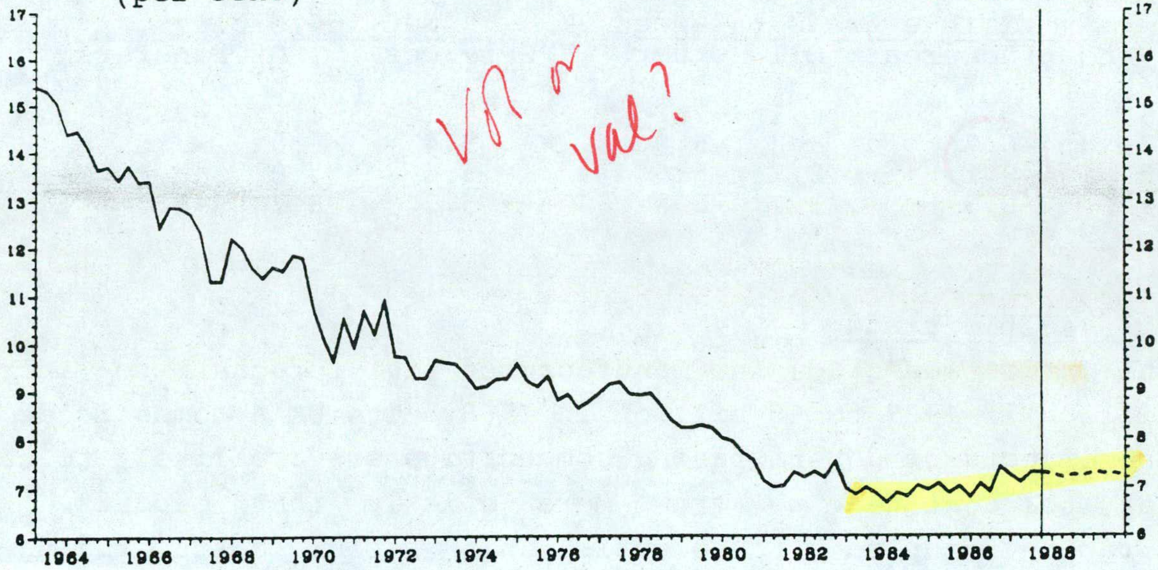
34 The volume of manufactured exports rose strongly during 1987 as the lagged benefits of improved competitiveness helped UK producers gain an increased share of world trade. Exports are forecast to rise more modestly during 1988 and 1989 as a result of recent lost competitiveness and - in 1989 - slower world trade growth.

TABLE 6 : TRADE VOLUMES
(per cent changes on previous year)

	Exports				Imports			
	Manufactures	Oil	Other	Total	Manufactures	Oil	Other	Total
1986	2.9	1.9	9.1	3.6	5.4	16.1	7.4	6.5
1987	8.1	-1.4	2.9	5.6	9.4	-4.0	4.1	7.1
1988	6.0	-3.1	2.6	3.7	9.9	12.1	0.1	7.3
1989	4.7	-5.9	2.5	2.7	4.3	4.3	-0.2	3.3

world pattern

CHART B : SHARE OF UK EXPORTS IN TOTAL WORLD TRADE IN MANUFACTURES
(per cent)



35 The volume of manufactured imports recovered sharply in the course of 1987 following the unexpected recorded fall in the early part of the year. The rise in imports has reflected probably both the strong rise in domestic demand as well as latterly the effects of lost competitiveness. Imports are forecast to rise less rapidly during 1988 with a further slowdown during 1989 as domestic demand growth eases.

TABLE 7 : STERLING AND THE TERMS OF TRADE
(per cent changes on previous year)

	Exchange rate index	Non-oil export prices	Non-oil import prices	Non-oil terms of trade	Oil export prices	Total terms of trade
1986	-6.9	0.2	0.9	-0.7	-50.1	-5.4
1987	-0.3	3.2	2.1	1.2	4.1	1.4
4. 1988	6.2	-0.1	-1.9	1.8	-21.8	1.4
1989	-0.8	2.4	2.6	-0.1	-1.9	0.5

36 The deficit on trade in non-manufactures fell slightly in 1987 as an improvement in the terms of trade more than offset the fact that import volumes rose faster than exports. The deficit is forecast to fall further in 1988. The terms of trade are projected to show a further improvement while export volumes grow modestly but import volumes grow less rapidly as the recent surge in domestic stockbuilding ends.

Oil trade

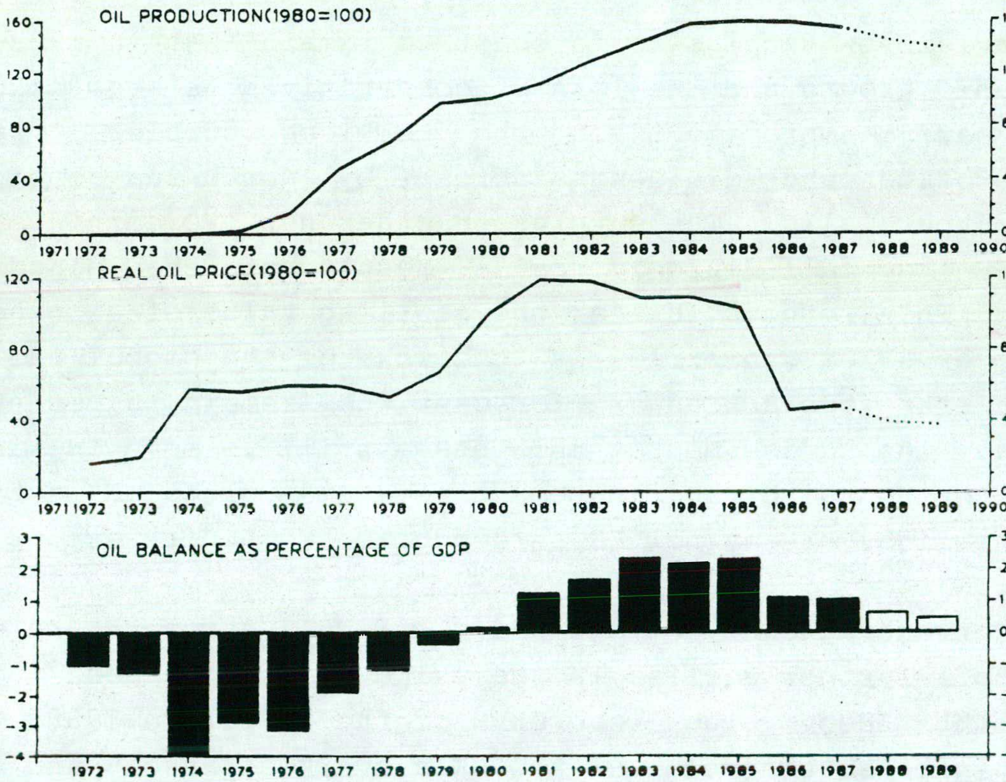
37 The strengthening of world oil prices in 1987 and a reduction in domestic demand for oil more than offset the rather more rapid than expected decline in North Sea output so that the oil trade surplus rose slightly. The surplus, however, is forecast to decline steeply in 1988 with a further fall in 1989 as sterling oil prices weaken, domestic demand for oil rises, and North Sea oil output falls.

TABLE 8 : NORTH SEA OIL

	Average North Sea oil price		N Sea output	Oil trade balance	N Sea* taxes
	$/barrel	£/barrel	mm tonnes	£ bn	£bn
1986	14.3	9.7	126.9	4.1	4.8
1987	17.8	10.9	123.4	4.2	4.6
1988	17.0	8.4	115.7	2.7	3.5
1989	17.4	8.5	111.4	2.1	3.4

* financial year totals

CHART C : OIL OUTPUT, PRICES AND TRADE



Invisibles

38 The surplus on invisibles, which rose strongly in 1986, seems likely - on the evidence so far available - to have fallen slightly in 1987, mainly as a result of an increase in net transfers to the EC. The

surplus on services increased modestly as a result of rising earnings from financial services which more than offset a worsening performance on travel, civil aviation, and sea transport. Net earnings from interest, profits and dividends rose slightly less than earlier expected as the pound's appreciation reduced the sterling value of overseas earnings.

39 The value of the UK's net overseas assets was reduced last year by sterling's appreciation, the fall in world equity prices and by the current account deficit. The latest estimate is that net overseas assets fell from £111 billion at end-1986 to £87 billion at end 1987.

TABLE 9 : THE INVISIBLES BALANCE

(£ billion)

	Services	**N Sea IPD**	**Other IPD**	**EC transfers**	**Other transfers**	**Total invisibles**	**Estimated net overseas assets (end-year)**
1986	5.1	-1.6	6.2	-0.7	-1.5	7.5	111
1987	5.4	-1.7	6.8	-1.8	-1.7	6.9	87
1988	5.3	-0.9	5.8	-1.5	-2.0	6.8	78
1989	5.2	-0.5	6.2	-2.0	-2.0	6.9	81

40 The invisibles surplus is forecast to remain flat in 1988 and 1989. The UK's rapid growth and the loss of competitiveness seem likely to work against any early improvement in the services surplus. Payments of interest, profits and dividends abroad by North Sea companies should decline as output falls. The surplus on other net IPD earnings, however, seems likely to fall largely as a result of the pound's forecast appreciation. This reduces further the sterling value of earnings although % only yields are expected to rise in the wake of the global fall in equity prices. Net transfers abroad are forecast to remain substantial, with transfers to the EC assumed at this stage still to move in line with the working of the Fontainbleau abatement system - although details could change in the light of any new EC agreement on Community expenditure.

41 The current account deficit and sterling's strength are expected to contribute to a further decline in the value of net overseas assets during 1988 to about £80b. The recovery of the dollar in 1989, however, is expected to increase the value of the UK's overseas assets and offset the continued drain from the current deficit so that the net asset position may show little further change.

(4) DOMESTIC DEMAND AND ACTIVITY

Personal Income and Expenditure

42 Consumers' expenditure is now estimated to have risen by 6 per cent in 1986 and by 5¾ per cent in the year to 1987Q3. Retail trade figures fell back slightly in December, but remain well above outturns prior to October. New car registrations in November were below peak September levels, but still 9 per cent higher than a year earlier. Given the gap between the expenditure and output measures of GDP in 1987, present estimates of consumers' expenditure probably understate the strength of spending in 1987.

43 The personal sector saving ratio has fallen by over half since 1980. The first estimate for 1987Q3 suggests that it could now be as low as 5 per cent, a level not experienced since the 1950s. If consumers' expenditure is subsequently revised up (and personal sector incomes are not revised up proportionately), the savings ratio in 1986 and 1987 could turn out even lower. Possible explanations for this fall are:

(i) Lower inflation - there is now less need to save to maintain real financial wealth.

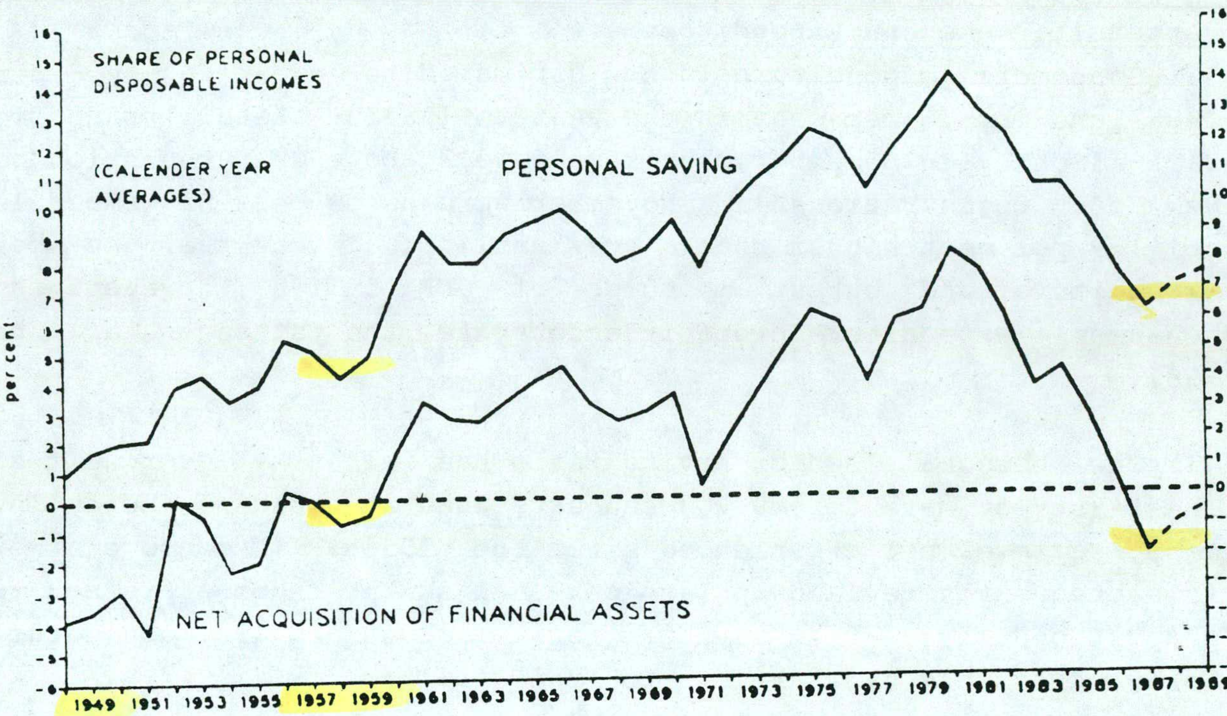
(ii) Recent increases in house prices may also have enabled greater spending, relative to income, through mortgage equity withdrawal.

+ "wealth effect"

(iii) Employers' pension contributions (part of measured personal income) have fallen over the past two years as firms have taken contribution holidays. Employers' pension contributions are unlikely to be perceived as "effective" income and probably do not influence personal spending. Their decline is more likely to show up as a fall in the saving ratio.

Whatever the reasons, the saving ratio has fallen over the last three years, whilst real incomes have risen substantially. This contrasts with historical behaviour; the saving ratio normally rises when income grows above trend, and falls when income grows below trend.

CHART D: PERSONAL SAVING AND NET ACQUISITION OF FINANCIAL ASSETS



44. Because consumer spending reacts to movements in net financial wealth with a lag the fall in stock prices since mid-October will probably do no more than offset the rise in consumer spending due in 1988 from the rise in wealth through 1986 and 1987. But an assumed reduction in personal taxes in the 1988 Budget should ensure another strong increase in consumption (4½ per cent) in 1988. Moreover, the recent fall in interest rates (which is assumed to be largely reversed through 1988) should also boost consumer spending in the short term. Total consumer spending growth could slow to about 3 per cent in 1989, as growth in real personal disposable income slows following a much smaller tax cut assumed for the 1989 Budget.

45. Prospects for private dwellings investment in 1988 are subject to two opposing influences; strong growth in real incomes and the fall in net financial wealth post stockmarket crash. On balance, private dwellings investment is likely to grow more slowly in 1988 and 1989 - about 3½ per cent in both years - than in 1986 and 1987 (10 and 6 per cent respectively). This is more closely in line with RPDI growth than over the last two years.

46 Continued fast growth in house prices in 1988 (10-11 per cent, slowing to 5-6 per cent in 1989), rising investment in dwellings and only

small increases in the saving ratio mean that the personal sector's net acquisitions of financial assets will be in persistent (though diminishing) deficit throughout 1987-89. This, too, is unprecedented since the 1950s.

TABLE 10: PERSONAL INCOME, EXPENDITURE AND SAAVING

	Real personal disposable income	Real consumers' expenditure	Persons' net acquisition of financial assets	Personal saving ratio
	(Percent changes on previous year)		(£ bn)	(per cent)
1985	2.3	3.9	6.0	9.2
1986	4.0	6.0	0.5	7.5
1987	3.5	5.1	- 5.5	6.1
1988	5.5	4.5	- 3.3	7.0
1989	3.4	2.9	- 2.0	7.4

Company Income and Expenditure

47. **Business investment** was erratic in the first three quarters of 1987. But, according to the latest DTI Investment Intentions Survey, **manufacturing investment** (including leasing) should be 6 per cent higher in 1987 than in 1986, when it actually fell by over 5 per cent. Investment by **the construction, distribution and selected service (including financial) industries** is also expected to rise by 6 per cent in 1987, after falling 1 per cent in 1986.

48. The forecast assumes little impact on investment from the stock market crash and is based largely on the December DTI Intentions Survey. Taken on its own, the fall in equity prices would have increased the cost of capital. But this effect will have been more than offset by the subsequent fall in interest rates. The stock market crash could, of course, also inhibit investment through a break in business confidence. But the limited evidence available from CBI enquiries suggests that confidence has not been significantly impaired, though there is anecdotal evidence of an increase in uncertainty. All in all, investment growth is likely to be fairly buoyant over the next two years, both in the manufacturing and in non-oil non-manufacturing sectors. Investment growth in the latter will be boosted by work on the Channel Tunnel.

TABLE 11: GROSS DOMESTIC FIXED CAPITAL FORMATION
(percentage changes on previous year)

	1986	1987	1988	1989
Business	- 3	4½	8½	4
of which				
North Sea	-14½	-25	5½	- 6½
Manufacturing	- 5½	6½	11	4½
Other business	- 1	6½	8	4½
Private dwellings	6½	5	2½	3
General government	5½	- 3	3½	½
TOTAL	0	3½	6½	3½

49. Stockbuilding increased sharply in 1987Q3, partly due to special factors. Over the forecast period, we assume that the long-run decline in stock-output and stock-sales ratios continues, though at a slower rate than in the past. As a result, stockbuilding is £¾-1b. (1980 prices) in both 1988 and 1989.

50. Non-North Sea industrial and commercial companies' profits net of stock appreciation (as currently recorded and abstracting from the effects of the re-allocation of some public corporations - particularly BGC - to the private sector) were 14 per cent higher in 1987 than in 1986 (Table 13). Profits growth may slow slightly in 1988 and by rather more in 1989 as a result of moderating output growth and the squeeze on margins following the rise in the exchange rate. Despite the slowdown in the growth of profits and the rise in company sector spending, there should be no financial or liquidity constraints. ICCs' net acquisition of financial assets falls, but remains in clear surplus.

TABLE 12 : THE FINANCIAL POSITION OF INDUSTRIAL AND COMMERCIAL COMPANIES

(per cent)	Profits as a share of money GDP: Total	Non-oil	Rate of return on assets, non-oil ICCs
1973-85 average	12.0	9.0	5½
1986	15	12½	9
1987	16½	13¾	10½
1988	16	14¼	11
1989	15	13½	10¼

51 Non-North Sea ICCs' profits growth is expected to slow down. Thus net income (approximately the Corporation Tax base) grows more slowly - the deceleration is accentuated in 1988 by rising interest rates.

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

	Non-North Sea Industrial and Commercial Companies*			Financial Companies
	Gross Trading Profits**		Net Income	Net Income
1986	22	(22)	26	22
1987	17	(14)	25½	24
1988	10½		7	8½
1989	1½		- 1½	11

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

** Net of stock appreciation.

Sectoral surpluses and deficits

52 The recent and prospective pattern of financial surpluses/deficits is unusual relative to the experience since 1950, notwithstanding the large residual error in 1987, which causes serious problems of interpretation. The most striking feature is the sharp decline in personal sector net acquisitions over the three years 1984-86; according to latest estimates it was probably in deficit in 1987. The forecast foresees further (though declining) personal sector deficits. The overseas sector reflects the forecast pattern of persistent current account deficits. Neither of these features is **necessarily** disturbing; the stock of personal sector financial assets has risen markedly in recent years, as has the stock of overseas assets. There is, therefore, scope for some rundown.

TABLE 14: SECTORAL NET ACQUISITIONS OF FINANCIAL ASSETS
(£billion: (-) deficit/(+)surplus)

	1984	1985	1986	1987	1988	1989
Persons	9.4	6.0	0.5	- 5.5	- 3.3	- 2.0
Companies:						
N. Sea	2.8	0.8	- 2.7	1.1	0.0	0.6
Non-N.Sea ICCs	4.5	6.0	8.5	9.0	5.4	2.0
Financial	0.6	1.1	4.4	6.0	3.3	4.6
Public sector	-12.9	-10.1	- 8.8	- 4.9	- 2.6	- 2.1
Overseas*	- 1.4	- 2.9	0.9	2.5	4.6	5.3
Residual Error	2.8	0.8	2.7	7.3	8.0	8.6

* The current account, with reversed sign, plus capital transfers.

Aggregate Demand and Output

53 The three GDP measures - Expenditure, Income, and Output - now show similar estimates of growth, of about 5¼ per cent, in the year to 1987Q3. Even so, the separate measures could depict markedly different growth rates for 1987 as a whole. GDP(O) is likely to show about 5 per cent growth, GDP(I) 4½ per cent and GDP(E) about 3½ per cent. Together these suggest GDP(A) growth of 4¼ per cent, though it is clearly difficult to assess the strength of the growth in 1987 with any precision. The output measure is normally the most reliable indicator of short term movements, and this confirms very rapid growth. There must be a strong expectation that 1987 expenditure will, at some stage, be revised up. Growth in the average measure of GDP could reach 4½ per cent, perhaps more.

54 GDP growth is expected to moderate in 1988, to about 3 per cent (3½ per cent excluding oil). The slowdown is largely due to weaker net exports. Domestic demand growth is likely to be higher in 1988 than so far recorded for 1987. It is expected to fall in 1989, particularly if tax cuts in the 1989 Budget are much more modest than in 1988. As a result, growth of GDP is likely to fall further in 1989, to 2½ per cent (2¾ per cent excluding oil).

TABLE 15 : EXPENDITURE AND OUTPUT

(percentage changes on previous year)

	1986	1987	1988	1989
Domestic demand	3.8	3.9	4.3	2.6
Exports of goods and services	3.1	5.7	3.1	2.4
Import of goods and services	6.2	6.9	6.6	3.2
Compromise adjustment	0.3	1.0	0.1	0.0
GDP(A)	3.0	4.3	3.1	2.4
Non-oil GDP	3.1	4.7	3.6	2.7
Manufacturing	0.8	5.8	4.7	3.0

(5) PRICES AND EARNINGS

55. RPI inflation in 1987Q4 was 4.1 per cent, very close to the 4 per cent predicted in the FSBR and the 1987 Autumn Statement, though higher than the 3½ per cent in the 1986 Autumn Statement. Producer price inflation in 1987Q4 turned out slightly higher than expected.

Producer Prices

56 Producer prices (excluding the food, drink and tobacco industries) rose by 4¾ per cent in the year to 1987Q4. The increase was mainly accounted for by rising margins and import costs, especially fuel prices, which recovered from the exceptionally low levels of 1986. Unit labour costs in manufacturing are also estimated to have increased, but only by ¼ per cent. Earnings rose by 8¼ per cent through 1987, but were largely offset by a 6¾ per cent increase in labour productivity and a 1¼ per cent reduction in other labour costs (the result of pension contribution holidays).

57 Productivity growth is likely to slow through 1988, as activity growth moves closer to trend; unit labour costs in manufacturing are expected to rise by 4¼ per cent in the year to 1988Q4. The cost of inputs, on the other hand, is expected to fall by about 3¾ per cent through 1988, as a result of the rise in the effective exchange rate and resumed weakness in oil prices. Producers are expected to take some advantage of the fall in material input prices (as they did in 1986) to raise domestic margins through the year. But the increase in margins through 1988 is less than half the rate of 1987; producers are constrained by foreign competition and the slowdown in output growth. Producer price inflation (excluding food, drink and tobacco) is expected to be around 3¾ per cent by end 1988. It may fall further, to about 3½ per cent by end-1989. The main reasons

?AS

for the fall are continued competitive pressures and a further slowdown in growth (both of which lead to a fall in profit margins).

TABLE 16: COSTS AND PRICES IN MANUFACTURING (percentage changes on previous year)

	Unit labour costs	Cost of materials and fuels	Estimated total costs	Domestic producer output prices*
1986 Q4	0.3	-5.6	-0.3	3.9
1987 Q4	0.2	6.2	1.3	4.8
1988 Q4	4.2	-3.8	2.0	3.8
1989 Q4	3.9	6.0	4.4	3.6

* excluding food, drink and tobacco.

Retail Prices

58 RPI inflation is expected to fall to 3½ per cent by mid-1988, as a result of lower mortgage rates introduced at the end of 1987. But it should pick up to around 4 per cent by end-1988, with notably sharp increases in domestic rates and some nationalised industry prices.

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

	1986Q4	1987Q4	1988Q4	1989Q4
Food prices	3.2	3.3	1.6	3.5
NI prices	3.6	2.3	6.6	5.5
NB Housing prices	7.1	7.0	8.2	8.2
Other prices	2.6	3.8	3.4	3.6
- of which petrol	- 12.6	1.3	-0.2	3.7
- other items	3.9	4.0	3.6	3.6
All items RPI	3.4	4.1	4.0	4.4
RPI excluding mortgage interest payments	3.4	4.0	3.8	4.2

59 Table 18 sets out the detailed changes in nationalised industry prices charged to domestic consumers over the year to 1987Q4 and 1988Q4, and table 19 gives real price increases over a run of financial years.

TABLE 18 : NOMINAL NATIONALISED INDUSTRY PRICE INCREASES FOR CONSUMERS

(per cent)	Year to 1987 Q4	Year to 1988 Q4
Post	3.0	2.8
Rail	5.7	7.1
Electricity	- 0.4	8.2
Coal and coke	0.0	1.5
Bus	6.7	5.4
Water	6.9	7.3

TABLE 19 : REAL NATIONALISED INDUSTRY PRICE INCREASES
(percent changes on previous financial year; weighted average for consumers and industry)

	Average 1983-84 to 1985-86	1986-7	1987-8	1988-9	1989-90
British coal	0.9	- 3.5	- 4.3	- 3.2	- 2.4
Electricity	- 3.1	- 2.0	- 3.7	3.6	1.3
BSC	- 1.4	- 2.0	- 3.0	- 1.9	- 2.4
Post Office	- 3.0	- 2.1	- 0.4	- 1.6	- 0.2
Water	1.9	4.5	2.3	3.3	2.0
LRT	- 6.1	2.2	2.1	4.6	2.8
British Rail	- 3.1	2.7	1.5	1.5	- 0.6

60 Increased nationalised industry prices will, by themselves, raise RPI inflation in 1988Q4 by a little more than ¼ per cent compared with inflation in 1987Q4. Other influences underlying the RPI inflation outlook to 1988(4) are:

(i) The formula relating gas prices to oil prices and the RPI should give about a 3½ per cent rise in domestic prices this year, following a 4½ per cent fall in 1987 (the difference is worth about 0.2 per cent on total RPI inflation).

(ii) A 12¼ per cent rise in average domestic local authority rate poundage (see para 87) this year compared with 7¾ per cent last year (the difference is worth 0.2 per cent on inflation).

(iii) Mortgage interest payments add 0.1 per cent to inflation in 1988Q4. (Mortgate interest rates are lower at end- 1988 than end-1987. However, the rising level of mortgage debt more than offsets this.)

61 All the above factors put upward pressure on inflation in the year to

1988Q4. They are largely offset, however, by a slowdown in inflation in other private sector prices. They rose 4 per cent over the past year; they would have risen by about 4½ per cent but for the non-indexation of duties in the 1987 Budget. The slowdown in 1988 is mainly accounted for by low import costs. It slows further in 1989, largely because of a squeeze on profit margins.

62. The table below sets out the monthly RPI inflation path for 1988. Inflation is likely to rise after March, as post Budget increases in specific duties and rates and electricity price increases show up in the index. However, this is offset by movements in the mortgage interest payments components, and weak gas and food prices.

TABLE 20: MONTHLY PATH OF RPI INFLATION (annual percentage changes)

		All items RPI	RPI excluding mortgage interest payments			All items RPI	RPI excluding mortgage interest payments
1987	August	4.4	3.7	1988	April	3.3	3.8
	September	4.2	3.5		May	3.7	3.9
	October	4.5	3.9		June	3.7	3.8
	November	4.1	4.0		July	3.8	4.0
	December	3.7	4.0		August	4.0	4.1
					September	3.9	4.1
					October	4.0	3.8
1988	January	3.6	3.9		November	3.8	3.7
	February	3.4	3.7		December	4.2	3.8
	March	3.3	3.6				

The GDP deflator

63. Recent revisions to the data have pushed up the **market price GDP deflator** in the first half of 1987. Latest estimates suggest a rise of 4.8 per cent in the year to 1987Q3. It now looks as if the FSBR and Autumn Statement projections for GDP price inflation in the current financial year (4½ and 4¼ per cent respectively) are on the low side; the outturn could be about 5 per cent. The market price GDP deflator moderates in 1988-89, primarily due to weak oil prices: the non-oil deflator picks up in 1988-89, before slowing thereafter as activity growth moderates. (The contrast between the rise in inflation measured by the non-oil GDP deflator and the small fall in retail and producer price inflation through 1988 reflects the differential effects on these measures of the projected slowdown in import prices: as occurred in 1986, this will tend to depress producer and retail prices but not the GDP deflator.)

TABLE 21: THE DEFLATOR FOR GDP AT MARKET PRICES
(percentage change on previous year)

	1986-87	1987-88	1988-89	1989-90
MTFS				
Total	3	4½	4	3½
non-oil	6	4¼	3¾	3¼
Winter forecast				
Total	3¼	5	4¾	4½
non-oil	6	4¼	5	4½

Earnings

64. The 1986-1987 pay round is now complete, though information on settlements is still coming in. But it seems that private sector settlements averaged 5¼ per cent, about ½ per cent lower than the previous round. In the manufacturing sector settlements were, on average, a full 1 per cent lower. But settlements were clearly on an upward trend through the year to August 1987 and this upward trend seems to have continued. The current pay round has barely begun and the number of settlements is small, but it seems most unlikely the settlements will turn out at less than 6 per cent (their average at the end of the previous round). That is the forecast for 1987-88. A similar figure is projected for 1988-89.

65. Overtime in manufacturing increased steadily through 1987. By November it was at record levels, contributing some ¾ per cent to the 8 per cent growth in private sector earnings over the year. The projected slowdown in activity should moderate the rise in settlements and reduce overtime payments (as overtime working falls back).

TABLE 22: PRIVATE SECTOR SETTLEMENTS AND EARNINGS
(Contributions to changes between third quarters of successive years)

	1986-87	1987-88	1988-89
Settlements	5¼	6	6
Drift	2¼	2¼	2¼
Overtime	½	- ¼	- ½
Increase in average earnings	8	8	7¾

66. In the year to August 1987 local authority earnings grew rather more slowly than the private sector. Over the year to August 1988 they are more likely to grow faster. Teachers were paid 7½ per cent from October and will receive a further 1 per cent in April from restructuring. We assume teachers settle in their next pay round in line with RPI inflation. Local authority manuals have already settled on a 10½ per cent increase. Other local authority workers face varied prospects. Overall, local authority earnings are likely to rise by 10¼ per cent in the 1987-88 pay round (compared to about 8 per cent in the private sector), and 8½ per cent in

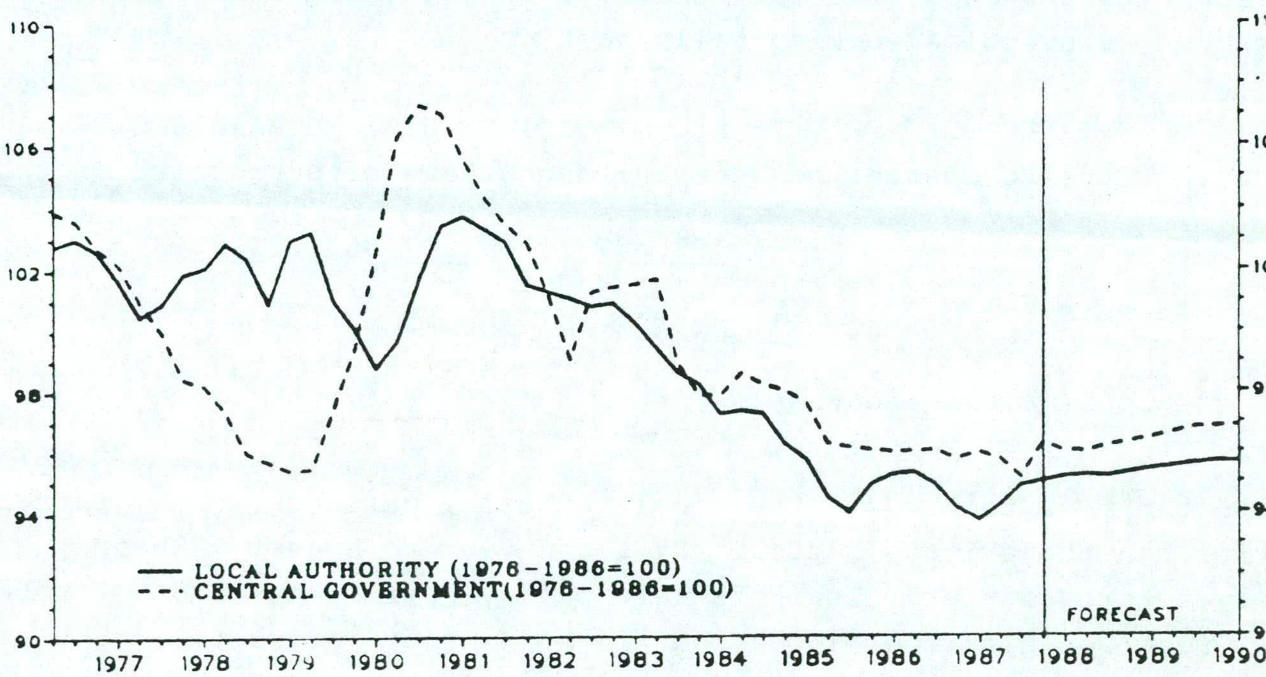
the following round. They come broadly into line with private sector settlements thereafter.

67. Central government earnings grew more slowly (7¼ per cent) than the private sector in the 1986-87 pay round, though nurses and some other health workers fared notably better. Health workers are likely to do better than the private sector over the forecast period. The rest of central government will continue to face slower earnings growth than the private sector, though for central government earnings as a whole, we project about 8¾ and 8¼ per cent for the 1987-88 and 1988-89 pay rounds.

TABLE 23: PUBLIC AND PRIVATE SECTOR UNDERLYING AVERAGE EARNINGS (percentage changes over years to August)

	Central Government	Local authorities	Private sector
1986-87	7¼	7½	8
1987-88	8¾	10¼	8
1988-89	8¼	8½	7¾

CHART E: RATIO OF LOCAL AUTHORITY AND CENTRAL GOVERNMENT EARNINGS TO PRIVATE SECTOR EARNINGS (FOUR QUARTER MOVING AVERAGE).



Labour Costs

68. Manufacturer's unit labour costs are likely to rise more quickly over the next two years, compared to 1987. Earnings growth picks up in the next year, and productivity growth falls back to more normal rates as output growth declines.

TABLE 24: LABOUR COSTS INCREASES IN MANUFACTURING
(percentage increases on previous year)

	UK	Major 7 (less UK)
1986	3.9	2.3
1987	- 0.2	1.3
1988	1.8	0.5
1989	3.8	1.7

(6) EMPLOYMENT, UNEMPLOYMENT AND PRODUCTIVITY

69. Preliminary estimates suggest that employment rose sharply in the first three quarters of 1987, by about 320,000. The fall in seasonally adjusted, adult unemployment that began in August 1986 also gathered pace through 1987; in the eight months to December it fell by an average 50,000 per month, compared to an average monthly decline of 24,000 in the previous eight months. These developments reflect recent strong growth in output and the influence of government measures.

TABLE 25: CHANGES IN UK ADULT UNEMPLOYMENT
(seasonally adjusted, 000's, Q2 to Q2)

	Unemployment	Effects of employment and training measures, restart and availability testing	Underlying unemployment
1984-1985	146	- 5	151
1985-1986	88	- 64	152
1986-1987	-238	- 165	- 73
1987-1988	-498	- 95	- 403
1988-1989	- 87	- 48	- 39

70 The recent and prospective growth of output suggests that employment will continue to rise through 1988 and adult unemployment could

fall to 2.41m in 1988Q4 and to 2.34m in 1989Q4. The labour supply is expected to grow by 300,000 over the two years to 1989Q4 and the working population by 170,000.

71. Manufacturing productivity rose 7.2 per cent in the three months to November 1987 compared with the same period a year earlier. Productivity in the private non-manufacturing sector rose by 3¾ per cent in the year to 1987Q3. Some of the increase in productivity was due to the cyclical strength in output and increased overtime working (manufacturing overtime per head reached record levels in October and November 1987). But there also seems to have been an increase in trend productivity growth and we expect this to be sustained over the future. Actual productivity, on the other hand, slows down in 1988 and 1989 with the deceleration in activity.

TABLE 27: LABOUR PRODUCTIVITY GROWTH
(per cent per annum)

	1965-73	1974-79	1980-86	Forecast 1987-89
Manufacturing	3¾	¾	3¾	5¼
Private non-manufacturing	3	½	1¼	2
Non-North Sea	2¾	½	1¾	2½
Whole Economy	2¾	1	2	2

72 The implications of trend productivity growth projections (and those for labour supply) for productive potential are shown below.

TABLE 28 : PRODUCTIVE POTENTIAL GROWTH
(per cent per annum)

	Trend non-North Sea productivity growth	Labour supply	Non-North Sea productive potential	Contribution of North Sea	Whole economy productivity potential
1974-79	¾	½	1¼	½	1¾
1980-86	1¾	½	2¼	¼	2½
1987-89	2½	¾	3½	- ½	3

(7) FINANCIAL CONDITIONS

73 The further projected sharp fall during 1988 in the dollar's exchange rate index would on its own put upward pressure on sterling and other non-

dollar currencies. Other major countries are assumed to lower interest rates, but the growing UK current deficit and worsening competitiveness may put downward pressure on sterling relative to non-dollar currencies with corresponding upward pressure on domestic interest rates.

74 The forecast therefore assumes that the emerging opportunity of headroom under the pound's DM3 ceiling will be taken to increase interest rates. Base rates rise to 9 per cent in the second quarter and 9½ per cent by the fourth quarter. This widens the differential against average world interest rates. About $4 billion of the recent intervention is also assumed to be unwound in the latter half of 1988 to prevent the sterling/DM rate falling below 2.90. The rate against the dollar, however, rises to $2.10 by the end of the year and the exchange rate index to 77.

CHART F : STERLING AND THE CURRENT BALANCE

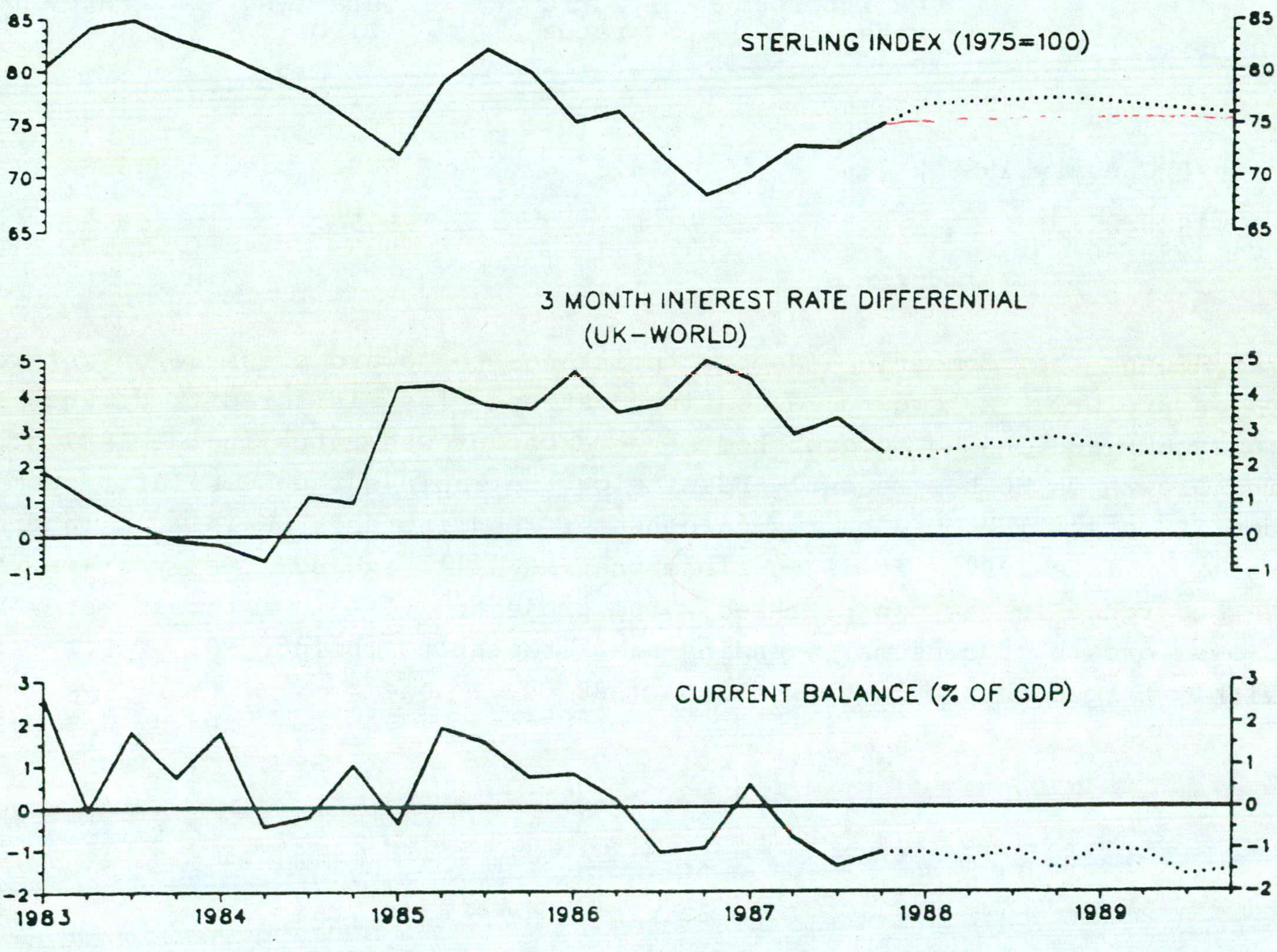


TABLE 27 : EXCHANGE RATES AND COMPETITIVENESS
(average year rates)

	US dollar index	Sterling index	$/£	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	85.0
1986	114.7	72.8	1.47	3.19	78.0
1987	101.3	72.6	1.64	2.94	75.5
20 January	94.0	74.8	1.79	2.98	78.9*
1988	85.5	77.1	2.01	2.96	79.8
1989	83.8	76.5	2.05	2.88	80.5

* 1988(Q1) estimate.

75 In 1989 the expected rebound in the dollar and the UK's current account deficit bring about a gradual easing in sterling. Any decline against the DM, however, is assumed to be braked by further intervention.

TABLE 28 : INTEREST RATES

	3-month US interest rates	3-month world rates	3-month sterling LIBOR	Mortgage rate
1987-88	7.3	6.5	9.2	11.0
20 January 1988	7.0	6.3	8.9	10.3
1988-89	8.7	6.7	9.5	10.5
1989-90	10.2	7.1	9.5	10.8

76 Among the domestic factors pointing to upward pressure on interest rates are brisk M0 growth, a continued strong rise in credit demand and money GDP continuing to overshoot the target growth rates in the 1987 MTFS. The growth in M0 has recently been below the rapid surge seen last summer, but it is still buoyed by rising consumer spending and the fall in interest rates in late-1987. It is possible that M0 will exceed its year-on-year target range in the months ahead. The projected rise in interest rates and slower growth of consumer spending are forecast to bring M0 growth back within target in the latter half of 1988.

TABLE 29 : MONETARY AGGREGATES AND CREDIT
(per cent change on a year earlier)

	Money GDP*	M0*	M3	M4	Lending by banks and building societies
1987-88	9.9 (7½)	5.1 (2-6)	20.4	15.3	18.8
December 1987	-	4.3	22.9	16.3	18.9
1988-89	7.6 (6½)	5.0 (1-5)	16.8	14.7	18.0
1989-90	7.0 (6)	3.1 (1-5)	12.2	12.4	15.1

* 1987 MTFS targets in brackets

77 Lending by banks and building societies which rose by 19 per cent in the year to December, is forecast to rise by a further 18 per cent in 1988-89 before slowing in 1989-90. Lending to persons is forecast to continue to grow strongly in the period ahead for both housing and other purposes, but is projected to rise less rapidly next year in reaction to rising ratios of debt and interest payments to income. Lending to companies seems likely to accelerate in 1988-89 as the weakness of the equity market encourages firms to turn to banks to finance a continued high rate of stockbuilding as well as their growing investment. The projected rise in private sector borrowing from all sources could well more than offset the decline in the public sector's needs and contribute to upward pressure on interest rates, particularly against a background where private savings are forecast to rise only slowly.

?

78 The forecast for M3 and M4 depends on the influences on different sectors - although uncertainties about the return on equities may generally encourage the non-bank private sector to increase the share of liquid assets in their total financial wealth. The growth of persons' liquid assets, however, is likely to be less rapid than in the past as a result of their low projected savings. Industrial and commercial companies which have built a strong liquidity position, are expected to invest increasingly in real assets reflecting the improved rates of return. Financial institutions' holdings of liquid assets are also expected to grow less rapidly than in the past reflecting their less buoyant inflows and wealth. M3 is forecast to rise by 17 per cent in 1988-89 and 12 per cent in 1989-90 while M4 rises by 15 per cent and 12 per cent.

79 The PSBR is assumed to be fully funded outside banks and building societies, but the move to a negative borrowing requirement leads to net

gilt repayments of £8 billion in 1988-89 and £9 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 £13 billion in the current financial year to £1½ billion in 1988-89 and £½ billion in 1989-90.

TABLE 30: PSBR AND FUNDING
(£ billion)

	PSBR	Gilt sales to nbnbsps*	Nat Savs	Reserves	Other-seas finance†	Other debt to nbnbsps	Over-fund+	Net gilt sales to banks and b.socs	Gross gilt sales to all sectors
1985-86	5.7	3.6	2.1	-2.4	4.3	-1.6	0.3	-0.7	11.7
1986-87	3.4	4.6	3.4	-3.8	5.3	-1.8	4.3	-1.2	14.6
1987-88	-2.8	2.3	1.8	-10.3	5.4	-2.8	-0.8	-1.8	13.1
1988-89	-3.4	-7.1	1.0	3.0	-0.1	-0.2	0.0	-0.5	1.7
1989-90	-3.7	-7.9	1.0	3.5	-0.1	-0.2	0.0	-0.5	0.6

* non-bank non-building society private sector

† includes foreign currency finance

\+ overfund on M4 definition

80 The bulk of the financing of the UK's current account deficit together with the projected continued net outflows of direct and portfolio investment is forecast to be achieved through the banking system. (The forecast assumes modest gilt sales by non-residents.) Banks' net external liabilities are projected to increase by £6-7 billion a year.

TABLE 31 : NET EXTERNAL CAPITAL FLOWS
(£ billion)

	Direct invest-ment	Other private non bank	Banks' foreign currency	Banks' sterling	General Gov't	Official reserves	Balancing item	Current balance
1986	-6.0	-7.7	3.0	-0.4	3.0	-2.9	11.9	-0.9
1987	-10.2	7.8	6.0	4.0	5.2	-11.8	1.5	-2.5
1988	-7.5	3.0	5.2	1.6	-0.6	2.0	1.0	-4.6
1989	-7.9	2.7	4.6	1.9	-1.0	4.0	1.0	-5.3

(8) PUBLIC FINANCES

81 Table 32 compares the forecast with the FSBR and internal October forecast. The projections in the FSBR and Autumn Statement were not the forecasters' central estimate of the outturn.

TABLE 32 : PUBLIC SECTOR EXPENDITURE, REVENUE, AND BORROWING
(£ billion)

	1987-88			1988-89			1989-90		
	FSBR	Oct Fore-cast*	Winter Fore-cast	FSBR	Oct Fore-cast*	Winter Fore-cast	FSBR	Oct Fore-cast*	Winter Fore-cast
General Government Expenditure	173½	172½	172	180½	184	183½	188½	196½	194½
General Government receipts	169	173	173½	178	192	189½	187	206	204
Assumed cuts in personal taxes (cumulative)				3	4	4	5	6	6½
GGBR	4½	-½	-2	5½	-3½	-2½	6	-4	-3
Public corporations' overseas and market borrowing	-1	-½	-1	-1	-1½	-1	-1	-1½	-½
PSBR	4	-1	-3	4	-5	-3½	5	-5½	-3½
(per cent of GDP) brackets)	(1)	(-¼)	(-¾)	(-¾)	(-1)	(-¾)	(1)	(-1)	(-¾)

* The internal forecast, not the Autumn Statement

(a) 1987-88

82 The PSBR for 1987-88 is now forecast to be a surplus of nearly £3b. The average absolute error on Winter forecasts made in the last 10 years is around 0.3 per cent of GDP (£1½b.). Five of the last six Winter forecasts, and each of the last four, have overpredicted the outturn.

say £2 bn?

83 The latest forecast represents an undershoot on the FSBR forecast of £6¾b., and a reduction of £1½b. from the October internal forecast. Three-quarters of the predicted undershoot of the FSBR forecast is accounted for by higher general government receipts and the remaining one-quarter accounted for mainly by lower general government expenditure. Public corporations' market and overseas borrowing is little different from the FSBR. Table 33 shows the main revisions. Well over four-fifths of the downward revision to the forecast since the Budget has been on central government own account borrowing, with much smaller contributions from lower public corporations' and local authorities' borrowing.

TABLE 33 : CONTRIBUTION TO THE CHANGE IN THE 1987 PSBR FORECAST SINCE OCTOBER AND THE FSBR

	£ billion	
	Changes since	
	FSBR	October
Higher General Government Receipts		
- higher North Sea revenues from a higher North Sea oil price;	-¾	-
- higher non-North Sea **corporation tax** reflecting higher profits in 1986 than recorded at Budget time (and also higher than currently recorded) and higher dividend payments (generating ACT) in 1987;	-1¾	-½
- higher **income tax** and **national insurance contributions** mainly reflecting higher money incomes;	-3¼ -1½	-¼
- higher **stamp duty** than in FSBR, but slightly lower than in October, reflecting stock market gyrations;	-¼	+¼
- higher **VAT**, in line with outturn to date, mainly reflecting higher than expected consumer spending;	-¾	-¼
- lower **ECGD trading surplus** due to delays in refinancing;	+¼	+½
- higher **other receipts**, including, compared with October capital taxes and interest and dividends;	-¼	-¾
Total	-5	-1
Lower General Government Expenditure		
- a lower public expenditure **planning total**	-1¾	-½
- lower **debt interest** from lower interest rates	-½	-¼
- changes to other **adjustments**	+¾	+¼
Total	-1½	-½
PC market and other borrowing	-¼	-¼
TOTAL CHANGE IN PSBR FORECAST	-6¾	-1½

(b) Public expenditure

84 There has been a small downward revision since October to the forecast of the **planning total** outturn in 1987-88. The outturn is now expected to undershoot the 1987 PEWP by about £1¾b. The assumed privatisation proceeds

in 1988-89 and 1989-90 are lower than in October but the forecasts of the rest of the planning total have been revised down. Neverless they imply that the new plans - ie those in the 1988 PEWP - will be overspent, by about £1b. in the first and £2¾b. in the second year. The forecast of these years takes account 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. For example in the case of 1989-90 the forecast is trying to anticipate not only any changes in plans agreed in the next Survey, but also any eventual over or underspend on the finally agreed planning total.

85 Table 34 sets out forecast increases in actual programme spending compared with successive PEWPs in terms of economic rather than departmental categories. The forecast for 1987-88 is compared with the 1987 PEWP and those for 1988-89 and 1989-90 with the 1988 PEWP.

TABLE 34 : FORECAST ADDITIONS TO EXPENDITURE PLANS

£ billion

	1987-88		1988-89		1989-90	
	PEWP 1987	Forecast Claims on Reserve	PEWP 1988	Forecast Claims on Reserve	PEWP 1988	Forecast Claims on Reserve
Allocated to programmes						
1. Social Security (including HB)	44.7	0.2	46.9	0.6	49.5	1.0
2. LA current (excluding HB)	32.5	1.0	34.9	1.9	36.0	3.9
3. CG pay	24.8	0.5	26.8	0.8	27.8	2.1
4. CG procurement	24.6	-0.1	25.5	0.7	26.8	1.3
5. LA capital	4.3	-0.6	4.0	-0.2	4.0	0.1
6. EC	0.9	0.8	0.8	0.4	1.5	0.2
7. Nationalised industries	0.7	-0.3	0.7	-0.2*	0.0	0.5*
8. Other	17.8	0.2	18.8	0.6	19.6	0.8
9. Total programmes	150.1	1.7	158.3	4.6	165.1	9.8
10. Privatisation proceeds	-5.0	0.0	-5.0	(-1.0) 0.0	-5.0	0.0
11. **Expenditure met from existing reserve**						
(i) allocated to programme baseline	0.0	1.7	0.0	3.5	0.0	7.0
(ii) unallocated	3.5	0.0	3.5	0.0	7.0	0.0
12. Underspend (-) Addition to Reserve(+)	0.0	-1.8	0.0	1.1	0.0	2.8
13. **PLANNING TOTAL**	148.6	-1.8	156.8	1.1	167.1	2.8

* includes EFL offsets to assumed privatisation of the Giro (-£60m.) in 1988-89 and BSC (+£150m.) in 1989-90

86 The forecast of social security expenditure is lower than in October mainly because of lower forecast unemployment and, in 1989-90, because the uprating is now forecast to be 4 per cent (based on forecast inflation to September 1988) and not 5½ per cent. The forecast still assumes continued underlying growth in social security spending - defined as the growth after allowing for the effects of changes in unemployment, upratings, policy changes, demographic factors etc - but at lower levels than the rather faster level which appears to have prevailed this year.

Underlying growth in social security expenditure - %

1986-87	1987-88	1988-89	1989-90
3.2	4.3	3.5	2.5

87 The forecast of **local authority current spending**, most of which is pay, assumes that numbers employed will rise at around 1½ per cent a year and that earnings increases will be above those in the private sector. This, together with the RSG settlements for 1988-89 and the assumption that authorities will build up balances in advance of the Community Charge, implies average rate poundage increases of about 11 per cent (12 per cent on domestic property) in 1988-89.

(NB treatment of RPI)

88 The forecast of **central government pay** assumes little change in numbers employed and earnings increases above those in the private sector. The forecast of **central government procurement** assumes growth in real terms much the same as the rate of the past two years.

89 **Local authority gross capital spending and receipts** are forecast to be flat in real terms. This is thought to be consistent with a LABR of a little over £1 billion a year compared with a revised forecast of just under £1b. for 1987-88 and an outturn of £¼b. in 1986-87.

90 **Nationalised industries** (NI) in aggregate may undershoot their EFLs in 1988-89 mainly because they may find it difficult to achieve the planned sharp rise in capital spending, but also because the Post Office's external financing requirement is reduced by the assumed privatisation of the Giro. By contrast 1989-90 may see an EFL overshoot because the profit projections underlying the PEWP look optimistic given the slow down in economic growth envisaged in the forecast. The forecast also assumes the loss of BSC's negative EFL in that year as a result of privatisation. Neither this nor the effect of the privatisation of the Giro is allowed for in the PEWP EFL.

91 The forecast of **debt interest** payments has also been revised down since October as a result of a lower forecast of interest rates. In addition the forecast of GGE has been reduced since October (by £1b. in 1989-90) as a result of an assumed switch in the composition of NIs' external finance away from general government finance towards market and other borrowing. This switch, which follows the 1988 PEWP, has no effect on the PSBR or the fiscal adjustment even though it reduces GGE. The downward revision to GGE in 1989-90 is smaller in real than in cash terms because of a lower forecast of the GDP deflator.

TABLE 35 PAST AND CURRENT FORECASTS
OF GGE EXCLUDING PRIVATISATION PROCEEDS

£ billion

Forecast	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	176	169	186	169	-	-
PEWP 1986	174	168	179	168	-	-
Jan 1987	179	171	190	173	202	175
PEWP 1987	179	172	185	172	193	174
Oct 1987	178	170	190	172	203	175
PEWP 1988	178	170	188	173	198	176
Jan 1988	177	169	188	171	200	173

* 1986-87 prices

92 The ratio of GGE (excluding privatisation proceeds) to money GDP starts in 1987-88 below the level in the 1988 PEWP, and is forecast to stay below the PEWP path, falling in each successive year, but only slightly in 1989-90.

TABLE 36 : RATIO OF GGE EXCLUDING PRIVATISATION PROCEEDS TO MONEY GDP

per cent

	1985-86	1986-87	1987-88	1988-89	1989-90
1988 PEWP	44½	44	42½	42	41¾
January Forecast	44½	44	41¾	41¼	41

(d) General government receipts

93 The forecast of general government receipts has been revised up for 1987-88 since October, continuing the pattern of revisions in earlier forecasts (see table 37). But the forecasts for 1988-89 and 1989-90 have been revised down. An upward revision of some £1¼b. a year to the forecast of non-North Sea corporation tax receipts has been more than offset by downward revisions to North Sea Revenues, stamp duties and capital taxes. Stamp duty is lower because of lower stock market prices and turnover. Lower stock market prices are also responsible for the downward revision to capital taxes, but because of assessment and payment lags this effect does have a significant impact on the numbers until 1989-90.

TABLE 37: COMPARISON OF FORECASTS OF GENERAL GOVERNMENT RECEIPTS (PRE-FISCAL ADJUSTMENT FOR 1988-89 AND 1989-90)*

£ billion

Forecast:	1987-88		1988-89		1989-90	
	Cash	Real Terms	Cash	Real Terms	Cash	Real Terms
January 1986	166	159	178	162	188	164
FSBR 1986	162	156	171	160	179	162
January 1987	169	162	184	168	197	171
FSBR 1987	169	162	178	164	187	167
October 1987	173	165	192	174	207	178
January 1988	174	165	190	172	204	177

* Forecasts made before the 1987 and 1986 Budgets have been adjusted to be consistent with current tax rates and allowances. Real terms figures are at 1986-87 prices.

94 Table 38 shows non-oil taxes and national insurance contributions (NICs) as a percentage of non-oil money GDP ie the non-oil tax burden. It is now forecast to rise by nearly ½ percentage point in 1987-88, the same as the rise in 1986-87. Before allowing for the assumed tax cuts a larger rise of about one point is forecast for 1988-89, but, with the tax cuts themselves equivalent to one percent of GDP, the tax burden is forecast to be flat after fiscal adjustment. A smaller rise in the non-oil tax burden, before fiscal adjustment, is forecast for 1989-90, but the effect of the assumed fiscal adjustment is to keep the tax burden broadly flat.

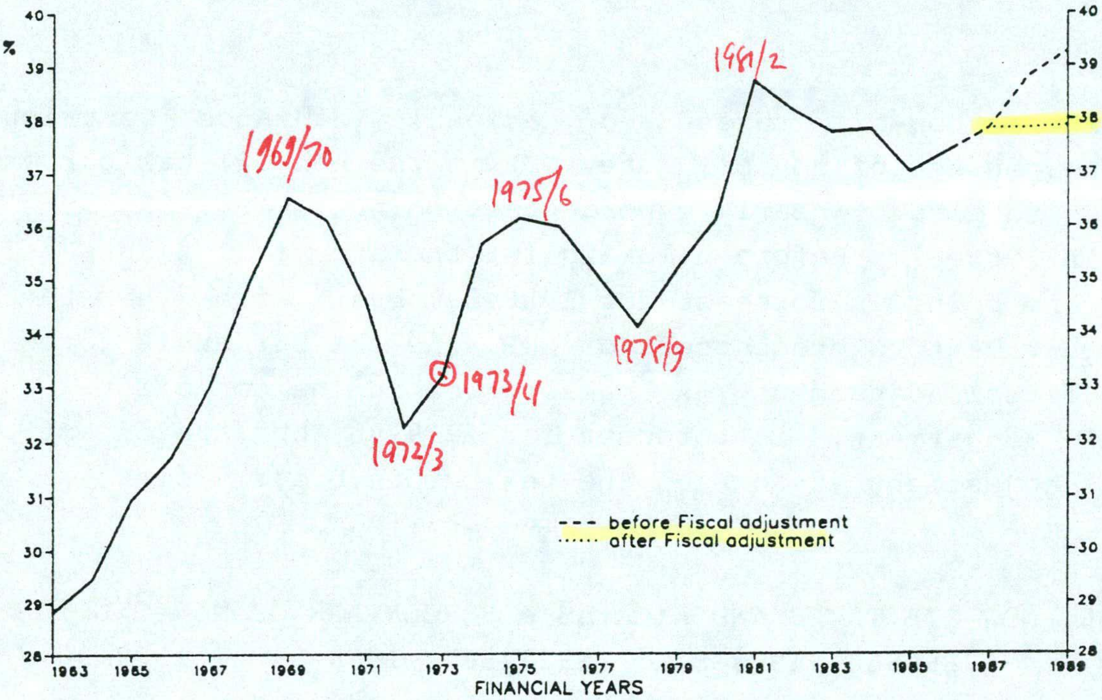
TABLE 38: NON-OIL TAXES AND NICs AS A PERCENTAGE OF NON-OIL GDP

	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
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
Winter Forecast					
(a) pre-fiscal adjustment	37.0	37.4	37.8	38.8	39.3
(b) post-fiscal adjustment	37.0	37.4	37.8	37.8	37.9

95 The non-oil tax burden is forecast to rise in 1988-89 before fiscal adjustment because of the forecast rapid growth in non-oil corporation tax (CT), real fiscal drag on income tax, and because local authority rates increases are expected to be in double figures. Non-oil CT (including ACT) is now forecast to increase by a third in 1987-88 and the buoyancy of

profits in 1987 should lead to another large increase (over 25 per cent according to this forecast) in 1988-89. However a marked fall in profit growth in 1988 is forecast to lead to a very modest increase in non-oil CT receipts in 1989-90, perhaps of the order of 5 per cent. The rapid rise in asset values up to October 1987 is expected to generate increases in capital taxes of around 20 per cent in 1987-88 and 1988-89 but the recent fall in share prices could lead to a levelling off of capital tax receipts thereafter.

CHART G : NON-OIL TAXES AND NICs AS A % OF NON-OIL GDP (FINANCIAL YEARS)



ANNEX I : COMPARISON WITH OUTSIDE FORECASTS

	WINTER FORECAST	AVERAGE OF OUTSIDE FORECASTS (JANUARY)
A. ACTIVITY		
1. <u>GDP VOLUME</u> (per cent change on year earlier)		
1987	4.3	
1988	3.1	2.4
2. <u>UNEMPLOYMENT</u> (UK, sa, excluding school leavers in millions)		
1987Q4	2.66	
1988Q4	2.41	2.66
B. INFLATION		
3. <u>RPI</u> (per cent change on year earlier)		
1987Q4	4.1	
1988Q4	4.0	4.0
C. PUBLIC FINANCES		
4. <u>PSBR</u> (£ billion)		
1987-88	-2.8	
1988-89	-3.4	1.9
D. MONETARY CONDITIONS		
5. <u>SHORT TERM INTEREST RATES</u> (per cent)		
1987Q4	9.2	
1988Q4	9.5	8.8
6. <u>STERLING INDEX</u> (1975=100)		
1987Q4	74.9	
1988Q4	77.4	73.6
E. CURRENT ACCOUNT		
7. CURRENT BALANCE (£ billion)		
1987	-2.5	
1988	-4.6	-3.5

SECRET

ANNEX II : NET ACQUISITION OF FINANCIAL ASSETS BY SECTOR
(AS PERCENTAGE OF GDP)

Calendar Years	Personal (1)	ICC (2)	Financial (3)	Total Private Sector (4)	Public (5)	Overseas (6)	Residual Error (7)
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	Personal (1)	ICCs North Sea	ICCs Other	Financial (3)	Total Private Sector (4)	Public (5)	Overseas (6)	Residual Error (7)
1963/64	1.8	0.0	1.8	-0.3	3.3	-3.1	0.0	-0.2
1964/65	2.4	0.0	-0.6	-0.3	1.6	-2.2	0.9	-0.2
1965/66	3.5	-0.1	-0.6	-0.3	2.4	-2.0	0.3	-0.8
1966/67	2.5	-0.1	1.0	-0.6	2.7	-2.6	-0.5	0.4
1967/68	1.8	-0.2	1.4	-0.6	2.4	-3.7	1.0	0.2
1968/69	1.2	-0.1	0.6	-0.9	0.8	-1.0	0.2	-0.1
1969/70	1.4	-0.1	1.0	-1.3	1.0	1.5	-1.5	-0.9
1970/71	2.1	-0.1	0.5	-0.9	1.6	0.8	-1.3	-1.1
1971/72	0.2	-0.2	2.4	-0.5	1.9	-1.1	-1.7	1.0
1972/73	1.3	-0.2	2.6	-0.5	3.2	-2.8	0.3	-0.7
1973/74	3.2	-0.5	0.6	-0.5	2.8	-4.6	2.1	-0.2
1974/75	4.3	-1.0	-0.8	-0.6	1.8	-6.2	3.5	0.9
1975/76	4.2	-1.4	2.1	-0.5	4.3	-7.1	0.9	1.9
1976/77	3.5	-1.2	0.9	-0.1	3.1	-5.9	1.1	1.8
1977/78	2.5	-0.9	2.0	-0.1	3.5	-4.4	0.0	1.0
1978/79	4.7	-0.6	0.8	-0.3	4.7	-4.8	-0.3	0.4
1979/80	4.1	0.0	-0.1	-0.3	3.8	-3.9	0.1	0.0
1980/81	6.4	0.0	0.4	-0.3	6.4	-4.9	-2.6	1.1
1981/82	4.7	-0.1	0.3	-0.2	4.8	-1.9	-2.5	-0.3
1982/83	3.3	0.2	1.9	0.2	5.6	-3.1	-1.6	-1.0
1983/84	2.8	0.6	1.6	0.5	5.4	-3.7	-0.9	-0.8
1984/85	2.6	0.7	1.5	0.1	4.9	-4.2	0.0	-0.8
1985/86	1.5	-0.2	2.0	0.6	3.8	-2.3	-1.0	-0.4
1986/87	-0.2	-0.1	1.9	1.4	3.0	-2.4	0.3	-0.9
Forecast								
1987/88	-1.7	0.2	2.2	1.1	1.9	-0.7	0.9	-2.1
1988/89	-0.6	0.0	0.9	0.8	1.2	-0.5	1.0	-1.8
1989/90	-0.4	0.1	0.3	1.0	1.0	-0.4	1.2	-1.8

NB Columns 1 + 2 +3 = 4

Columns 4 + 5 + 6 + 7 = 0

FINANCIAL FORECAST

T

FROM: A BOTTRILL

DATE: 22 January 1988

ECONOMIC SECRETARY

cc: Chancellor of the Exchequer
Chief Secretary
Financial Secretary
Sir Peter Middleton
Sir Terence Burns
Sir Geoffrey Littler
Mr Scholar
Mr Monck
Mrs Lomax
Mr Odling-Smee
Mr Sedgwick
Mr Hibberd
Mr Mowl
Mr S Davies
Mr Grice
Miss O'Mara
Miss Noble
Mr Ilett
Mr Westaway
Mr Owen
Mr Courtney
Mr Pike
Mr Allum
Mr Lyon

FINANCIAL FORECAST

The attached note on the Winter Financial Forecast complements that on the Treasury Economic Forecast circulated by Mr Sedgwick on 21 January. The forecast examines the prospects to the end of the financial year 1989-90.

A Bottrill

A BOTTRILL

CONTENTS Paragraph

ASSUMPTIONS AND SUMMARY

The main policy assumptions underlying the forecast are:

- Interest rates and intervention are used to achieve a broadly stable DM/£ exchange rate.
- The PSBR is fully funded in 1988-89 and 1989-90 by the non-bank/non-building society private sector and by the overseas sector.
- National Savings after raising almost £2 billion this financial year, raise £1 billion a year in 1988-89 and 1989-90.

Table 1: Summary of the forecast

(per cent changes on previous year)

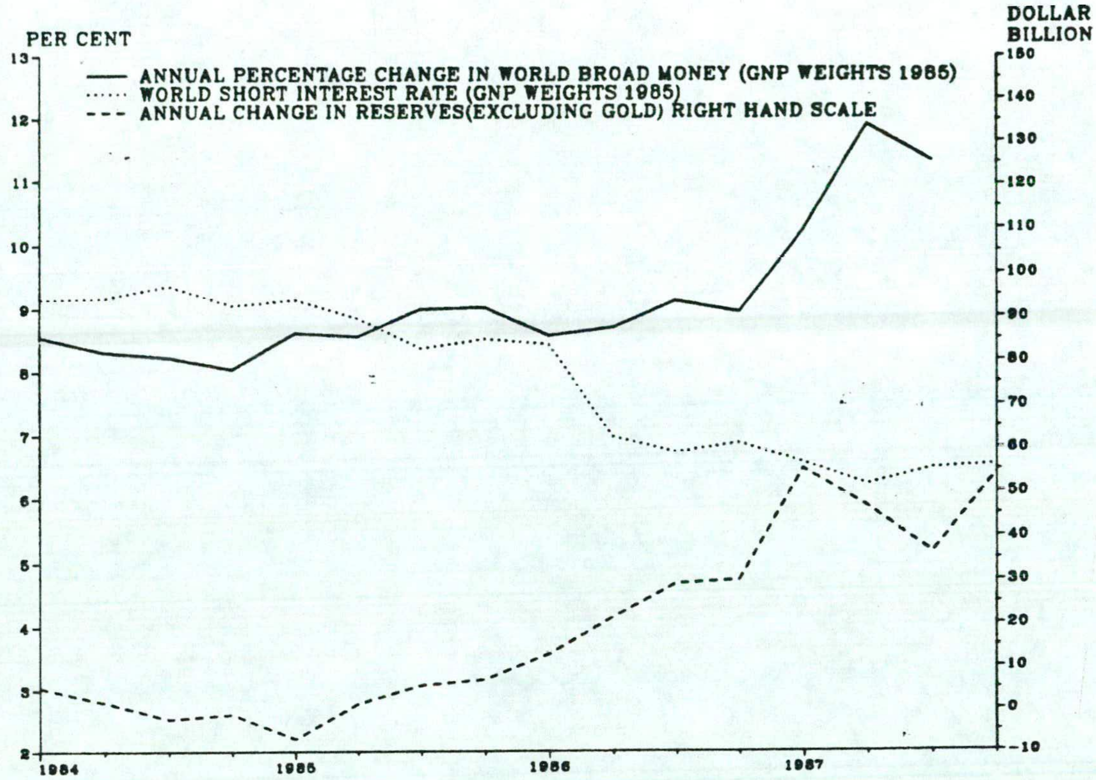
	3-month interest rate	Sterling index 1975=100	M0	M3	M4	Bank + B.Soc lending	Money GDP
1986-87	10.5	71.5	4.3	19.4	15.5	18.6	6.7
1987-88	9.2	74.3	5.1	20.4	15.0	18.8	9.9
1988-89	9.4	77.2	5.0	16.8	14.7	18.0	7.6
1989-90	9.5	76.1	3.1	12.2	12.4	15.1	7.0

2. The dollar's weakness will put upward pressure on sterling along with other currencies but the UK's worsening current balance and competitive position imply that higher interest rates and some support from the reserves may be needed to prevent sterling falling below about DM 2.90 even though the effective rate rises. Domestic considerations also point to higher interest rates to bring money GDP growth closer to the MTFS target. Both persons and companies at present have high levels of liquidity and wealth in spite of the fall in equity prices. The projected low saving by persons and decline in companies' financial surplus, however, suggest that holdings of financial assets will grow less rapidly in future. These may be held increasingly in liquid form in view of the uncertainties about equity returns - but the main aggregates seem likely to rise less rapidly with M3 growing by 17 per cent in 1988-89 and 12 per cent in 1989-90. M0 may exceed its ceiling in the months ahead before returning within the MTFS range later in the year.

THE EXCHANGE RATE AND INTEREST RATES

3. The weakness of the US dollar over the past year has forced other countries to acquiesce in an appreciation of their currencies or try to prevent this through lower interest rates coupled with rising intervention in the exchange markets - at the cost of faster domestic monetary growth. The UK in common with Japan and Germany has suffered from these pressures. The WEP forecast that the dollar will fall further in 1988 in spite of a rise in American interest rates suggests the pressures will continue with lower interest rates in a number of countries outside the US.

Chart 1: Interest rates, reserve changes and broad money growth of major countries (excl US)

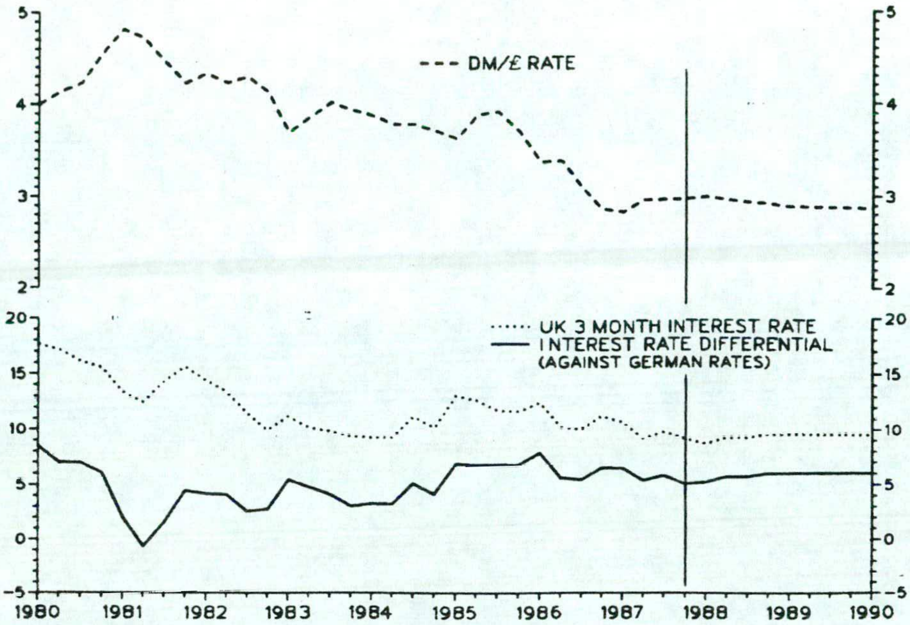


4. The impact on the UK, however, is expected to be rather different. Sterling may rise against the dollar but the UK's growing current account deficit, worsening cost competitiveness and a declining real oil price all point to downward pressure on the pound at least against non-dollar currencies. Some of the past year's official intervention is assumed to be unwound to help limit any sterling depreciation against the DM. The emergence of headroom under the DM3/£1 ceiling is also assumed to be accompanied by an increase in interest rates during the rest of this year - partly for external but also for domestic reasons. Base rate rises to 9 per cent in the second quarter and 9½ per cent in the fourth. In these circumstances, the sterling effective rate might rise by 3-4 per cent to about 77 by the end of the year with the $/£ rate at 2.10 and the DM/£ rate easing slightly to 2.92.

Table 2: The 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	71.1
1987 Q4	97.7	74.9	1.74	2.98	78.0
1988 Q1	89.9	76.8	1.90	3.00	78.9
2	85.8	77.0	1.99	2.97	79.5
3	84.0	77.2	2.06	2.94	79.7
4	82.4	77.4	2.10	2.92	81.0
1989 Q4	86.9	76.0	1.96	2.88	81.7

Chart 2: The pound and relative interest rates



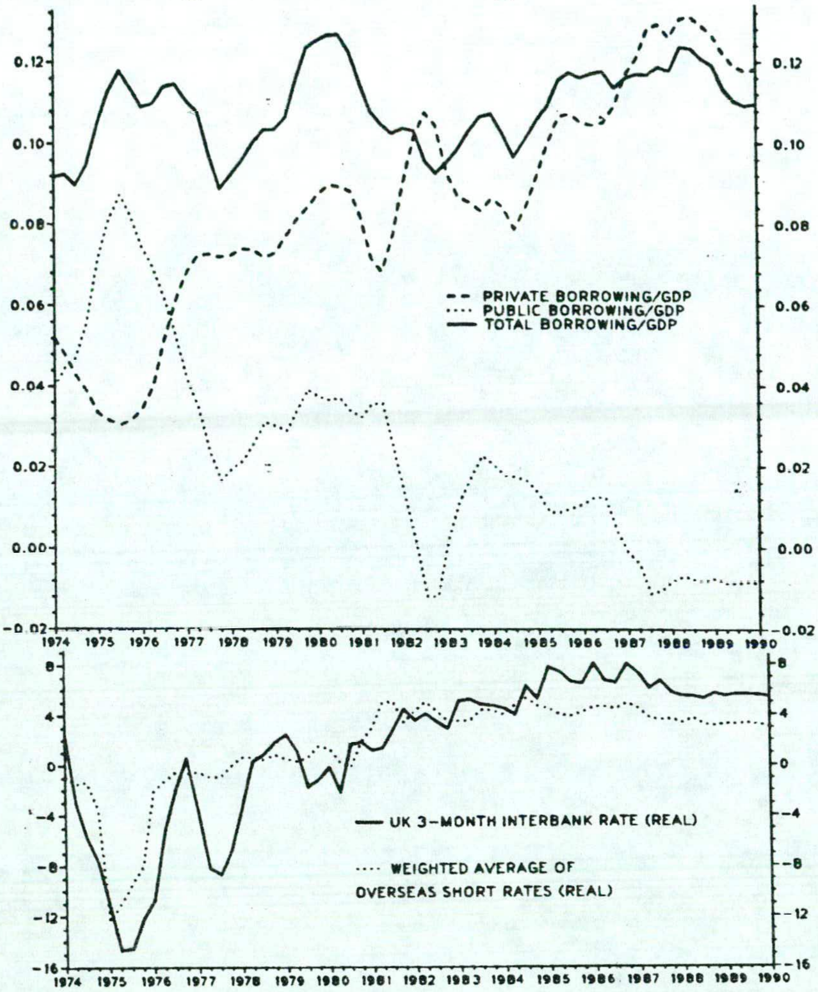
5. In 1989, the dollar's rebound might ease some of the downward pressure on the DM/£ rate but other factors will continue adverse. We have assumed further intervention to support sterling and no scope for lower interest rates. The differential between UK and Germany 3-month interest rates remains at 6 per cent. The sterling effective rate might ease slightly - almost entirely as a result of a decline against the dollar with little change in the DM/£ rate.

Table 3: Foreign and domestic interest rates

	3-month interest rates				UK differentials vis a vis		
	UK	**US**	**Germany**	**World**	**US**	**Germany**	**World**
1986-87	10.5	6.2	4.5	6.3	4.3	6.0	4.2
1987-88	9.2	7.3	3.9	6.5	1.9	5.3	2.7
1988-89	9.4	8.7	3.5	6.7	0.7	5.9	2.7
1989-90	9.5	10.2	3.5	7.1	-0.7	6.0	2.4

6. The main domestic factor pointing to upward pressure on interest rates is the forecast continued high level of borrowing against a background of low saving rates. A continued rise in borrowing by persons and companies - coupled with privatisation issues by the public sector - will tend to offset the fact that healthy public finances will allow the authorities to be heavy net purchasers of gilt in 1988-89 and 1989-90. Long rates are projected to remain flat so that the yield curve becomes horizontal by the end of the year.

Chart 4: Public and private borrowing



7. The projected rise in interest rates and sterling's firmness will help to slow money GDP growth but not enough to bring it within the ranges set in the 1987 MTFS. Money GDP which seems likely to overshoot its target by some 2½ per cent in 1987-88 as a result of both unexpectedly rapid real growth and higher inflation will continue to overshoot by 1 per cent a year in both 1988-89 and 1989-90 - but this time entirely 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	3.2	3	3.4	6	6.7
1987-88	4½	5.0	3	4.6	7½	9.9
1988-89	4	4.8	2¾	2.7	6½	7.6
1989-90	3½	4.6	2¾	2.3	6	7.0

DOMESTIC FINANCIAL DEVELOPMENTS

8. The prospects for the growth of domestic liquidity and credit depend on the positions of different sectors in the economy. Major discrepancies within and between the national accounts and the financial accounts make it extremely difficult to interpret both real and financial developments. Table 5 illustrates the different estimates for sectors' acquisition of financial assets.

Table 5: Alternative estimates of net acquisitions of financial assets by sector (£ billion)

National accounts	Persons	ICCs	Financial companies	Total private	Overseas	Public sectual	Residual error
1985-86	5.1	6.3	2.1	13.6	-3.9	-8.2	1.6
1986-87	-0.1	7.2	5.4	12.5	1.0	-9.2	4.3
1987-88	-7.2	10.4	4.8	7.9	4.1	-3.0	9.0
1988-89	-2.8	4.4	3.8	5.5	4.6	-2.1	8.0
1989-90	-1.9	2.0	4.9	5.0	5.6	-2.1	8.6
Financial statistics							
1985-86	17.3	-2.0	-0.2	15.1	-6.9	-8.2	0
1986-87	11.9	3.0	-2.7	12.2	-5.6	-6.5	0
1987-88	19.5	5.7	-19.9	5.0	-0.6	-4.6	0
1988-89	7.5	-1.6	-7.3	-1.3	3.6	-2.3	0
1989-90	5.9	-4.0	-4.5	-2.6	4.6	-2.1	0

vernal

9. The National Accounts currently show a positive net accumulation of financial assets for all sectors taken together reflecting the fact that recorded expenditure is below recorded income. This residual error which has grown rapidly in the past two years to about £9 billion or 2 per cent of GDP, is accompanied by an historically unusual rundown of persons' net assets, coupled with uncharacteristic net accumulation of assets by industrial and commercial companies and financial institutions. The overseas sector has moved towards surplus and the public sector's deficit has fallen. Past experience suggests that estimates of expenditure will be revised upwards. If at least part of this is spending by persons, then the rundown in their assets would be even steeper. Alternatively, the extra spending may be heavily concentrated in companies with higher investment and stockbuilding, it which case their surpluses may also have been lower. It is difficult to understand why financial institutions should show large net acquisitions.

10. The financial accounts presents a broadly similar picture for the overseas and public sectors but with major differences within the domestic private sector. Persons are shown continuing to accumulate net financial assets. Companies have run smaller surpluses than the National Accounts suggest and financial institutions remain in deficit. The latest figures for 1987-88 are particularly uncertain and it is possible that persons' net acquisition of assets has been smaller. We have assumed relatively modest net acquisitions in future. The smaller surplus of companies would be consistent with more buoyant recent spending on investment and stockbuilding, and we have assumed that companies increase their net liabilities modestly in the forecast period. The estimated deficit of financial companies in 1987-88 is probably too large, and we have assumed smaller deficits in future. These judgments are necessarily broad brush given the uncertainties - but they form the base of the financial forecast for individual sectors.

Personal sector

11. Persons' gross wealth which continued increasing strongly until 1987Q3 largely as a result of rising equity and house prices, fell steeply after the stock market crash but remains historically high relative to incomes. The rise in gross wealth has been accompanied by a continued growth of borrowing both for housing and consumption which

has shown no sign of slackening. Net wealth, both including and excluding housing, however, is also still historically high. The forecast assumes that with modest net acquisitions of financial assets and a gradual recovery of equity prices gross wealth will show little change relative to incomes.

Chart 5: Persons' wealth relative to income

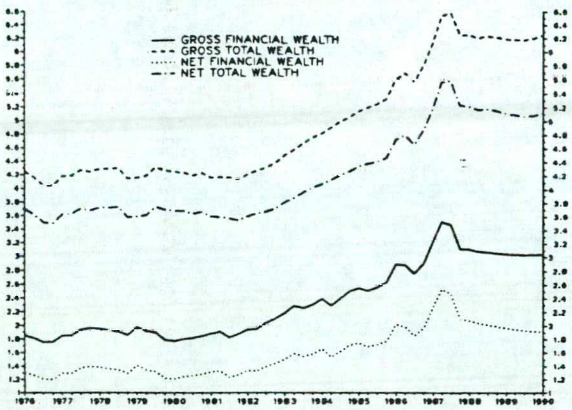
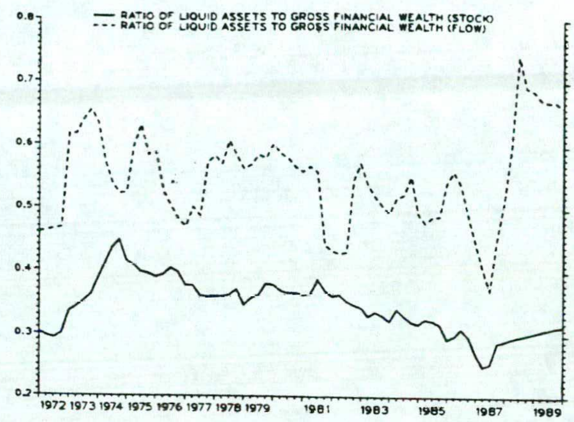


Chart 6: Liquid asset shares in wealth



12. The growth of borrowing is forecast to fall slightly reflecting slower income growth and the fact that debt-income ratios and the share of income needed for interest payments (after allowing for the rise in the number of owner occupiers) have reached historically high levels. This judgement however is particularly uncertain in view of the fact that credit levels were depressed previously by rationing. These assumptions lead to a gradual decline in net wealth relative to incomes over the forecast period. It is of course possible that personal sector borrowing will continue to rise rapidly - encouraged by aggressive competition among lenders - leading to a faster decline in net wealth relative to income.

Table 6: Flow of non-mortgage credit to personal sector

(annual growth of stock outstanding in brackets)

£bn	Banks*	Other OFIs	o/w B.Socs	Total	Memo: Mortgage equity withdrawal**
1985-86	4.8 (15.9)	1.0 (10.6)	0.0	5.8 (14.2)	10.7
1986-87	6.5 (12.6)	1.2 (8.0)	0.1	7.7 (12.0)	15.5
1987-88	4.6 (19.1)	2.0 (5.0)	0.4	6.6 (13.9)	16.5
1988-89	8.6 (16.1)	1.2 (9.0)	1.2	9.9 (15.2)	15.9
1989-90	8.3 (13.1)	1.7 (9.0)	2.1	10.0 (13.0)	17.4

* includes lending to unincorporated businesses
** estimated data

Chart 7: Persons' debt relative to income

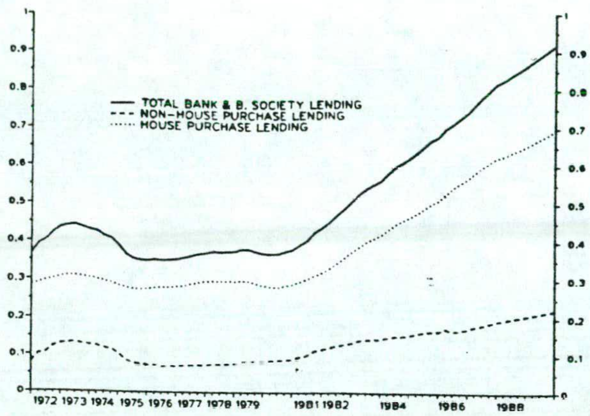


Chart 8: Persons' income gearing

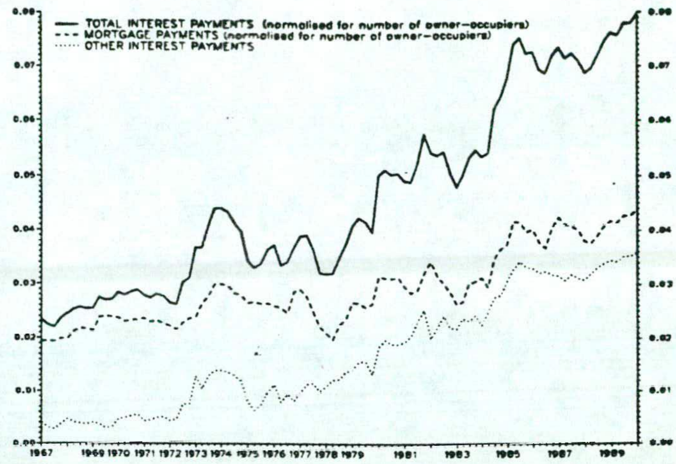


Table 7: Persons' sources and uses of funds

	Sources				Uses			
	Borrowing House purchase	Borrowing Other	Other sources (1)	Total	Liquid Assets (2)	LAPFs (3)	Unit trusts and equity	Other uses (4)
1985-86	19.8	7.7	32.2	59.6	23.6	19.2	1.5	15.4
1986-87	26.8	7.5	30.4	64.7	21.8	21.3	2.0	19.6
1987-88	29.3	9.2	39.7	78.2	27.8	21.5	7.6	21.3
1988-89	30.0	10.3	30.4	71.0	30.4	19.8	-1.6	22.4
1989-90	32.4	10.0	30.6	73.0	31.3	19.1	-1.3	23.8

(1) Saving, capital transfer receipts, accruals adjustment and balancing item

(2) £ bank deposits, national savings, building society shares and deposits

(3) forecast using the EA1 Satellite model

(4) physical investment, other public sector debt

13. Uncertainties about returns on equities seem likely to encourage persons to place a higher proportion of new savings in liquid assets, which are forecast to continue to rise by about 11 per cent a year in spite of the projected slower growth of incomes and lower overall net acquisitions of financial assets. Difficulties in interpreting the recent figures make this aspect of the forecast particularly uncertain. If persons increase net disposals of equities or borrowing continues to grow rapidly then liquid assets might also continue to rise quickly.

Industrial and commercial companies

14. Higher company profits, large capital issues and increase bank borrowing have enabled companies to finance not only growth in real investment and stockbuilding but also increased takeover activity at home and abroad and a rise in liquid assets.

Chart 9: Relative rates of return on ICCs' real investment and liquid assets

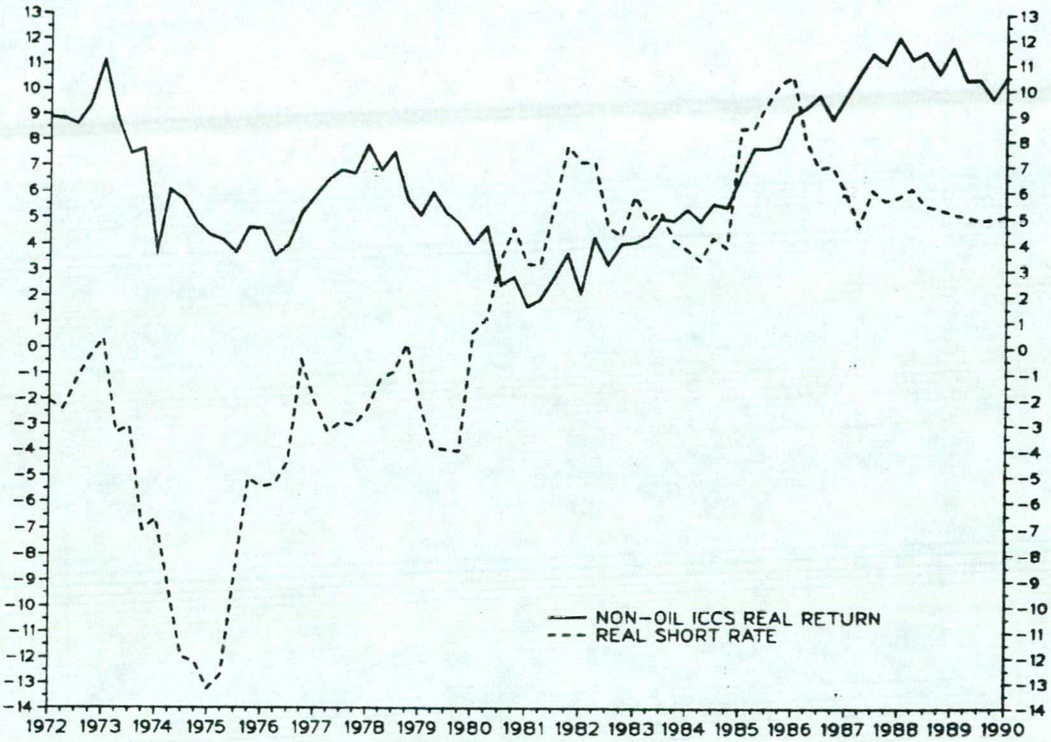


Table 8: Selected financial transactions of ICCs

(£ billion)

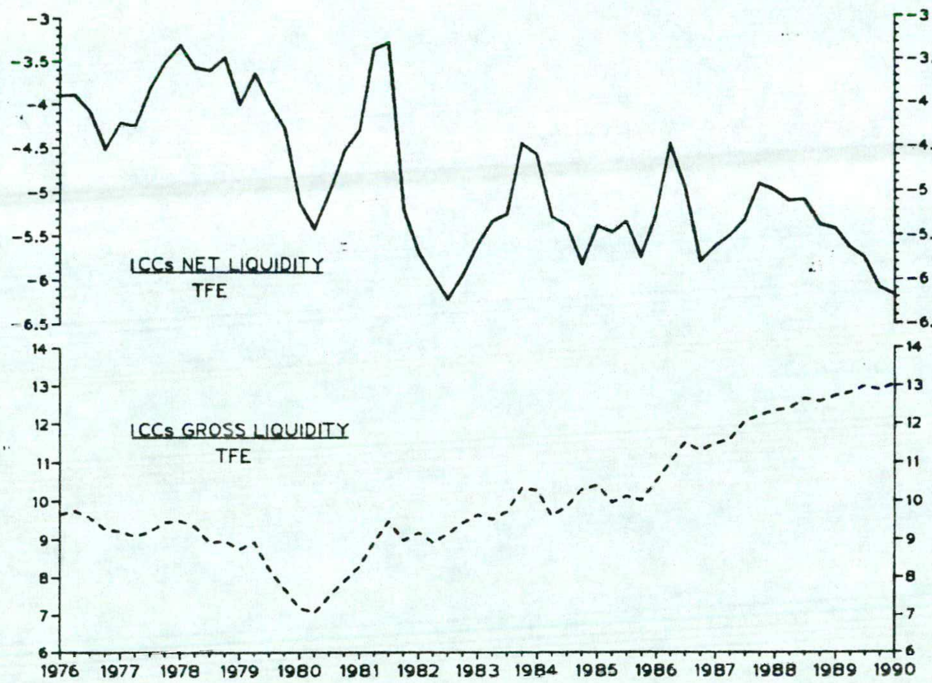
£bn	Financial surplus(1)	Investment in UK company securities	Investment abroad	Borrowing requirement	Capital issues	Liquid assets (3)	Bank borrowing
1985-86	-2.0	1.0	2.2	6.7	4.7	-4.4	7.0
1986-87	3.0	1.5	6.5	7.4	8.4	-11.0	5.8
1987-88	5.7	4.5	11.0	14.1	17.1	-13.1	9.4
1988-89	-1.6	3.3	5.6	14.4	7.0	-7.8	10.7
1989-90	-4.0	3.0	4.9	16.7	8.0	-5.7	9.9

(1) Financial Statistics definition
(2) Cash expenditure on domestic mergers
(3) Increase negative

15. The forecast slowdown in profits combined with rising real investment implies a sharply falling financial surplus for companies. Domestic takeover activity and investment abroad are both forecast to fall but their net borrowing requirement remains high throughout the forecast. The stock market crash has made equity issues less

attractive although companies may issue fixed interest debt to exploit the gap left by the dearth of gilts. They are expected to turn increasingly, however, to short-term finance, mostly bank lending but also commercial paper. They are also expected to reduce the growth of their liquid assets and net liquidity falls over the forecast period.

Chart 10: ICCs' gross and net liquidity relative to TFE



Building societies and the mortgage market

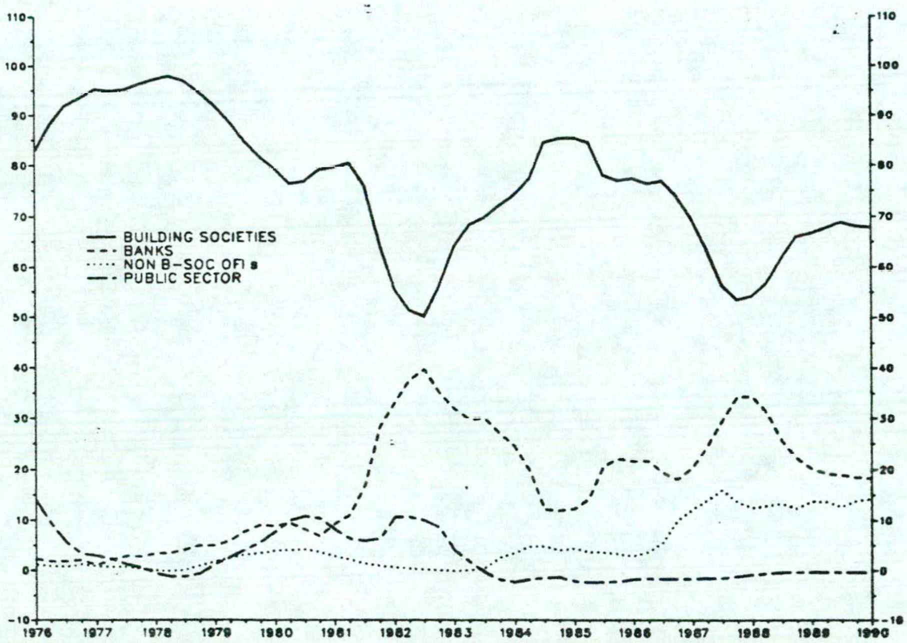
16. Building societies which have been unable to attract sufficient funds to avoid loss of share in the new mortgage market seem likely to achieve renewed retail inflows and to regain much lost ground in the mortgage market. Competition for funds from unit trusts and equities is likely to be reduced with the ending of the bull market. The raising of the limit on societies' wholesale funding also removes a potential constraint.

Table 9: Building societies summary table

	Interest rate differentials			% growth	% growth	end period	
	mortgage less gross share rate (margins)	mortgage less base rate	net share less net bank deposit rate	in retail inflows	in mortgage demand	liquidity ratio (%)	wholesale ratio (%)
1985-86	1.1	1.2	1.4	15.4	16.3	17.0	5.9
1986-87	1.3	1.2	1.3	9.7	18.5	15.1	9.8
1987-88	1.3	1.9	1.9	12.3	16.9	15.8	10.8
1988-89	1.3	1.3	1.4	14.0	14.7	16.0	11.6
1989-90	1.4	1.3	1.3	13.0	13.8	16.0	12.5

17. Societies may widen margins by reducing relative rates on high interest accounts. But they are forecast to recovery market share by returning mortgage rates to a more competitive position vis-a-vis base rates. The projected slowdown in the growth of total mortgage demand as a result of the forecast slower rise in incomes and house prices and the rise in interest rates is likely to intensify competition in the mortgage market. Societies may respond partly in non-price terms, by raising income multiples or by product innovation. They are also expected to diversify into new areas of business particularly banking, financial and property services earning significant fee income and taking custom from banks. Some societies may themselves turn towards incorporation.

Chart 11: Building societies' share of mortgages



Non-bank financial institutions (excl. building societies)

18. Financial institutions' balance sheets which grew rapidly in 1986-87 with buoyant inflows to life assurance and pensions funds, rising sales by unit trusts and increased borrowing by both security dealers and new mortgage lenders, appear to have grown less rapidly in 1987-88. Much of the reason for the slowdown remains unexplained, but bank lending in 1987-87 was exceptionally high because of Big Bang and capital issues were boosted by the TSB flotation. The reduction in available finance has been accompanied by an apparent sharp fall in overseas investment while purchases of company securities and bank deposits have remained high.

Table 10: OFIs' (excl. building societies) sources and uses of funds

Sources

	Savings etc (1)	LAPF inflows	Unit trust net inflows (2)	Capital issues	Bank advances	Other	Total
1984-85	2.9	17.6	0.6	0.4	9.1	-0.1	30.6
1985-86	4.6	18.5	1.2	0.5	3.8	0.3	28.9
1986-87	-0.3	20.2	3.1	3.1	20.4	-0.2	46.4
1987-88	-18.0	20.9	2.7	3.4	16.6	0.2	25.8
1988-89	-9.3	19.2	1.0	2.0	13.7	0.2	26.8
1989-90	-7.0	18.4	1.1	2.7	13.3	0.2	28.7

(1) Savings, balancing item, net capital transfers, accruals adjustments
(2) Inflows net of LAPF's purchases

Uses

	UK company securities	Overseas investments (3)	Gilts	Bank deposits	Loans and mortgages	Other (4)	Total
1984-85	5.4	4.0	5.9	4.4	1.2	9.6	30.6
1985-86	6.2	6.6	3.8	6.1	1.7	4.6	28.9
1986-87	9.8	11.6	2.3	10.8	4.2	7.7	46.4
1987-88	9.8	-1.3	1.3	8.2	4.0	3.7	25.8
1988-89	7.2	3.8	-6.2	4.9	5.5	11.6	26.8
1989-90	8.9	3.9	-7.0	5.4	6.1	11.4	28.7

(3) Overseas securities and direct investment abroad
(4) Includes fixed investment, other public sector debt instruments, building society deposits, miscellaneous overseas instruments.

19. Inflows to life assurance and pension funds are forecast to fall in 1988-89 and 1989-90 partly reflecting contribution holidays. Unit trust sales are also projected to be less buoyant than in the recent past. New mortgage lenders, however, seem likely to raise further capital issues and increase bank borrowing. Financial institutions as a whole are also expected to run down their gilt holdings in the face of official repurchases. Thus in spite of relatively modest available finance by the standards of recent years institutions seem likely to continue to purchase substantial quantities of domestic securities as well as increasing their mortgage and other loans. Their bank deposits, however, are forecast to rise considerably more slowly than in recent years - although if interest rates rise more sharply than forecast or equity prices appear likely to fall steeply again we might see a flight to liquidity by financial institutions.

Overseas sector capital account

20. Non oil outward direct investment, which remained at a high level in the first three quarters of 1987, as a result of buoyant unremitted profits and continued overseas acquisitions, is expected to be lower in future as overseas mergers are constrained by the projected deterioration in domestic companies' financial position and

the higher cost of equity finance. Overseas takeovers of UK companies are similarly expected to fall. Net non-oil direct investment outflows are projected to decline from £8 billion in 1987 to around £7 billion in both 1988 and 1989. Net oil outward direct investment which rose sharply in 1987 as a result of BP's takeover of Sohio, is forecast to return to modest net outflows in future.

Table 11: Overseas sector capital account

	1986	1987	1988	1989
Direct investment				
Inward	5.4	6.1	5.9	5.4
Outward	-11.4	-16.2	-13.4	-13.4
Net	-5.9	-10.1	-7.5	-8.0
Non bank private				
Inward	8.9	12.1	10.1	10.6
Outward	-16.5	-4.3	-7.1	-7.9
o.w. OFIs portfolio	-14.0	0.0	-4.1	-4.6
Net	-7.7	7.8	3.0	2.7
Banks				
Net sterling	-0.4	4.0	1.6	1.9
Net f.c.	3.0	6.0	5.2	4.6
General government				
Inward	3.5	6.0	0.1	-0.3
o.w gilts	2.1	5.5	-0.2	-0.5
Outward	-0.5	-0.8	-0.7	-0.7
Net	3.0	5.2	-0.6	-1.0
Net capital flows	-8.1	12.8	1.6	0.3
Balancing item	11.9	1.5	1.0	1.0
Reserves	-2.9	-11.8	2.0	4.0
Current account	-0.9	-2.5	-4.6	-5.3

21. Other outward investment by the **non bank private sector** - mainly portfolio investment by financial institutions - declined sharply in 1987 from the exceptional high 1986 level, as securities dealers partially unwound their very substantial positions in overseas bonds. Other financial institutions continued to invest in overseas equities but the world stock market crash and the subsequent depreciation of the dollar has substantially reduced the overseas share in their portfolios. Only modest overseas investment by securities dealers is expected over the next two years but other institutions are assumed broadly to maintain the recent share of their inflows which they place overseas. The overseas share in their portfolios is likely to fall a little further during 1988 as the dollar declines, before beginning to recover in 1989 (chart 12).

Chart 12: OFIs' overseas assets relative to total assets

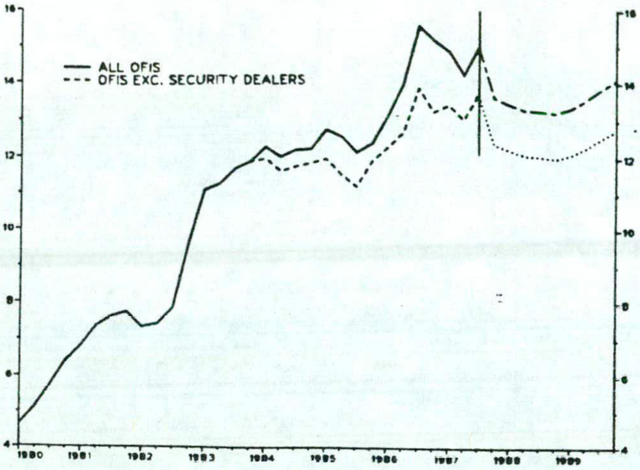


Chart 13: Non-bank external liabilities relative to total liabilities

22. **Portfolio inflows** are expected to be smaller than in the past, given the uncertainty in equity markets and the projected reduction in UK companies' capital issues (see chart 14). The recent very large overseas inflow into gilts also seems unlikely to continue against a background of substantial net gilt redemptions, and consequently modest net disposals of gilts by non-residents are projected.

23. **UK banks** are expected to maintain their share of the flow of new BIS cross-border foreign currency lending, which is consistent with a continued slow decline in their share of gross cross-border claims. But, as over the past year, they are expected to attract around £6 billion net foreign currency deposits from overseas in 1988, for on lending to the non bank private sector whose demand for foreign currency borrowing is likely to be sustained by the continued strength of sterling and rising imports. As sterling weakens in 1989 net foreign currency inflows are projected to fall. Net sterling inflows are expected to fall from £4 billion in 1987 to £1½-2 billion a year over the next two years as the rather lower interest rate differential and less buoyant prospect for the exchange rate in 1989 reduce the incentive for foreigners to hold sterling. The remaining financing gap is assumed to be met by an outflow from the reserves of £1 billion a quarter from mid 1988 onwards.

<u>**Monetary sector**</u>

24. The banking sectors' balance sheet which expanded rapidly in 1986-87 as the growth in deposits by persons and companies, financed increased lending for housing, consumption and security purchases, has continued to grow quickly in the current financial year but is forecast to rise more slowly in 1988-89 and 1989-90. The growth of deposits seems likely to be less rapid as a result of the reduced financial

surpluses of companies and persons even after allowing for some switch towards more liquid assets. Lending to domestic residents is correspondingly forecast to be less rapid as borrowing by persons slows as a response to increased indebtedness levels and more than offsets increased borrowing by companies. The slowdown in balance sheet growth is likely to encourage banks' higher fee income from arranging securitised lending.

Table 12: Banks' balance sheet

	Flows					Stock
	1985-86	1986-87	1987-88	1988-89	1989-90	1987Q1
Domestic						
£ assets	21.2	30.5	41.1	37.0	36.1	185.8
£ liabilities	18.4	25.4	31.1	25.8	24.0	153.4
FC assets	3.7	13.1	8.3	5.5	5.5	51.0
FC liabilities	3.9	8.0	3.7	1.0	1.0	28.7
Net deposit liabilities	2.6	-10.1	-14.6	-16.7	-16.6	-54.7
Overseas						
£ assets	6.3	5.5	3.9	1.2	2.7	33.6
£ liabilities	3.7	4.2	8.1	6.2	7.2	42.0
FC assets	33.6	53.3	55.5	53.3	44.9	430.1
FC liabilities	27.9	59.7	59.4	58.0	49.6	438.3
Net deposit liabilities	-8.3	5.1	8.1	9.7	9.2	16.6
NNDLs £	2.0	4.7	3.5	5.4	5.6	38.6
FC	3.7	0.2	3.0	1.6	1.8	
Memo item:						
Net foreign currency	1.8	-1.5	-2.3	-1.8	-2.0	

MONETARY AGGREGATES

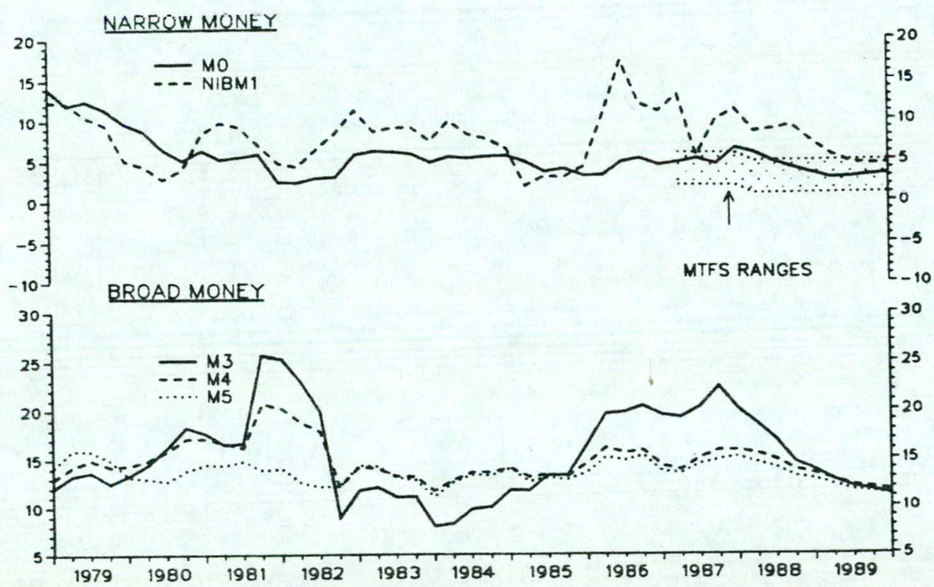
25. The monetary aggregates have continued to rise rapidly with M0 in the upper half of its target range and the broad aggregates continuing the rapid increases begun in 1986-87. The forecast is that the projected slower growth of domestic activity accompanied by smaller financial surpluses for the non-bank private sector will lead to a progressive slowdown in the growth of the monetary aggregates in 1988-89 and 1989-90. The foregoing discussion of individual sectors, however, has illustrated how vulnerable this forecast is to the interpretation of recent figures on financial surpluses, the desire of both persons and companies to extend their borrowing and the extent to which the reduced attractiveness of the stock market encourages financial re-intermediation through the banking system.

Table 13: Monetary aggregates

(per cent change over previous year)

	MO		NIBM1	M3	M4	M5
	MTFS Range	Outturn/ Forecast				
1985-86		4.3	3.4	13.1	13.4	13.0
1986-87		4.3	11.8	19.4	15.5	14.7
1987-88	2-6	5.1	10.0	20.4	15.0	14.3
1988-89	1-5	5.0	9.0	16.8	14.7	13.9
1989-90	1-5	3.0	5.2	12.2	12.4	11.9

Chart 14: Monetary aggregates (per cent change on year earlier)



26. Lower interest rates and buoyant consumer spending contributed to M0 growth at an annualised rate of 7 per cent in the second half of 1987 although the year-on-year figures remained around 5 per cent due to the abnormally low numbers in earlier months. The rapid growth in the later period implies that the year-on-year growth for M0 is still likely to breach the 6 per cent ceiling in February - unless last year's unusual fall is repeated this year in the weeks ahead. Higher interest rates and slower real consumption growth and lower inflation are expected to reduce M0 growth later in the year but it does not turn within the MTFS target range of 1-5 per cent a year until the autumn of 1988.

27. **NIBM1** growth is also currently rising rapidly because of strong consumption growth and recent falls in interest rates although it has also been boosted by oversubscriptions to capital issues and privatisations earlier in the year which do not appear to have unwound fully. Current growth rates above 10 per cent a year are expected to

fall sharply over the forecast period to below 5 per cent a year by the end of 1989-90 as a result of higher interest rates, slower consumption growth and continued financial innovation as balances are attracted from non-interest bearing accounts.

28. Growth of the broader aggregate, **M4**, which includes private sector sterling deposits in banks and building societies, is forecast to decline gradually from its current rate of 16 per cent a year to 11½ per cent a year by the end of 1989-90. The fall in **M3**, which excludes building society liabilities, is more marked falling from above 23 per cent a year to a growth rate in line with M4 by mid-1989. This convergence of growth rates is mainly explained by a decline in the growth of companies' and financial institutions' bank deposits which together form a larger proportion of M3 than of M4. It also reflects the fact that persons' deposits in building societies rise faster than those in banks - although both gain share of persons' liquid assets at the expense of National Savings. The slower growth of ICCs' bank deposits is in line with the slower rise in their total liquid assets. Building societies' deposits in banks are also forecast to slow from the recent exceptionally high rate. Other financial institutions' deposits are also likely to rise less rapidly in the light of the projected decline in their inflows.

Table 14: Broad money by sector

(per cent change on year earlier)

	Persons	M3 ICCs	B Socs	Other OFIs	M3 Total	M4 Total
1985-86	8.0	13.8	54.6	27.1	13.1	13.4
1986-87	11.9	24.8	60.9	23.0	19.4	15.5
1987-88	10.0	25.7	55.3	33.1	20.4	15.0
1988-89	12.8	17.3	41.9	17.0	16.8	14.7
1989-90	10.3	7.4	24.3	18.6	12.2	12.4

Chart 15: Growth rates of M4 by sector

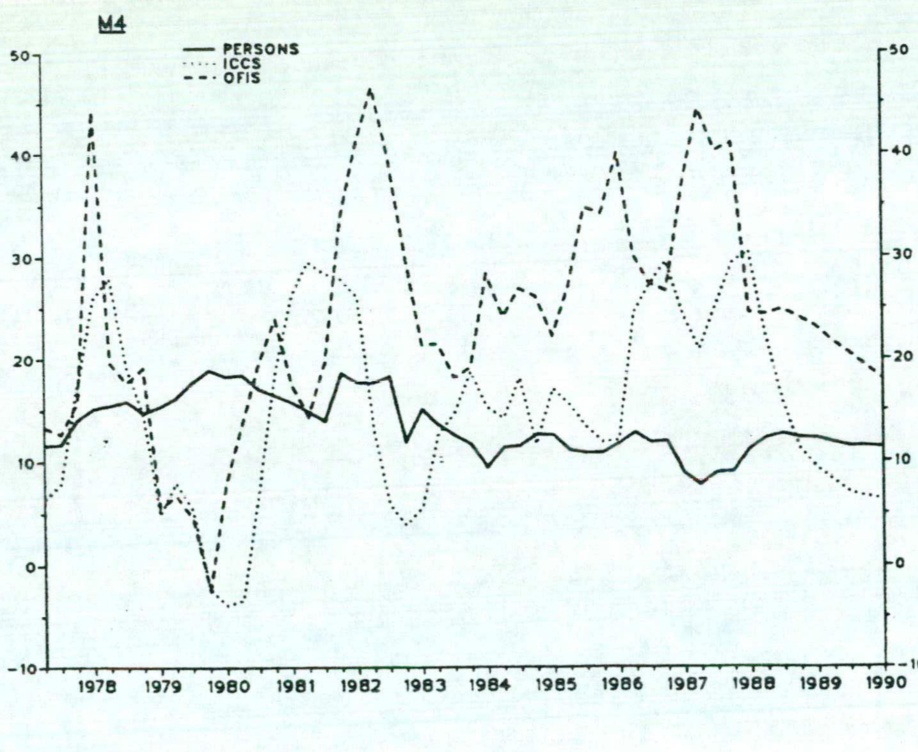


Table 16: Counterparts analysis of broad money (£ billion)

(a) M3

	1985-86	1986-87	1987-88	1988-89	1989-90
Overfunding (M3 definition)	-0.4	-0.4	0.0	-0.1	-0.1
Sterling bank lending to nbps	21.1	30.6	41.2	37.2	31.2
Banking external	-0.7	-0.6	-6.2	-3.4	-4.0
Increase in nndls	-2.0	-4.7	-3.5	-5.4	-5.6
Change in M3*	18.9	26.0	32.1	26.4	24.5

* M3 determined from sectoral equations; counterparts do not exactly sum to M3

(b) M4

	1985-86	1986-87	1987-88	1988-89	1989-90
Overfunding (M4 definition)	0.3	4.3	-0.8	0.0	0.0
Sterling bank lending to non-bank non-b.soc private sector	36.2	46.9	57.8	56.5	57.3
Other counterparts	-6.6	-17.5	-14.2	-14.5	-15.9
Change in M4	29.9	33.7	42.8	42.0	41.4

29. An alternative description of broad money growth is given by the counterparts analysis. We assume that the PSBR is fully funded on the M3 definition in the current financial year and on the M4 definition thereafter; over the forecast, the difference in overfunding definitions is less than £0.1 billion a year. Credit to the private sector from banks and building societies continues to grow more quickly than the corresponding deposit liabilities. Private sector net borrowing in foreign currency also increases partly as a response to the emerging current account deficit. The banking external is contractionary as sterling inflows from overseas continue at current high levels over the forecast period consistent with high covered interest rate differentials; the weakening of sterling in early 1989 might suggest that domestic interest rates may have to rise further than we have assumed to continue attracting these inflows. Net non-deposit liabilities of banks also have an increasingly contractionary effect on the counterparts as banks increase capital issues to provide further against their exposure to third world debtors.

Table 17: Sterling lending by banks and building societies

	Bank + B.Soc lending		Bank lending		Bank lending by sector (% growth)			
					Persons			
	£bn	% growth	£bn	% growth	House Purchase	Other	ICCs	OFIs
1985-86	35.1	17.8	20.8	17.8	20.7	16.3	13.1	29.5
1986-87	47.1	18.4	30.6	19.1	24.1	13.3	11.1	43.5
1987-88	55.6	18.8	40.5	22.0	32.7	15.6	13.6	39.0
1988-89	56.5	18.0	37.1	20.5	24.9	17.9	17.1	25.2
1989-90	57.4	15.1	36.2	15.5	14.4	14.3	12.6	21.3

Velocity trends

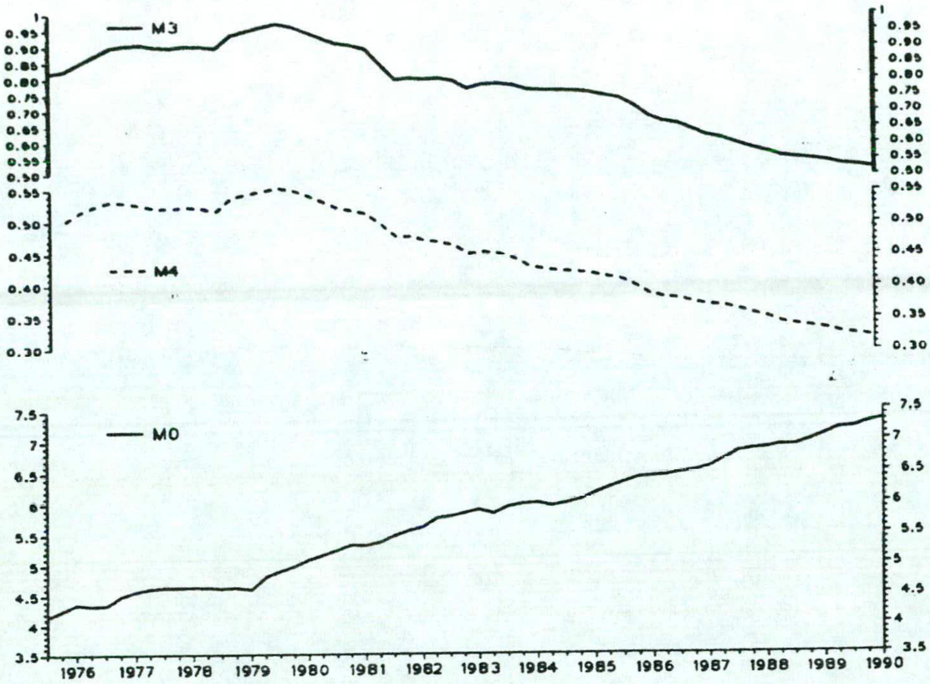
30. M0 velocity which has fallen below trend during recent months as lower interest rates have increased M0 growth, rises above trend as interest rates increase before returning to a more normal upward path reflecting continued financial innovation. Broad money velocity falls less sharply during the year ahead than in the past year.

Table 18: Income (GDP) velocity of money

(per cent changes on previous year)

	M0	M3	M4
1984-85	1.6	-2.1	-5.3
1985-86	5.1	-3.1	-3.4
1986-87	2.4	-10.6	-7.6
1987-88	4.6	-8.8	-4.4
1988-89	2.4	-7.8	-6.2
1989-90	3.8	-4.6	-4.8

Chart 15: Monetary aggregates' velocity



FUNDING AND MONEY MARKET ASSISTANCE

31. In the current financial year, the PSBR surplus of £2¾ billion is assumed to be fully funded outside the banking sector with net debt purchases of £7 billion by the non-bank private and overseas sectors helping to offset the £10¼ billion build up in reserves. In 1988-89 and 1989-90, the PSBR is in slightly larger surplus of £3½ billion a year and is now assumed to be fully funded on the M4 definition. The funding consequences are, however, very different since with the assumed run down in the reserves and with less repayment of debt by local authorities, net gilt government purchases of gilts of over £7 billion a year are required despite the smaller funding contribution of £1 billion a year by National Savings. Most of this implied net disposal of gilts is borne by the private sector, mainly the institutions. Gross gilt sales are forecast to fall from £13 billion in the current financial year to less than £1 billion a year by 1989-90. Early buying-in of maturing gilts is required throughout the forecast period, tending to flatten the expected redemptions 'hump' in 1989-90.

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Table 19: PSBR and overfunding

	PSBR	Gilt Sales to nbnbsps*	National Savings	Reserves	Other OS and FC finance	Other debt sales to nbnbsps	Over funding**
1985-86	5.7	3.6	2.1	-2.4	4.3	-1.6	0.3
1986-87	3.4	4.6	3.4	-3.8	5.3	-1.8	4.3
1987-88	-2.7	2.3	1.8	-10.3	5.4	-2.8	-0.8
1988-89	-3.4	-7.1	1.0	3.0	-0.1	-0.2	0.0
1989-90	-3.7	-7.9	1.0	3.5	-0.1	-0.2	0.0

* non-bank non-building society private sector

** overfunding on M4 definition

Table 20: Gilt Sales by Sector

	Net Sales (exc. Repos							
	Persons	ICCs	OFIs*	Monetary Sector	Over-seas	Total	Redemp-tions	Gross Sales
1985-86	0.2	-0.5	3.1 (-0.7)	0.1	2.3	5.2	6.5	11.7
1986-87	1.6	-0.3	0.2 (-2.1)	1.4	2.8	5.8	8.8	14.6
1987-88	0.3	0.0	2.0 (0.6)	-0.8	4.9	6.3	7.0	13.1
1988-89	-0.9	0.0	-6.2 (0.0)	-0.5	-0.5	-8.1	9.8	1.7
1989-90	-1.0	0.0	-7.0 (0.0)	-0.6	0.0	-8.9	9.5	0.6

* of which sales to building societies in brackets

32. Money market influences are forecast to reduce the bill mountain in the current financial year and throughout the forecast period. Under a regime of full funding, this contractionary effect is mostly explained by repayment of debt to banks by local authorities and public corporations with modest disposals of gilts by banks broadly offset by the increase in notes and coin. The stock of money market assistance outstanding rises from its current level of £7¼ billion to £8 billion by the end of this financial year before falling to £5¾ billion by the end of 1989-90.

Table 21: Money Market Influences and Operations (£ billion)

	CGBR	Gilt Sales (excl. REPOs)	National Savings	Overseas and Other Finance	Money Market Influences
1985-86	11.0	-5.2	-2.1	0.0	3.7
1986-87	10.5	-5.8	-3.4	3.1	4.4
1987-88	2.3	-6.1	-1.8	8.9	3.3
1988-89	-1.8	8.1	-1.0	-3.7	1.6
1989-90	-2.8	8.9	-1.0	-4.2	0.9

	Overfunding*	Notes and coin	Net sales of CG debt to banks	Net sales of OPS debt to banks	Money market influences
1985-86	0.4	-0.4	-0.1	3.8	3.7
1986-87	0.4	-0.5	-0.4	5.0	4.4
1987-88	0.0	-0.9	1.0	3.1	3.3
1988-89	0.1	-0.5	0.5	1.6	1.6
1989-90	0.1	-0.5	0.5	0.8	0.9

	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	13.3 (10.1)
1986-87	-3.1	-1.1	-4.2	0.2	9.7 (7.1)
1987-88	0.9	-4.6	-3.5	-0.2	8.1 (8.0)
1988-89	-1.5	0.0	-1.5	0.1	6.5 (6.4)
1989-90	-0.8	0.0	-0.8	0.1	5.7 (5.6)

* Change in bankers balances minus money market influences
** of which ID and BD bills in brackets

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COPY NO. 1

FROM: COLIN MOWL
DATE: 22 January 1988

CHANCELLOR cc

Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
PCC members
Mr Sedgwick
Mr Hawtin
Mr Culpin
Mr Moore
Mr Odling-Smee
Mr Peretz
Mr Turnbull
Miss Peirson
Mr Luce
Mrs R J Butler
Mr Hibberd
Mr Gieve
Mr Bottrill
Mr Mortimer
Mr M G Richardson
Mrs M Brown
Mr Potter
Mr McIntyre
Mr S J Davies
Mr Riley
Mr Ritchie
Mr Franklin
Mrs Todd
Mr Cropper
Mr Tyrie
Mr Call

TREASURY ECONOMIC FORECAST: PUBLIC FINANCES

I attach a copy of the report on the forecast for the public sector finances. It provides more detailed explanation of the forecasts of expenditure and receipts which were summarised in section 8 of the main forecast report (The Treasury Economic Forecast) circulated yesterday by Mr Sedgwick.

Colin Mowl

COLIN MOWL

SECRET

TREASURY ECONOMIC FORECAST

REPORT ON PUBLIC FINANCES

WINTER 1988

CONTENTS

TREASURY ECONOMIC FORECAST: PUBLIC SECTOR FINANCES

I PUBLIC EXPENDITURE

1. The forecast of expenditure relative to plans in the 1987 and 1988 PEWPs is set out in table 34 of the main forecast report.

The Economic Background

2. Differences between the forecast and PEWP should be interpreted in the light of differences between the general economic prospect in this forecast and the economic assumptions used in the 1988 PEWP. Inflation as measured by the GDP deflator is forecast to be higher than assumed in the PEWP. While higher inflation could be partly reflected in lower real public expenditure within year, it is likely to come through in part as higher cash spending in future years and the effect will be bigger the further ahead one looks.

3. In certain cases, social security for example, there is a direct link between inflation and expenditure. But here it is the RPI (and the RPI excluding housing costs) and not the GDP deflator which matters and this is now forecast to increase less in the year to September 1988 than assumed in the PEWP (see table V). This largely reflects interest rate movements, in particular in the mortgage rate. The forecast of benefit upratings based on the RPI less housing costs is the same as the PEWP assumption.

4. A significant proportion of public spending is also sensitive to the general level of economic activity. For example lower unemployment than assumed in the PEWP should, as this year, relieve some of the pressure on social security expenditure. However, recent experience suggests that a buoyant economy may also generate higher demand for the outputs of programmes such as health and education, creating pressure for higher expenditure in real terms.

5. Table I compares the forecast of the GDP deflator and unemployment with the assumptions used in the FSBR and PEWP. The net result of all the judgements made in the forecast in an attempt to reconcile the conflicting pressures on spending is a level of public expenditure in real terms lower than that in the 1988 PEWP (see table 35 of main report). In cash terms the forecast is above the PEWP.

TABLE I: ECONOMIC BACKGROUND

	1987-88	1988-89	1989-90
GDP deflator growth (%)			
FSBR 1987	4½	4	3½
PEWP 1988	4¼	4½	3½
January Forecast	5	4¾	4½
Unemployment (GB m)			
FSBR 1987	2.8	2.8	2.8
PEWP 1988	2.7	2.6	2.6
January Forecast	2.3	2.2	2.3

6. The rest of section I considers each broad category of expenditure in turn.

Central Government Pay

7. As in previous forecasts the number of central government employees is assumed to remain broadly stable. The forecast of average earnings is set out in 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 the financial year beginning the following April. In recent years central government earnings growth has been lower than the private sector average by about 1¼ per cent a year. In the forecast however central government earnings growth is assumed to be a little above the private sector average in both the 1987-88 and 1988-89 pay rounds. This might result in the 1987-88 round from near double figure increases for NHS review body groups, a somewhat smaller increase than this for the Armed Forces and a Civil Service increase a bit below the private sector average. But the aggregate forecast is consistent with a number of possible outcomes for settlements by individual groups.

TABLE II: CENTRAL GOVERNMENT AVERAGE EARNINGS GROWTH - %

		Pay Rounds		
	(Weights)	1986-87	1987-88	1988-89
Review Body Groups (Nurses, Doctors, Armed Forces)	(56)	8½	9½	9
Civil Service	(27)	5½	7¾	7¾
NHS non-Review Body and Other	(17)	5¾	7¼	7½
Average CG	(100)	7¼	8¾	8¼
Average Private Sector		8*	8*	7¾*

* Underlying earnings growth

Central Government Procurement

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

9. The forecast growth of procurement in real terms in 1988-89 and 1989-90 is on average much the same as in the previous two years but well below the average growth in the five years before that. Following the end of the NATO commitment, which boosted defence spending in the early 1980s, defence procurement has been falling in real terms in recent years. The forecast assumes that this cannot continue for much longer, and incorporates only a small real fall in 1988-89 and a small rise the year after. Health procurement is forecast to rise in real terms at the same rate as the past two years. The large increases in the "other" category in 1986-87 and 1987-88 are spread across a number of programmes such as social security administration, employment training measures and privatisation costs. The PEWP implies a real fall in this category in 1988-89 but the forecast assumes a small increase well below the 1980s average.

TABLE III: CENTRAL GOVERNMENT PROCUREMENT IN REAL TERMS

annual % increases

	Weight in 1986-87	Average 1980-81 to 1985-86	1986-87	1987-88	1988-89	1989-90
MOD	45	3¼	- 4¼	- 2½	- ½	½
DHSS Health	33	3¾	4½	4	4	4½
Other	22	3¼	9½	6	1½	2
Total	100	3¼	1¾	1½	1½	2¼

Social Security Expenditure

10. The forecast of social security benefit expenditure for 1987-88 is derived from the figures in the January IMBE report - the DHSS in-year monitoring system (formerly CYMS). We have reduced the IMBE forecast by £0.2 billion as it was based on an unemployment assumption which now appears too high. In addition, £0.1 billion has been added to cover compensation for the under-recording of the RPI.

11. For 1988-89 onwards, the 1988 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 a realistic 'underlying' growth rate (ie. the growth after allowing for the effects of upratings, changes in unemployment, changes in policy, demographic factors etc) on the basis of past experience. This underlying growth can be seen as representing increases in benefit take-up or in the average levels of benefit payment.

12. The underlying growth rate is estimated to have risen from 3¼ per cent in 1986-87 to 4¼ per cent in 1987-88. There is no obvious explanation for this. It could be an aberration, rather than a change in trend, or it could be associated with the rapid fall in unemployment (for example these losing unemployment benefit could be moving on to other benefits). Uncertainty over the future path of underlying growth is further exacerbated by the reforms in the benefit system due next April. It is not clear whether these will increase or reduce the underlying growth of expenditure. Giving some weight to (i) the view that 1987-88 was partly an aberration (ii) the smaller falls in unemployment forecast compared with the recent past, (iii) the view that underlying growth cannot be positive indefinitely, the forecast projects lower underlying growth than in 1987-88 (see paragraph 86 of main report).

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

		£ billion	
	1987-88	**1988-89**	**1989-90**
Forecast overspend*	0.2	0.6	1.0
Due to:			
(a) Economic Assumptions:			
(i) Unemployment	- 0.9	- 0.7	- 0.8
(ii) Upratings	-	-	- 0.1
(b) More realistic underlying growth	1.1	1.3	1.9

* relative to 1987 PEWP for 1987-88 and to 1988 PEWP thereafter

13. Table IV shows that the resulting forecast of expenditure is lower than in the PEWP because of differences in economic assumptions (table V) but that this is more than offset by the

adoption of a higher underlying growth rate than implicit in the PEWP.

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

	1987-88	1988-89	1989-90
1. Unemployment (GB, million)			
PEWP 1988	2.7	2.6	2.6
January Forecast	2.63	2.3	2.2
2. Upratings (% pa)			
(i) RPI			
PEWP 1988	2.1	4.2	4.5
January Forecast	2.1	4.2	3.9
(ii) ROSSI*			
PEWP 1988	2.0	3.2	3.5
January Forecast	2.0	3.2	3.5

* RPI less housing costs

The National Insurance Fund

14. 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) as shown in table VI.

15. Given the prospect of otherwise very 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 £1¼ billion higher than forecast in 1988-89 and 1989-90 respectively. By 1989-90, when the Supplement is down by assumption to 3 per cent, the scope for minimising the flow surpluses by reductions in subsequent years would of course be much reduced.

Why not abol. of Tsy Supp.

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

	1986-87	1987-88	1988-89	1989-90
Surplus: flow	0.4	0.9	1.3	1.8
: level end-year	5.7	6.6	8.0	9.8
Treasury Supplement (rate %)	2.4 (9)	2.1 (7)	1.6 (5)	1.0 (3)

Net EC Contributions

16. Table VII shows the forecast of total net payments to EC institutions and compares this with PEWP provision. The forecast assumes a change in the ceiling for EC own resources from 1.4 per cent of VAT to 1.2 per cent of community GNP, the change coming into effect during 1988-89.

TABLE VII: NET EC CONTRIBUTIONS (£bn)

	1987-88	1988-89	1989-90	1990-91
1988 PEWP	0.9*	0.8	1.5	1.3
Forecast	1.7	1.2	1.7	1.6

* PEWP 1987

17. The projected overspend in 1987-88 compared with the 1987 PEWP reflects a shortfall in agricultural receipts, a higher own resources share, the payment of a VAT adjustment on 1 August and the effect of the provisional twelfths regime currently in operation, which reduces substantially our abatement entitlement in the first quarter of 1988. In subsequent years a large part of the forecast overspend is due to the assumed change in the ceiling for EC own resources (the 1988 PEWP assumes a continuation of the 1.4 per cent VAT ceiling).

18. The forecast of net EC contributions is, as always uncertain. In view of this, the path of net contributions has been partially smoothed. The 1988-89 dip reflects an anticipated bounce back of abatements as the effects of the provisional twelfths regime are unwound.

Other Central Government Expenditure

19. The largest components of this category are capital expenditure, current grants other than social security (including employment grants and overseas aid) and subsidies. Overspends totalling £0.4 billion and £0.8 billion are forecast for 1988-89 and 1989-90 respectively, mainly from assuming higher inflation than in the plans leads to additional cash spending. But the growth of this category of expenditure in total in real terms is also slightly above that implicit in the PEWP.

Local Authorities

20. Table VIII summarises the forecast of local authorities' finances.

TABLE VIII: LOCAL AUTHORITY SUMMARY

	1986-87	1987-88	1988-89	1989-90
Relevant Current Expenditure (% increase)	9½	9½	9	9
LA Average Earnings (% increase)	8½	8¼	8¼	8
LA Manpower (% increase)	2¼	2	1½	1½
Grant percentage (GB, accruals-% level)	46¼	46	44¾	44½
Gross Rate Poundage (% increase)	11½	6¾	11	9½
Gross Capital Spending In Real Terms (% increase)	- 3¼	3¼	0	0
Total Capital Receipts (£ billion)	2.9	3.4	3.6	3.8
LABR (£bn)	0.2	0.9	1.1	1.2

The forecast of current expenditure in 1987-88 is based on local authorities' budgets. In recent years authorities have spent slightly less than anticipated in their budgets but this forecast assumes that expenditure will turn out marginally above budgets in 1987-88 for two reasons: first because LAs appear to have made unduly low provision for pay increases and second due to higher expenditure occasioned by storm damage.

21. In later years forecasts of current expenditure result from judgements about average earnings, manpower and levels of procurement. Continued rises in LA manpower are forecast (see table VIII). Local authority earnings are forecast to rise faster than in the private sector, particularly in the current pay round (see table IX). The larger differential in the current pay round mainly reflects the already agreed manuals settlement and the lagged effects of the earlier teachers' settlement.

TABLE IX: AVERAGE EARNINGS GROWTH %

Pay Rounds	Local Authorites	Private Sector*
1986-87	7½	8
1987-88	10¼	8
1988-89	8½	7¾

* underlying

22. Table X indicates that the forecast excess over provision for local authority relevant current expenditure is not out of line with recent experience.

TABLE X: LA RELEVANT CURRENT EXPENDITURE COMPARED WITH PROVISION*

Overspends	1985-86	1986-87	1987-88	1988-89
£ billion	1.4	2.8	1.2	1.8
%	5½	10½	4	5½

* PEWP provision in current year eg. 1988 PEWP for 1988-89.

23. The forecast indicates a much larger increase in rate poundages in 1988-89 than in 1987-88, but a smaller increase than in 1986-87. This is due to a tighter rate support grant settlement for 1988-89 than in 1987-88 (reflected in a sharp reduction in grant percentage) the expectation that local authorities will build up balances in anticipation of the community charge, and high expenditure growth. A smaller rise in rates is forecast for 1989-90, though still virtually in double figures. But the outlook for rates in this last year before the introduction of the community charge in England and Wales is particularly uncertain. Authorities may be more than usually willing to rate up and there is a risk that rate poundage increases will be even higher than forecast.

24. A sharp rise in local authority capital receipts is estimated for 1987-88 (see table VIII). This partly reflects an increase in the gross proceeds of council house sales, but is also due to growth of repayments of local authority mortgages as first-generation council house owners realise their capital gains. Local authorities may also be raising extra receipts from sales of non-housing assets. The forecast assumes that authorities will have the scope and incentive to maintain the projected 1987-88 level of capital receipts in real terms.

25. Gross capital spending is now expected to recover in real terms in 1987-88 after falling in 1986-87. In 1988-89 and 1989-90 it is forecast to be broadly constant in real terms, implying significant overspends in those years of £½-1 billion on 1988 PEWP provision. But the higher forecast level of capital receipts more than offsets this in 1988-89 and generates a small underspend on net capital spending, with tiny net overspends thereafter.

26. The local authority borrowing requirement (LABR) in the first nine months of 1987-88 was about £1 billion higher than in the equivalent period last year following an unusually high level of borrowing in December. The forecast assumes that borrowing in the remaining three months will be somewhat lower than in previous years. Even so the forecast for the year as a whole of £0.9 billion is well up on the 1986-87 outturn of £0.2 billion, and higher than in the October forecast. While it can be argued that the new forecast represents a return to a more usual level of borrowing it is not possible to reconcile it with the latest estimates of LA income and expenditure. Aggregate LA finances remain therefore something of a puzzle.

27. With gross capital expenditure and receipts constant in real terms, the LABR is forecast to rise gently in cash terms in 1988-89 and 1989-90 (see table VIII).

Nationalised Industries and the PCBR

28. Nationalised industry (NI) output has on average in the past grown more slowly than both manufacturing and total output. It is expected to rise by 4 per cent in 1987-88, only a little below the growth of GDP, but this figure is distorted upwards (and downwards in 1986-87) by the closure of BSC's Redcar blast furnance for maintenance work in 1986-87. Abstracting from this the relative growth of NI and total output over the past year or two has been in line with the historic experience. The forecast assumes that NI output growth will continue below that of GDP.

TABLE XI: NATIONALISED INDUSTRY TRADING PERFORMANCE AND INVESTMENT*

	1984-85	1985-86	1986-87	1987-88	1988-89	1989-90
Output (%)	½	2¾	- 1	4	2	1½
Employment (%)	- 5½	- 7	- 6¼	- 3¾	- 2	- 2
Productivity (%)	6½	10¾	5½	8¼	4	3¾
Real Prices (%)	- 1½	- 1	- ¼	- 2¼	½	0
Profits (%)**	..	..	5	22	21	15
Real Investment (%)+	- 12¾	3¼	- ½	½	4¾	2¾

* The figures relate to the current composition of the NI Sector. They adjust for the coal strike, except in the case of real investment and profits.

** Gross of depreciation and net of stock appreciation and subsidies (.. indicates not definable).

\+ Gross of depreciation and sale of fixed assets.

29. Growth in output and continued productivity improvements are reflected in strong growth in profits in 1987-88 of over 20 per cent, despite an expected real price fall. Further output growth and real price increases should sustain this profit growth in 1988-89, but some deceleration is likely thereafter.

30. NI investment is planned to rise in cash terms in 1988-89 by over 10 per cent with particularly large rises, among the major industries, by BR, electricity and the Post Office. The forecast assumes, particularly in view of the likely failure to meet investment targets this year, that investment will not be as high as planned in 1988-89. Even so the forecast rise of nearly 5 per cent in real terms is high by recent standards.

31. Table XII shows the forecast of external finance and the PCBR. External finance in 1987-88 is expected to be the same as in 1986-87 despite the loss of BGC's and BA's negative external financing requirements. The external finance forecast for 1988-89 has a small undershoot of the PEWP largely as a result of the forecast investment shortfall but also because of the assumed privatisation of the Giro, a wholly owned Post Office subsidiary. The proceeds will reduce the Post Office's, external financing requirement in a way not allowed for in the PEWP. An EFL overshoot is forecast for 1989-90 partly reflecting a judgement that NI profits will not be as buoyant as implicit in the PEWP and partly the result of the assumed privatisation of BSC. The PEWP EFL takes credit for a negative BSC EFL.

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

	1986-87	1987-88	1988-89	1989-90
External Finance				
1987 Budget		0.8	0.3	- 0.1
PEWP*		0.7	0.7	0
Winter Forecast	0.4	0.4	0.5	0.4
PCBR				
1987 Budget	- 1.4	- 0.9	- 0.7	- 1.1
Winter Forecast	- 1.4	- 1.4	- 0.8	- 0.8

* 1987 PEWP for 1987-88, 1988 PEWP thereafter

32. Both external finance and the PCBR for 1987-88 are forecast to undershoot the forecasts made at the time of the Budget by nearly £½ billion. Although external finance is forecast to stay close to its 1987-88 level in 1988-89 and 1989-90 the PCBR is expected to rise because grants are expected to fall, in line with the plans. This implies that any deviation in external finance from the PEWP is largely met by borrowing.

Debt Interest

33. General government gross debt interest payments are lower than in the October forecast in each year, mainly due to lower forecasts of interest rates. With the profile of interest rates fairly flat, the level of interest payments eventually falls in cash terms as a result of the negative GGBR. But the influence of this last factor is offset in the short term by the need to finance the large rise in the foreign exchange reserves over the past year (the gross interest cost of this is partly offset by higher interest receipts on EEA investments).

TABLE XIII: GENERAL GOVERNMENT GROSS DEBT INTEREST PAYMENTS

£ billion

	1986-87	1987-88	1988-89	1989-90
October Forecast	17.4	17.7	18.0	17.5
1988 PEWP	17.4	17.8	18.0	18.0
January Forecast	17.6	17.4	17.5	16.9

34. General government net debt interest payments are forecast to fall by increasing amounts.

TABLE XIV: GENERAL GOVERNMENT NET DEBT INTEREST PAYMENTS

£ billion

	1986-87	1987-88	1988-89	1989-90
October Forecast	11.4	12.1	12.4	12.1
1988 PEWP	11.4	12.3	13.0	13.0
January Forecast	11.6	11.4	11.6	11.1

II GENERAL GOVERNMENT RECEIPTS

35. Table XV sets out details of the forecast of general government receipts in the format of FSBR Table 1.2. All the figures in this section of the report are before taking account of the fiscal adjustment. Changes in the forecast since the FSBR and internal October forecast are summarised and discussed in table 33 and paragraph 93 of the main report.

TABLE XV: GENERAL GOVERNMENT RECEIPTS - % changes

	Shares in 1987-88	1985-86	1986-87	1987-88	1988-89	1989-90
Income Tax	0.24	+ 7½	+ 7½	+ 7	+ 10½	+ 9½
Corporation Tax (excl. North Sea)	0.09	+ 22	+ 34	+ 35	+ 26	+ 5½
Capital Taxes	0.02	+ 31	+ 21	+ 21	+ 23	0
VAT Receipts	0.14	+ 4½	+ 10½	+ 12½	+ 8½	+ 6½
Local Authority Rates	0.10	+ 7	+ 13	+ 8	+ 13	+ 11½
Stamp Duties	0.01	+ 38	+ 46	+ 31	0	+ 25
Other Expenditure Taxes	0.15	+ 11	+ 6	+ 3	+ 7	+ 6
North Sea Revenues	0.03	- 6	- 58	- 4½	- 23	- 4½
Other Taxes	0.00	- 1	- 2	- 52	20	- 35
Total Taxes and Royalties	0.76	+ 7½	+ 4½	+ 11	+ 10½	+ 8
National Insurance Contributions	0.17	+ 8½	+ 8½	+ 8	+ 8½	+ 8½
Interest and Other Receipts	0.07	+ 6	+ 10½	- 10	- 2½	+ 1
General Government Receipts	1.00	+ 7½	+ 5½	+ 8½	+ 9	+ 7½

does this sum?

36. General government receipts are forecast to rise by 8½ per cent in 1987-88, a little below the 10 per cent growth now forecast for money GDP. The forecast rise in taxes and national insurance contributions (NICs), at 10½ per cent, is marginally

above that in money GDP. However, this simple comparison understates the buoyancy of tax revenues in 1987-88. The 1987 Budget tax cuts were estimated to reduce tax revenues by over £2½ billion - 1½ to 1¾ per cent of total taxes and NICs - in 1987-88, implying that the underlying growth in taxes and NICs is in excess of 12 per cent, significantly higher than that of money GDP. And within total taxes, North Sea revenues are falling. As in 1986-87, a major explanation of the buoyancy of non-North Sea tax revenues is a very large rise (now forecast at 35 per cent) in non-North Sea corporation tax receipts.

37. The buoyancy of tax revenues is expected to continue next year. The forecast for 1988-89 is for a rise in general government receipts of 9 per cent, and in total taxes and NICs of 10 per cent. These figures compare with forecast growth of 7 per cent in money GDP. Rather slower growth in revenues (7½ per cent for general government receipts, 8 per cent for taxes and NICs) is expected in 1989-90, though this would still mean that revenues growing significantly faster than money GDP (forecast at 6½ per cent).

38. The forecast tax burden is summarised in paragraphs 94 and 95 of the main report.

Income Tax

39. Income tax receipts so far in 1987-88 have been running at levels well above those expected at the time of the 1987 Budget, and the current forecast reflects this. As compared with the FSBR, the forecast of income tax revenues has been revised upwards by £1.1 billion. Nearly all of this change is accounted for by higher PAYE receipts, and is attributable for the most part to wages and salaries growth turning out higher than earlier forecast.

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

TABLE XVI: EFFECTIVE TAX RATES FOR INCOME TAX*

	1985-86	1986-87	1987-88	1988-89	1989-
PAYE	19.5	19.1	18.8	19.3	19.7
Total income tax	13.1	13.3	13.4	13.9	14.2

* denominator is wages and salaries for PAYE and total personal income for total

Corporation Tax (excluding North Sea)

41. The exceptional buoyancy of corporation tax (CT) last year has continued in 1987-88. The current forecast implies that 1987-88 will be the second year running to record a rise in CT receipts (including ACT) in the 30 to 40 per cent range. The current forecast represents an upward revision of over 12 per cent to the forecast level of CT receipts in the FSBR, but can be partly, although not entirely, attributed to upward revisions in tax determinants - data for profits in 1986 (for mainstream corporation tax (MCT)) and the forecast for dividends in 1987 (for advance corporation tax (ACT)). The year-on-year rise in the effective tax rate for MCT, shown in table XVII, is now projected at 2.4 percentage points, as compared with a 1.7 percentage point rise implied by the FSBR forecast on the basis of profits data as it then stood. But it is quite possible that future upward revisions to the profits data will reduce, though not eliminate, this rise in the effective tax rate. The upward revision to the ACT forecast (£0.5 billion) can be entirely attributed to a revised dividends forecast.

42. The forecasts for future years show a further substantial rise in MCT receipts in 1988-89, as a result of continuing buoyancy in profits growth in 1987. However, the forecast for profits is for a very marked slow-down in 1988, which leads to a forecast of only a small rise in MCT receipts in 1989-90. Table XVII shows the forecast in terms of effective tax rates (calculated for MCT on the basis of tax accruals and profits in the <u>previous</u> calendar year). The current forecast is in line with its recent predecessors as seeing 1987-88 as representing a peak for the MCT effective rate. From 1988-89 onwards, the changes in investment allowances following the 1984 CT reforms will be tending to push down the effective tax rate, as writing-down allowances from earlier years begin to build up under the new system. Another factor tending to reduce

CT accruals for 1987, and thus MCT receipts in 1988-89, is the offset against tax liability of increases in bad debt provisions by the major clearing banks - which could be worth up to £1 billion off 1988-89 receipts.

TABLE XVII: DETERMINANTS OF NON-NORTH SEA CORPORATION TAX AND EFFECTIVE RATES

	Percentage Growth Rates for:-					
	Revenue		Tax determinants		Effective Tax Rates (%)	
	MCT+ Receipts	ACT	Company Incomes (previous calendar year)	Dividends (Calendar year)	MCT*	ACT
1985-86	+ 21	+ 21	+ 15	+ 24	11.0	59.3
1986-87	+ 57	+ 17	+ 26	+ 33	13.2	52.2
1987-88	+ 46	+ 17	+ 29	+ 36	15.6	44.7
1988-89	+ 25	+ 17	+ 23	+ 23	15.1	42.3
1989-90	+ 3	+ 8	+ 3	+ 8	15.0	42.7

[* numerator is tax accruals for previous year]
[+ includes MCT on capital gains]

VAT

43. VAT receipts have been running at a level somewhat above Budget-time expectations so far in 1987-88, and the forecast for the year as a whole has been raised by around £¾ billion from that in the FSBR. Interpretation of recent trends in VAT has, however, been made more difficult by the continuing impact of the Keith reforms to collection procedures, first announced in the 1985 Budget, and by the very substantial upward revisions to consumers' expenditure data made since earlier forecasts (including the FSBR). It now seems that the original estimates of the once-for-all impact from Keith on VAT receipts (through shortening payment lags and thus reducing arrears) were too low. Customs and Excise's latest tentative estimates, used in this forecast, imply a total once-for-all gain in receipts from reduced arrears of £1 billion over four years, as compared to the original (1985) estimate of £0.6 billion. For 1987-88, we are now assuming £0.4 billion additional receipts from Keith, as compared to £0.2 billion in the FSBR forecast. Thus Keith effects account for around a quarter (£0.2 billion) of the upward revision since the FSBR.

44. The revisions to consumers' expenditure data mean that recent movements in the effective tax rate (see table XVIII) now look rather different than they did at the time of the FSBR forecast. At that time, the effective tax rate (adjusted for Keith) appeared to have recorded a substantial rise in 1986-87, which accorded with the theory - to which we have given some weight in earlier forecasts - that fast real growth in consumption tends to lead to increases in the effective tax rate, because at the margin additional expenditure tends to be disproportionately on VATable goods and services (or, more strictly, not on zero-rated goods and services). However, following a substantial upward revision to 1986 consumers' expenditure data, it now appears that the VAT effective tax rate actually fell in 1986-87. Last year's experience now seems to be repeating itself. VAT receipts are running significantly above earlier expectations, and, on the basis of the current best estimate of consumers' expenditure in 1987, the effective tax rate is projected to rise substantially between 1986-87 and 1987-88. But, following last year's experience, there must be a likelihood that higher than expected VAT receipts will eventually prove to be an early indicator of upward revisions to consumers' expenditure data, rather than an indication of a rise in the effective tax rate.

45. The forecast for VAT is set out in Table XVIII. The forecast is presented in terms of 'underlying' VAT receipts - ie. VAT adjusted for Keith effects, and with the effects of the 1987 Budget (which contained some administrative changes which had the effect of increasing VAT receipts) removed. Notwithstanding the experience of 1986-87, and the risk that revisions to consumers' expenditure will erase the apparent rise in 1987-88, the forecast gives some weight to the hypothesis of a link between real consumption growth and the effective tax rate, and assumes a rise in the effective rate in 1988-89 (real consumption growth for 1988 is forecast at 4½ per cent). With lower real consumption growth forecast for 1989 - under 3 per cent - the forecast assumes that the VAT effective rate does not record a further significant rise in 1989-90.

TABLE XVIII: 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	13.6	9.2	9.01	19.4	0.1	19.5
1986-87	8.1	9.8	8.87	21.0	0.4	21.4
1987-88	12.0	8.5	9.16	23.5	0.6	24.1
1988-89	9.2	8.4	9.23	25.7	0.5	26.1
1989-90	7.0	6.9	9.24	27.5	0.4	27.9

[* reduction of arrears from Keith; 1987 Budget effects]

[+ Calendar year]

North Sea Revenues

46. Government revenues from the North Sea in 1987-88 are now projected at £4.6 billion, £0.7 billion above the FSBR forecast. The sterling oil price has been higher than assumed in the FSBR because the dollar oil price has been higher.

47. However in 1988-89 North Sea revenues are now projected to decline sharply to £3½ billion as a result of a further fall in oil production and the decline in the oil price: the sterling oil price is expected to be 22 per cent lower on average in 1988 than in 1987, reflecting a slightly lower dollar oil price and the projected depreciation of the dollar. Production is expected to decline further in 1989 but the effect on revenues is moderated by the ending of repayments of APRT after 1988-89.

TABLE XIX: GOVERNMENT REVENUES FROM THE NORTH SEA

£ billion

	1986-87	1987-88	1988-89	1989-90
FSBR 1987	4.8	3.9	3.8	4.1
January 1988	4.8	4.6	3.5	3.4
Change	-	0.7	- 0.3	- 0.7
of which: $ oil price		0.5	0.4	0.1
exchange rate		- 0.1	- 1.1	- 1.0
production		-	-	-
other (incl. lower expenditure)		0.3	0.4	+ 0.2

Stamp Duties and Capital Taxes

48. Stamp duties and capital taxes (capital gains tax, corporation tax on gains and inheritance tax) are the taxes where the fall in the stock market last October has a direct and substantial impact on receipts. The impact on stamp duty receipts is fairly immediate, at least as regards duty on transactions in stocks and shares - where there is a lag of around one month between transaction and receipt of duty. The impact on capital taxes, on the other hand, will take some time to work through - both because of payment lags (taxes on capital gains are generally paid a year in arrears) and because the basis of taxation is realised gains, not accrued gains.

TABLE XX: RECEIPTS OF STAMP DUTY AND CAPITAL TAXES

£ billion

	1985-86	1986-87	1987-88	1988-89	1989-90
Stamp Duty	1.2	1.8	2.4	2.4	3.0
Capital Taxes	2.4	2.8	3.3	4.1	4.1

49. Stamp duty receipts have been exceptionally buoyant over the past two years, and, even after the fall of the stock market, are forecast to record a rise of over 30 per cent for 1987-88 (see table XV). No further increase in total stamp duty receipts is now forecast for 1988-89. This reflects the stock market fall and the subsequent lower levels of prices and turnover. Stock market prices are forecast to remain constant in real terms at current levels and turnover volume, which fell in the weeks following the October crash, is forecast to return to pre-October levels by late 1988.

50. Stamp duty on land and buildings - roughly half of the total - is forecast to rise by over 20 per cent in 1988-89, but this is offset by a forecast reduction in duty receipts from stock market-related activities (from duty on transactions in shares and - especially - from capital duty on new equity issues). A resumption of buoyant growth in stamp duty receipts is forecast for 1989-90, reflecting the assumption of rising turnover volume through 1989.

51. Capital taxes have also been buoyant in the past year, particularly taxes on capital gains; a rise of over 20 per cent in capital tax receipts for 1987-88 is forecast. A further 20 per cent plus rise is forecast for 1988-89, again largely coming from taxes on capital gains. This buoyancy is expected to come to an end, once tax starts to be levied on the (smaller) gains realised after the stock market fall in October. The forecast for 1989-90 - no further rise in tax receipts on 1988-89 - reflects this.

National Insurance Contributions

52. NICs revenues, like income tax, have so far this year been running above the levels expected at Budget time - reflecting higher than expected wages and salaries growth. But the degree of overshoot has, perhaps surprisingly, been significantly lower than for PAYE income tax (under 1½ per cent for NICs, nearly 3 per cent for PAYE income tax). The forecast, shown in table XXI, has NICs revenues growing quite closely in line with wages and salaries.

TABLE XXI: EFFECTIVE RATES FOR NICs (%)

	Employees	Employers	Total Accruals	Total Receipts
1985-86	7.1	7.3	14.3	14.3
1986-87	7.1	7.3	14.3	14.3
1987-88	6.8	7.4	14.2	14.0
1988-89	6.6	7.5	14.1	14.0
1989-90	6.6	7.6	14.1	14.0

UNIT LABOUR COSTS AND OIL IMPORTS

CONFIDENTIAL

FROM: A BOTTRILL
DATE: 28 JANUARY 1988

SIR TERENCE BURNS

cc : PPS
Sir Peter Middleton
Mr Sedgwick
Mr Hibberd
Mr Owen
Mr Young

ECONOMIC FORECAST: UNIT LABOUR COSTS AND OIL IMPORTS

I understand that you wanted more information about the assumptions on relative unit labour costs and on oil imports in the recent forecast.

2. UK unit labour costs are estimated to have risen by about 1 per cent between the fourth quarters of 1986 and 1987 while those of our major competitors fell by about 1 per cent in national currency terms. After allowing for sterling's appreciation during 1987 this led to an erosion of almost 10 per cent in competitiveness from the exceptionally favourable level at the end of 1986. During 1988 UK unit labour costs are forecast to rise by about 4 per cent compared to 1½ per cent for competitors and after allowing for a further appreciation of sterling we lose an additional 4 per cent of competitiveness.

dubious

Table 1: Unit labour costs in manufacturing in the UK and overseas

(1980 = 100)

	UK	Competitors: Domestic currencies	Competitors: Sterling	Relative costs: Domestic currencies	Relative costs: Common currencies
1986	125.8	120.3	161.9	104.7	78.0
1987	126.0	121.0	167.0	104.3	75.5
1988	128.7	121.8	161.4	105.8	79.8
					(per cent changes on a year earlier)
1987	0.2	0.6	3.2	- 0.4	- 3.2
1988	2.1	0.7	- 3.4	1.4	5.7
1987Q4	0.9	- 0.8	- 8.0	1.8	9.7
1988Q4	4.1	1.6	0.2	2.5	3.9

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3. Our forecast for trade in oil is influenced heavily by the projected fall in North Sea oil production which is expected to be reflected mainly in lower exports, but partly in higher imports. In 1987, production fell by about 3 per cent but domestic demand for oil also declined so that the net trade balance showed little change with both exports and imports down. In 1988 and 1989 output is forecast to fall more steeply and domestic demand to rise. An increasing proportion of the decline in output is reflected in lower exports with the balance made up in higher imports.

Table 2: Oil output, demand and trade

(annual changes, £bn 1980)

	Oil output	Oil demand	Net exports	Gross exports	Gross imports
1987	- 0.4	- 0.3	0.0	- 0.1	- 0.2
1988	- 0.8	0.2	- 0.9	- 0.3	0.6
1989	- 0.8	0.1	- 0.8	- 0.6	0.2

(annual per cent changes)

	Oil output	Oil demand	Net exports	Gross exports	Gross imports
1986	- 0.8	- 0.4		1.9	16.1
1987	- 3.1	- 4.2		- 1.4	- 4.0
1988	- 6.4	3.6		- 3.1	12.1
1989	- 6.3	1.2		- 5.9	3.2

4. These assumptions about exports and imports are necessarily arbitrary with little effect on net oil trade. On balance, we expect much of the fall in output to be reflected in lower exports but the effect may vary from year to year. There are presentational advantages in not depressing the total export forecast unduly although this implies an offsetting rise in imports which may appear steep at times - given the modest starting base.

A Bottrill

A BOTTRILL

BURNS POLICY IMPLICATIONS

SECRET

pmp

FROM: SIR T BURNS
DATE: 29 JANUARY 1988

CHANCELLOR

cc Principal Private Secretary
Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir G Littler
Mr Anson
Mr Byatt
Sir A Wilson
Mr Scholar
Mr Culpin
Mr Odling-Smee
Mr Sedgwick
Miss C Evans
Mr A Hudson
Mr Cropper
Mr Tyrie
Mr Call

WINTER FORECAST 1988: SOME POLICY IMPLICATIONS

You have seen the Winter Economic Forecast. This note comments on some aspects of the forecast and the policy implications.

2. When considering the growth prospects for 1988 it is worth paying some attention to the growth through the year in addition to the annual growth figures. Output has grown so rapidly during 1987 that even modest growth rates through 1988 are sufficient to produce a respectable figure for the annual growth rate.

3. Table 1 shows figures for a number of years - defining through the year as growth between the second half of the year and the second half of the previous year.

Table 1

Output and Expenditure

Percentage changes on a year earlier	**1986 H2**	**1987 H2**	**1988 H2**	**1989 H2**
Real GDP	3.6	5.0	2.0	2.4
Non-oil GDP	3.9	5.8	2.5	2.6
Exports of goods & services	6.1	5.2	1.6	2.5
Imports of goods & services	10.2	7.1	3.8	3.1
Domestic Demand	4.6	5.0	3.0	2.6
Consumer Spending	6.0	5.7	3.2	2.8
Fixed Investment	3.3	2.7	6.7	3.2

4. The main features of the table are as follows:

- output growth through 1988 is expected to fall to 2 per cent following growth of about 5 per cent through 1987. The turnround in non-North Sea GDP could be even more dramatic - from almost 6 per cent to 2½ per cent;

- an important force behind the slower growth is the pattern of export growth. It has been very rapid through 1987, reflecting some pick-up of world trade growth, a strong competitive position against non-dollar currencies and better performance generally. The projections show much reduced growth through 1988 mainly because we are looking for slower growth of world trade. In addition there are likely to be some adverse effects from sterling's appreciation against the dollar;

Through 88, but not 88/87

- domestic demand growth is also expected to be lower through 1988. Consumer spending is one contributory factor as the savings ratio is projected to rise following recent sharp reductions. Stockbuilding may also make less of a contribution this year. On the other hand investment growth is expected to be much stronger in 1988 than in 1987.

5. The current account deficit is projected to widen further - this reflects the bigger contribution which exports are expected to make to the slowdown compared with domestic demand.

6. Inflation, as measured by the RPI, is not expected to change much although the relative contribution of costs and margins may be different. For the past two years unit labour costs in manufacturing have scarcely changed. But companies have taken advantage of the strength of demand to raise margins. Next year slower growth of output is likely to mean a slower growth of productivity and more rapid growth of unit labour costs. The forecast has no further increase in margins in 1989.

7. The fiscal background continues to look favourable. The forecast shows a negative PSBR for each of the years 1987-88 to 1989-90 of between ½ and ¾ per cent of GDP after allowing for a cumulative fiscal adjustment of over £6 billion over the next two years.

8. As background to the assessment of risks it is worth considering how things have turned out over the past year compared to the forecast made 12 months ago.

Table 2

Forecast and Outturn

Percentage changes 1987 H2 on a year earlier	Winter Forecast 1987	Estimated Outturn
Real GDP	2.5	5.0
Exports of Goods & Services	2.1	5.2
Imports of Goods & Services	4.7	7.1
Domestic Demand	3.2	5.0
Consumer Spending	2.5	5.7
Fixed Investment	4.2	2.7
RPI	4.8	4.2
GDP deflator	4.3	5.0
World trade in manufactures	3.4	4.5
G6 GNP	2.8	3.0

9. The comparison in table 2 concentrates on the growth rates between the second half of 1986 and the second half of 1987:

- output grew about twice as fast as expected. Domestic demand and, particularly, exports were much stronger than forecast;

- the strength of exports partially reflects stronger growth of world trade of manufactures. One interesting feature is that the faster world trade growth owes virtually nothing to the strength of G6 GNP but to faster demand growth elsewhere. The rest of the explanation for UK export growth has to be put down to better performance;

- imports also grew faster than expected. But this can more than fully be explained by the more buoyant final expenditure; adjusted for differences in final expenditure and competitiveness changes the growth of imports was probably less than expected;

- the more buoyant domestic demand growth was more than accounted for by consumer spending - investment growth was below expectations. Some of the consumption growth is endogenous and reflects stronger output and income; but more than half is due to the unexpected decline of the savings ratio;

- the exchange rate was much stronger than expected even though the interest differential with other countries was smaller. This combination helped the RPI inflation rate which turned out less than expected. By contrast the growth of manufactured output prices (excluding food, drink and tobacco) and the GDP deflator grew by more than shown in the forecast. This was despite a slow growth of costs and reflects a sharp increase in profit margins. Cost growth was helped by a very large increase in manufacturing productivity;

- public sector finances have been very strong and the PSBR error is likely to be bigger than for many years. It is difficult to disentangle the contribution of faster growth and a stronger structural position. Both seemed to have played a significant part.

10. Taken at face value the forecast prospect would be a reasonably satisfactory outcome. After two years of relatively rapid output growth - virtually 10 per cent growth in non-oil output between the second halves of 1985 and 1987 - it would mean a return to a rate only a little below our estimate of medium-term potential growth. In the past periods of above average growth have often been followed by periods of below average growth.

11. But as set out in the Forecast report there are clear risks. And if some of these risks emerge the outcome will not be so comfortable.

12. It is not difficult to set out a combination of factors that could lead to a potentially troublesome outcome. For example if domestic demand was to continue to grow rapidly (because the savings ratio did not rise) but export growth slowed (because the delayed effects of competitiveness losses are greater than assumed), the current account position would deteriorate further. Equally if this was combined with more inflationary pressure (because demand growth left room for a further increase in margins) sterling might weaken and interest rates would have to rise. If the subsequent braking of the economy coincided with a sharp world downturn we could see a more abrupt slowdown later than shown in the forecast although it might not occur until 1989.

13. Another possibility is a repeat of the 1987 pattern and exports as well as domestic demand growth turns out significantly higher than shown in the forecast. The outcome would then depend on the reasons for the faster export growth. If it was faster world trade growth we would expect to see world commodity prices strengthen and margins at home might widen. Combined with rising interest rates it would make some upturn of the inflation rate difficult to avoid. If the faster export growth was simply due to better performance the threat from commodity prices would be less and there would be less additional domestic inflationary pressure because of improved supply.

14. A slowdown in demand at home and/or abroad compared with the forecast would be tolerable as long as it was not too sharp. It would take the pressure off prices and domestic capacity and improve the chance of reducing inflation further. Indeed after the recent period of rapid growth a short period of pause would be a suitable opportunity for everyone to draw breath.

15. I have no strong views as to the balance of risks. We cannot explain the scale of the recent fall in the savings ratio, as it normally rises when disposable income is growing rapidly. And yet we know it can fluctuate sharply mainly because of cycles in durable spending. Similarly the exchange rate has been surprisingly strong given our large growth gap with other countries and the diminishing interest rate differential; but we know from past experience that this can also turn round quickly. Productivity growth is another uncertainty. In recent years it growth has persistently outperformed our expectations. The forecast assumes a marked slowdown but this may again be too cautious.

16. My instinct is that in the absence of the stock market crash and the recent dollar weakness we would have had a further year of growth, close to, or even a little above, trend as investment added to the existing momentum. But it would probably have brought with it some upturn of inflation. The stock market effects have to be set against this. It will take time before these are felt even though markets have been relatively stable recently. But they must be a negative influence on growth and probably beneficial for inflation.

17. To summarise: the picture as projected, whilst being far from ideal, is more than satisfactory. There are no obvious biases to the forecast but given recent growth, the present situation and objectives for inflation, the costs associated with more rapid domestic growth probably exceed the costs of a period of pause. This leads me to continue to argue for some tightening of monetary policy when the opportunity arises and to be cautious about the

size of the fiscal package in the Budget. In recent years we have had the pleasant experience of finding government revenues repeatedly outperforming expectations, partly because we have underestimated output growth. But we know that such errors tend to cycle - errors in one direction persisting for a few years before being reversed. And there are obvious risks on the expenditure front - for example public sector pay, social security growth and the puzzle of local authorities' finances: although the forecasters have made some allowance for greater expenditure than the plans envisage in these areas.

18. I do not want to suggest abandoning the package you are considering. It is a coherent whole and I accept that basically we buy virtually all of it or have a very different budget.

19. With steady growth real fiscal drag provides some scope for "tax cuts" year after year, of maybe £2 billion. In addition public expenditure is declining as a share of GDP and the PSBR is close to balance even excluding privatisation proceeds.

20. There is scope for a larger package than in recent budgets if there are good structural arguments. The most worrying features are the substantial costs in later years but these are an integral part of the package. Nevertheless it does imply doing what is possible to minimise the size of the total package - particularly for the later years - within the constraints of the present approach.

T BURNS

ph:85

PICKFORD 16/2

covering SECRET

FROM: S J PICKFORD

DATE: 16 FEBRUARY 1988

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Mr Scholar
Mr Culpin
Mr H P Evans
Mr Odling-Smee
Mr Sedgwick
Miss Simpson
Mr Patterson
GJ/003

BRIEFING FOR CABINET: 18 FEBRUARY

I attach the following briefs for Thursday's economic discussion in Cabinet:

- A Recent economic developments
- B Economic prospects
- C Fiscal prospects
- D Tax options (including an annex on Ministerial representation)
- D International comparisons

The briefs have been produced by EA, FP and IF, as well as EB.

2. Brief A includes the labour market statistics which will be published on Thursday at 11.30 am. You will be receiving tomorrow separate briefing from MG1 on the money figures and from EA1 on the capital expenditure statistics (also published on Thursday).

3. Mr Odling-Smee will be submitting separately a speaking note to introduce your paper, and MG1 will be putting up a fact sheet on interest and exchange rates tomorrow.

Stephen Pickford

S J PICKFORD

PERSONAL AND CONFIDENTIAL
until 11.30am on Thursday 18 February

BRIEF A

BRIEF A

UK ECONOMY : RECENT DEVELOPMENTS

(i) Retail price inflation

- Annual increase of 3.4 per cent in 1986 and 4.2 per cent in 1987. Fell from 4.4 per cent mid-1987 to 3.7 per cent in December 1987 and 3.3 per cent in January 1988.
- Excluding mortgage interest payments, running around 4 per cent in year to 1987Q4.

(ii) GDP and components (1980 prices)

percentage changes from previous period

	1981H1 to first 3 qtrs of 1987 average annual rate	1987Q3 on 1987Q2	1987Q3 on 1986Q3
Consumers' expenditure	3½	2½	5¾
General government consumption	¾	1½	¾
Fixed investment	4	0	2
Exports of goods and services	4¼	3¾	7½
Imports of goods and services	6¾	6	8¾
GDP(A)	**3**	**2¼**	**5¼**
GDP(A) excluding oil	2¾	2¼	6

(iii) Industrial production : in 1987Q4 1¼ per cent higher than in 1987Q3 and nearly 4½ per cent up on 1986Q4. In 1987 3 per cent higher than in 1986.

(iv) Manufacturing output: in 1987Q4 1½ per cent higher than 1987Q3 and over 5½ per cent higher than in 1986Q4. In 1987 5½ per cent higher than in 1986. Manufacturing productivity up 6¼ per cent in year to 1987Q4.

(v) Company sector

- Industrial and commercial company (ICC) profits (excluding North Sea oil companies) up 16 per cent in first 3 quarters of 1987 on year earlier. Trebled in nominal terms since 1980 and doubled in real terms.

- For non-North Sea ICCs, profitability 9 per cent in 1986. Manufacturing profitability 7¼ per cent in 1986. In both cases, risen every year since 1981, now highest since 1973, and likely to rise further in 1987.

(vi) Fixed investment :

- Total investment in first 3 quarters of 1987 up over 3¼ per cent on year earlier.
- Manufacturing investment fell 2½ per cent between 1987Q2 and Q3 but up nearly 5 per cent between 1986Q3 and 1987Q3. [NB Provisional figures for 1987Q4 published on 18 February.]

(vii) Construction output : Up nearly 5 per cent between 1987Q2 and Q3, and over 9 per cent higher than year earlier.
Construction orders in 3 months to November up 11 per cent on year earlier.

(viii) Retail sales volume in 3 months to January nearly 6½ per cent higher than year earlier.

(ix) Current account

- Deficit of £2.7 billion in 1987, around ¾ per cent of GDP.

- Non-oil export volumes of goods (excluding erratics) in 1987 up 8 per cent on 1986. In 1987Q4 up 4½ per cent on 1986Q4.

- Non-oil import volumes of goods (excluding erratics) in 1987 up 9½ per cent on 1986. In 1987Q4 up 11 per cent on 1986Q4.

(x) Employment up by over 1½ million since March 1983. Risen for eighteen successive quarters.

(xi) Unemployment level : 2,563,000 (9.2 per cent of working population) in January 1988. Seasonally adjusted total fell 51,000 in January; over last 12 months fallen by 549,000. Fallen for eighteen months in succession. Fallen in all regions over past year.

(xii) Underlying rate of increase in average earnings risen from 7½ per cent in first 3 months of 1987 to 8½ per cent in year to December. This rise in part due to higher overtime hours, partially offset by effect of lower settlements. But recent figures boosted by second stage of teachers' settlement and LA manuals' settlement.

(xiii) Unit wage and salary costs in manufacturing in 1987Q4 up 2.0 per cent on year earlier. In whole economy risen 3.3 per cent in year to 1987Q3.

P Patterson
EB Division (Ext 5207)
16 February 1988

CONFIDENTIAL

BRIEF B

ECONOMIC PROSPECTS

I. DEMAND AND ACTIVITY

i. GDP rose by about 4 per cent in 1987. In 1988, growth is likely to move back closer to 3 per cent trend of last five years.

ii. Domestic demand expected to grow in 1988 at about same rate as in 1987 and to be balanced, with faster growth of business investment and slower growth of personal spending.

Company Sector

iii. DTI Investment Intentions Survey (December 1987) points to 11 per cent increase in manufacturing investment in 1988 and 6 per cent increase in investment by construction, distribution and selected service industries. January CBI survey (post-stock market fall) also suggests strong growth in manufacturing investment.

iv. Real rate of return on non-North Sea industrial and commercial companies was probably 10-11 per cent in 1987, a level not seen since the 1960s. Profitability should remain high in 1988.

Personal Sector

v. Consumer's expenditure rose 5 per cent in 1987. It is likely to continue growing in 1988, but at a slower rate.

vi. Housing investment, after recent boom, likely to grow more slowly, more in line with real personal disposable income.

vii. Saving ratio likely rise in 1988 from recent very low levels, though still remain low by historical standards.

External Trade and Current Account

viii. Merchandise export volumes (excluding oil) rose sharply in 1987, by 7 per cent. Likely to show further growth in 1988. Growth in import volumes should slow down as GDP growth moderates.

ix. With continuing decline in oil exports, current account deficit could widen slightly from the modest (½-¾ per cent of GDP) recorded in 1987.

II INFLATION

i. Annual rate of RPI inflation in 1987Q4 was 4 per cent, and 3.3 per cent in January 1988. Should edge up in coming months on conventional assumption of specific duties' revalorisation (no revalorisation in last Budget) and nationalised industry prices increase (after falling in real terms in last three years). Inflation likely to be close to 4 per cent in 1988Q4.

ii. Average earnings rose by about 8 per cent over past year. Pay settlements declined slightly during 1986-87 pay round, but earnings boosted by record overtime working.

iii. Pay settlements may increase in current pay round, but overtime working and overtime earnings should moderate during 1988, as economic growth closer to trend.

III PRODUCTIVITY, EMPLOYMENT AND UNEMPLOYMENT

i. Manufacturing output per head in 3 months to November up 6½ per cent on year earlier. Average growth of more than 4 per cent per annum since 1979. Underlying productivity growth should remain high in 1988.

ii. Non-manufacturing output per man hour risen by 2½ per cent per annum since 1983 (output per head grown more slowly because part-time unemployment rising).

iii. Employment rose sharply during 1987; in the year to September 1987 increased by over 450,000. With continued output growth, it is likely to rise further through 1988.

iv. Unemployment (seasonally adjusted, adult) fallen for eighteen months in succession, by total of 600,000. It should continue to fall. Revised assumptions for public expenditure recently issued to Departments are for 2.4 million adult unemployment in GB in 1988-89 (December 1987 figure was 2.5 million).

IV OUTSIDE FORECASTS

Current average of outside forecasters' views for 1988 is:

1988 GDP growth	$2\frac{1}{2}$%
1988 Current Account	-£$3\frac{1}{2}$ billion
1988Q4 RPI (change on year earlier)	4%

LINE TO TAKE

Positive

i. Forecast depicts further steady growth in GDP in 1988 while inflation remains low. Since 1981 growth has averaged 3 per cent, compared to 2 per cent average in 1970s.

ii. Employment growth likely to continue and unemployment should fall further.

Defensive

i. Growth based on consumer boom? Growth in 1988 likely to be balanced, with investment growth picking up.

ii. Consumer growth sucking in imports? All categories of imports grew in 1987; capital goods and raw materials for industry, as well as consumer goods.

iii. Capacity constraints? [January CBI Survey showed record balance of firms reporting not working below capacity]. CBI Survey showed high capacity utilisation, but no widespread indications of capacity problems. Inflation remains low, few labour shortages evident (cf 1973 when labour shortages were acute), current account deficit remains small as share of GDP. Moreover, industry better able to work efficiently at high levels of capacity utilisation and, given prospects for slower growth and more buoyant outlook for investment, capacity not expected to be a problem

iv. Current account too optimistic? 1987 deficit much as predicted in the 1987 FSBR and Autumn Statement.

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BRIEF C

BRIEF C

FISCAL PROSPECTS

Factual

a) **Historical statistics on PSBR**

(For longer run of figures see Annex)

	PSBR			PSBR excluding privatisation proceeds		PSFD	
	Cash £ billion	Real terms (base year 1986-87) £ billion	Ratio to GDP (per cent)	Cash £ billion	Ratio to GDP (per cent)	Cash £ billion	Ratio to GDP (per cent)
1969-70	- 0.6	- 3.3	-1¼	- 0.6	-1¼	- 0.8	-1¾
1975-76	0.3	28.5	9¼	10.3	9¼	8.1	7¼
Average 1974-75 to 1978-79	8.2	21.3	6¾	8.3	6¾	7.3	5¾
1979-80	10.0	16.7	4¾	10.4	5	8.0	3¾
1986-87	3.4	3.4	1	7.8	2	9.6	2½
Average 1979-80 to 1986-87	8.7	11.0	3¼	10.2	3½	9.5	3¼

PSBR (including and excluding privatisation proceeds) on course to be lowest as percentage of GDP since beginning of 1950s, with single exception of 1969-70.

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SECRET

b) 1987-88 PSBR Outturn to date

	April to January Outturn 1987-88	1986-87	£ billion Difference
PSBR	- 6.9	0.5	- 7.4
PSBR excluding privatisation proceeds	- 1.8	3.7	- 5.6
CGBR(O)	- 6.0	2.2	- 8.2
LABR	0.1	- 0.6	0.6
PCBR	- 0.9	- 1.1	0.2

PSBR (excluding privatisation) April - January £5½ billion lower than in same period last year.

c) PSBR in 1987-88 - Forecasts

	1987 Budget forecast	1987 Autumn statement forecast	1988 January Internal*	£ billion
General government expenditure	173.5	172.8	171.9	
General government receipts	168.8	171.1	173.7	
General government borrowing requirement	4.7	1.7	- 1.9	
Public corporations' markets and overseas borrowing	- 0.8	- 0.7	- 0.9	
PSBR	3.9	1.0	- 2.8	
PSBR (excluding privatisation proceeds)	8.9	6.0	2.2	
PSBR as per cent of GDP	2¼	1½	- ¾	

* January forecast has not been circulated outside the Treasury except to No. 10.

SECRET

d) Forecast of Taxes and NICs in 1987-88

£ billion

	1987 Budget forecast	1988 January Internal*	Difference
Income Tax	40.0	41.2	+ 1.2
Non-NS Corporation Tax	13.5	15.2	+ 1.7
VAT	23.3	24.1	+ 0.8
Stamp duties	2.1	2.4	+ 0.3
Other Non N.Sea Taxes	45.0	45.0	-
North Sea Revenues	3.9	4.6	+ 0.7
NICs	28.5	28.9	+ 0.4
Total Taxes and NICs	156.3	161.4	+ 5.1

* January forecast has not been circulated outside the Treasury except to No. 10.

Positive

1. Surplus on PSBR this year now looks likely. Would be only second surplus recorded since beginning of 1950s.

2. Reaping rewards of sticking to our policies of firm control of public expenditure, within framework of MTFS. Has achieved economic growth and falling unemployment, without rising inflation.

Defensive

1. Continuing economic success requires keeping public expenditure under control. Only way to make more resources available is by creating them in the first place through economic growth.

2. Cannot count on buoyancy of revenues over past two years continuing indefinitely. Growth in economy likely to slow in 1988 - and growth in revenues with it.

UNCLASSIFIED

PUBLIC SECTOR BORROWING: HISTORICAL TRENDS

	PSBR			PSBR excluding privatisation proceeds		Public Sector Financial Deficit (PSFD)	
	Cash £ billion	Real terms (1986-87 prices) £ billion	Ratio to GDP (per cent)	Cash £ billion	Ratio to GDP (per cent)	Cash £ billion	Ratio to GDP (per cent)
1948	not av	not av	not av	not av	not av	-0.3	-2¼
1949	not av	not av	not av	not av	not av	-0.3	-2½
1950	not av	not av	not av	not av	not av	-0.4	-2¾
1951	not av	not av	not av	not av	not av	0.2	1½
1952	0.8	8.2	5	0.8	5	0.6	3½
1953	0.6	5.9	3½	0.6	3½	0.7	4
1954	0.4	3.7	2	0.4	2	0.4	2½
1955	0.5	4.5	2½	0.5	2½	0.4	2
1956	0.6	5.1	2¾	0.6	2¾	0.5	2½
1957	0.5	4.2	2¼	0.5	2¼	0.5	2½
1958	0.5	4.1	2	0.5	2	0.4	2
1959	0.6	4.6	2¼	0.6	2¼	0.6	2¼
1960	0.7	5.7	2¾	0.7	2¾	0.7	2¾
1961	0.7	5.5	2½	0.7	2½	0.7	2¾
1962	0.5	4.1	1¾	0.5	1¾	0.5	1¾
1963	0.8	6.1	2¾	0.8	2¾	0.8	2¾
1963-64	1.0	7.7	3¼	1.0	3¼	1.1	3¼
1964-65	0.9	6.4	2¾	0.9	2¾	0.8	2¼
1965-66	0.9	6.4	2½	0.9	2½	0.6	1¾
1966-67	1.1	7.4	3	1.1	3	1.0	2¾
1967-68	2.0	12.7	4¾	2.0	4¾	1.7	4¼
1968-69	0.4	2.2	¾	0.4	¾	0.4	¾
1969-70	-0.6	-3.4	-1¼	-0.6	-1¼	-0.8	-1¾
1970-71	0.8	4.1	1½	0.8	1½	-0.2	-½
1971-72	1.0	4.7	1¾	1.0	1¾	0.7	1¼
1972-73	2.4	10.9	3½	2.4	3½	2.0	3
1973-74	4.3	18.1	5¾	4.3	5¾	3.5	4½
1974-75	8.0	28.0	9	8.0	9	6.0	6¾
1975-76	10.3	28.5	9¼	10.3	9¼	8.1	7¼
1976-77	8.3	20.4	6½	8.3	6½	7.5	5¾
1977-78	5.4	11.6	3½	5.9	4	6.6	4¼
1978-79	9.2	18.0	5¼	9.2	5¼	8.3	4¾
1979-80	10.0	16.7	4¾	10.4	5	8.0	3¾
1980-81	12.7	17.9	5¼	13.1	5½	11.7	5
1981-82	8.6	11.1	3¼	9.1	3½	5.2	2
1982-83	8.8	10.6	3	9.3	3¼	8.3	3
1983-84	9.7	11.1	3¼	10.9	3½	11.5	3¾
1984-85(1)	10.2	11.1	3 [2.1]	12.3	3¾ [2.9]	13.1	4 [3.1]
1985-86(1)	5.8	5.9	1½ [1.3]	8.5	2¼ [2]	8.2	2¼ [2]
1986-87	3.4	3.4	1	7.8	2	9.2	2½
1987-88 (AS forecast)	1.0	1.0	¼	6.0	1½	6.1	1½

(1) Figures in brackets are adjusted for coal strike.

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FP1

BRIEF D

TAX OPTIONS

1. Tax Burden and Incomes

- Taxes (including NICs and LA rates) as percentage of GDP:

	% Non-north sea GDP	Excluding North Sea Taxes	North Sea Taxes	Total, incl. North Sea Taxes
1970-71		36.2	0	36.2
1974-75		35.7	0	35.7
1978-79	34.1	33.5	0.3	33.8
1979-80	35.2	34.0	1.1	35.1
1980-81	36.1	34.6	1.7	36.3
1981-82	38.7	36.9	2.5	39.4
1982-83	38.2	36.1	2.8	38.9
1983-84	37.8	35.6	2.9	38.5
1984-85	37.8	35.4	3.7	39.1
1985-86	37.0	35.4	3.1	38.5
1986-87	37.4	36.7	1.2	37.9
1987-88 (est)	37.7	36.9	1.1	38.0

(not in your paper)

- Income tax and NICs as percentage of earnings:

Multiples of Average Earnings	Single 1978-79	Single 1987-88	Married: One Earner, No Children 1978-79	Married: One Earner, No Children 1987-88	Married: One Earner, Two Children* 1978-79	Married: One Earner, Two Children* 1987-88
50 per cent	23.6	25.0	16.0	18.9	2.5	6.2
100 per cent	31.5	30.5	27.8	27.4	20.9	21.1
200 per cent	33.7	32.2	31.4	29.7	27.9	26.5

* net of child benefit

- Percentage change in real take-home pay:

Multiples of Average Earnings	Single 78-79 to 87-88	Married: One Earner, No Children 78-79 to 87-88	Married: One Earner, Two Children 78-79 to 87-88
50 per cent	20.9	19.2	18.6
100 per cent	25.1	23.9	22.9
200 per cent	26.1	26.4	25.6

2. Income Tax and NICs

The Record since 1979:

- Main personal allowances increased by 22 per cent in real terms.

BRIEF D

- First higher rate threshold increased by over 10 per cent and 60 per cent threshold by over 60 per cent in real terms.
- Age allowance increased by 13 per cent in real terms and enhanced age allowance introduced in 1987 for over 80s.
- Basic rate cut 6 percentage points to 27 per cent.
- Reduced rate band of 25 per cent on first £750 taxable income abolished.
- Top rates cut from 98 per cent (unearned) and 83 per cent (earned) to 60 per cent on both.
- Employees' NICs up from 6.5 per cent to 9 per cent (not contracted-out) for those earning above £105 per week.
- Reduced rate NIC bands introduced in 1985. Employee rates in 1988-89:

Below £ 41	Nil
£ 41 - £ 69.99	5 per cent on all earnings
£ 70 - £104.99	7 per cent on all earnings
£105 - £305	9 per cent on all earnings
Above £305	9 per cent on £305

3. **Background to Income Tax Options**

- Ready Reckoner:

	1988-89 cost	**1989-90 cost**
Reduce basic rate by 1p	£1250m	£1600m
Increase personal allowances and higher rate thresholds by 1 per cent	£ 215m	£ 295m
Abolish all higher rates above 50p	£ 280m	£ 590m

- For those on average earnings, cut in basic rate much more effective than equal-cost increase in allowances at reducing percentage of earnings taken in income tax and NICs.
- Chancellor told 1987 Party Conference that tax treatment of married women no longer acceptable and must change.
- Proposed top rates of tax in other countries: USA 45% (inc. local tax), New Zealand 48%, Australia 49%, France 50%, Germany 53%, Ireland 56%.
- UK's starting rate of income tax well above US, Japan and Germany but UK tax threshold as percentage of earnings above average for developed countries. (See annex)

4. **Taxes on Business**

- Burden of Business Tax:

	CT as percentage of total taxes	Business Taxes as percentage of GDP
1978-79	8.1	9.1
1979-80	7.6	8.9
1980-81	6.5	8.9
1981-82	5.7	9.2
1982-83	6.2	8.9
1983-84	6.4	8.6
1984-85	7.8	8.6
1985-86	9.4	8.7
1986-87	11.3	9.5

The Record since 1979:

- Major reform of CT in 1984; rate reduced in stages from 52 per cent to 35 per cent; stock relief withdrawn; initial allowances replaced by writing down allowances.
- Companies' capital gains taxed at same rate as their income from 1987.
- Small companies' rate reduced in stages from 42 per cent to 27 per cent and limit for marginal relief greatly increased.
- BES introduced.
- Employers' NICs up from 10 per cent to 10.45 per cent and UEL scrapped, but NIS abolished and reduced rates introduced.
- Employers' NIC rates in 1988-89:

Below £41	Nil
£ 41 - £ 69.99	5 per cent on all earnings
£ 70 - £104.99	7 per cent on all earnings
£105 - £154.99	9 per cent on all earnings
Above £155	10.45 per cent on all earnings

- Self-employed (class 4) NICs 50 per cent deductible since 1985.

5. **<u>Background to Business Tax Options</u>**

- Ready Reckoner:

	1988-89 <u>cost</u>	**1989-90 <u>cost</u>**
Cut full CT rate by 1p*	£ 360m	£ 560m
Cut top rate of employers' NICs by 1 percentage point	£1550m	£1700m

*Costed on Autumn Statement convention, ie revenue cost if new rate applied to incomes from 1 April of preceding year.

- Transitional effects of 1984 CT reforms now worked through and company sector paying lower effective tax rates for given level of profit and investment than under old system.
- Strong profit growth, healthy pace of investment, marked growth in dividends and buoyant pay settlements all indicate ample corporate liquidity.
- CT rate lowest in EC and one of lowest in industrialised world. Employers' NIC burden also very much below the average.

6. **<u>Initiatives in past Budgets</u>**

- Profit Related Pay: 480 schemes registered by end of JANUARY ~~1987~~, covering over 80,000 employess.
- Personal Equity Plans: 230,000 plans taken out by end-November 1987, with £415 million invested.
- Payroll Giving: more than 2200 employers have now set up schemes.

UNCLASSIFIED

Income tax: rates and thresholds (1987)

Single person

	Tax rate(1) %	Income tax as % of APW(2) earnings %	Threshold(3) £	Threshold as % of APW(2) earnings %
UK (1987-88)	**27**	**20**	**2,425**	**25**
Denmark	51	44	1,900	18
France (1986)	26	8	4,070	57
West Germany	22	20	1,930	20
Italy	12	15	2,460	37
Japan	15	8	2,740	35
Netherlands	15	13	2,635	28
US	11	15	2,540	21

Married without children

	Tax rate(1) %	Income tax as % of APW(2) earnings %	Threshold(3) £	Threshold as % of APW(2) earnings %
UK (1987-88)	**27**	**17**	**3,795**	**39**
Denmark	51	38	3,455	33
France (1986)	19	2	6,330	89
West Germany	22	12	3,370	34
Italy	22	13	3,565	48
Japan	11	5	4,590	51
Netherlands	16	7	4,840	51
US	11	10	4,320	36

(1) Starting rate of tax on employment income. Tax rates are sum of national and local income taxes.

(2) APW = average production worker

(3) Thresholds converted using purchasing power parity. Local income tax thresholds may differ from the national thresholds above.

Source: Board of Inland Revenue 'International Comparisons of Direct Tax on Employment Income', December 1987. Does not include Canada.

UNCLASSIFIED

MINISTERIAL REPRESENTATIONS

Letters from: Lord Young and Messrs Fowler, King, Ridley, Baker, MacGregor, Rifkind, Channon, Moore, Parkinson and Luce

Meetings with: Lord Young, Mr Ridley and Ministerial group on alcohol abuse.

Main Topics:

EXCISE DUTIES

Messrs Ridley, Rifkind and Parkinson support increased differential for **unleaded petrol**;
Mr Channon prefers no change.

Messrs Rifkind and Moore support significant increase for **tobacco**;
Mr King suggests revalorisation only.

Mr Moore supports increase for **alcohol**;
Mr Hurd wants duty to have a close relationship to alcoholic strength;
Mr Rifkind wants no increase for Scotch Whisky.

IT AND CT

No comments on main rates except that Lord Young supports reductions. Some detailed suggestions eg Lord Young proposes relaxation of dispensation requirements for PIID forms.

NICs

Lord Young concerned about steps for employers;
Mr Fowler proposes 50% allowance for Class 2.

CGT

Mr Rifkind suggests replace by tax on short term gains;
Mr MacGregor wants to reduce CGT burden for farmers and landowners.

IHT

Mr MacGregor recommends raising threshold and widening bands;
Mr Fowler suggest some relief for unquoted companies.

VAT

Mr Luce argues against extension to books and papers.
Number of detailed changes suggested by Lord Young and Messrs Baker and Fowler.

BUSINESS TAXATION

Lord Young and Mr Fowler proposes a number of measures, some technical, intended to encourage enterprise and small businesses. Many have been considered and rejected before, eg "Local Enterprise Companies".

BRIEF E: INTERNATIONAL COMPARISONS

1. GDP/GNP growth

- Growth in UK expected to be above major seven average and EEC average in 1986, 1987 and 1988.

- Growth in UK probably highest among G7 in 1987.

	Percentage change from year earlier		
	1986	1987 (estimate)	1988 (forecast)
United Kingdom	3.1	4*	2½*
United States	2.9	2.9	2½
Japan	2.4	3½	3½
Germany	2.5	1.7	1½
France	2.0	1½	1½
Italy	2.7	2¾	2
Canada	3.3	3¾	2¾
Major seven	2.8	2¾	2½
EC	2.6	2¼	1¾

Note: OECD estimates and forecasts except UK.

* Autumn Statement forecast.

2. Inflation

- UK inflation now lower than US, Italy and Canada. At 3.3 per cent in January, it is now close to averages for Major 7 and for EC (but still above average if mortgage rate excluded).

Percentage change from year earlier

	1986	1987	December 1987	1988 (forecast)
United Kingdom	3.4	4.2	3.7	4½*
United States	1.9	3.7	4.4	4
Japan	0.4	-0.2	0.5	1¾
Germany	-0.2	0.3	1.0	1¾
France	2.5	3.3	3.1	2¾
Italy	6.2	4.6	5.1	4¾
Canada	4.2	4.4	4.2	4
Major seven	1.9	2.7	3.4	3¼
EC	3.2	3.0	3.3	3¼

Note: OECD forecasts of consumers' expenditure deflator except UK.

* Autumn statement forecast, for 1988Q4 (RPI).

3. Industrial Production

	Percentage change over a year earlier		
	1986	1987Q1-Q3	Latest 3-months
United Kingdom*	1.8 (0.4)	2.9 (5.5)	3.8 (5.6)
United States	1.1	3.1	5.6
Japan	-0.3	2.2	9.3
Germany	2.1	-0.3	1.9
France	0.8	1.3	2.6
Italy	2.7	3.2	5.7
Canada	1.3	3.7	8.1
Major seven	1.1	2.3	5.4

Source: OECD

* Figures in brackets are for manufacturing, which has grown faster than total industrial production since 1986 with oil output declining.

4. Productivity growth

- Since 1980 productivity growth in UK manufacturing highest among G7.

- Since 1980 whole economy productivity growth in UK equal highest with Japan among G7.

	Manufacturing productivity 1980-87	Whole economy productivity 1980-87
United Kingdom	5.3	2.7
United States	4.1	0.9
Japan	2.8	2.7
Germany	2.2	1.7
France	2.9	1.7
Italy	3.3	1.7
Canada	3.2	1.4
Major seven	3.6	1.6

Note: Includes estimates for 1987.

5. Current account

- UK deficit forecast for 1988 small compared to imbalances of US, Japan, Germany even when expressed as percentage of GDP.

$ billion (% of GDP)

	1986	1987 (estimate)	1988 (forecast)
United Kingdom	-2 (-0.3)	-3 (-0.4)	-6 (-0.7)
United States	-141 (-3.3)	-156 (-3.5)	-134 (-2.8)
Japan	86 (4.4)	86 (3.7)	81 (3.0)
Germany	37 (4.1)	44 (3.9)	41 (3.2)
France	3 (0.4)	-3 (-0.4)	-5 (-0.5)
Italy	4 (0.7)	-2 (-0.3)	-4 (-0.4)
Canada	-7 (-1.8)	-7 (-1.6)	-7 (-1.6)
Major seven	-20 (-0.2)	-41 (-0.4)	-35 (-0.3)

Source: OECD forecasts.

6. Interest rates

Per cent

	3-month rates		10-year bond yield	
	One year ago	9.2.88	One year ago	9.2.88
UK	11.0	9.5	10.1	9.8
US	6.1	6.6	7.2	8.2
Japan	4.0	3.8	4.8	4.3
Germany	4.0	3.4	6.2	6.3
France	8.3	7.6	8.9	9.1
Italy	11.6	11.0	9.8	10.2
Canada	7.5	8.5	8.5	9.2

7. General government financial deficit

- UK deficit lower, as a percentage of GDP, than G7 average.

	Per cent of GDP		
	1979	1986	1987
United Kingdom	3.3	2.6	2.1*
United States	-0.5	3.5	2.4
Japan	4.7	0.9	1.2
Germany	2.5	1.2	1.7
France	0.7	2.9	2.8
Italy	10.1	11.2	10.3
Canada	2.0	5.5	4.4
Major seven	1.7	3.2	2.5

Source: OECD

* Autumn Statement forecast (<u>not</u> latest internal forecast). See also brief on Fiscal Prospects.

8. Share prices

	October 15 to February 11	Year to February 11
United Kingdom	-25½	-5½
United States	-14½	-6½
Japan	-10½	+11½
Germany	-31	-24½
France	-23	-32
Italy	-35	-37½
Canada	-17½	-12½
Major seven*	-19	-10½

* weighted by GDP/GNP.

1. MISS O'MARA ~~MOM~~ 17/2

2. CHANCELLOR

FROM: N I HOLGATE
DATE: 17-Feb-88

cc. Chief Secretary
Sir I Middleton
Mr Scholar
Mr Peretz
Mr Pickford
Ms Goodman
Mrs Ryding

CABINET 18 FEBRUARY: MARKET MOVEMENTS

I attach a table. Your office may wish to check the position before Cabinet.

N I Holgate

N I HOLGATE

MARKET MOVEMENTS

MARKET MOVEMENTS TO 17 FEBRUARY

	17 March 1987	19 Oct 1987	10 Feb 1987	17 Feb 1988	Change since 17 March 1987	19 Oct 1987	10 Feb 1988
Domestic							
Interbank rates							
1 month	9 7/8	9 13/16	8 25/32	8 11/16	-1 3/16	-1 1/8	-3/32
3 month	9 11/16	10 11/32	9 9/32	9 9/32	-13/32	-1 1/16	0
12 month	9 3/8	10 13/16	9 11/16	9 3/4	3/8	-1 1/16	1/16
3 month Euro$	6 7/16	9 1/4	6 11/16	6 7/8	7/16	-2 3/8	3/16
Gilts							
Index	91.08	83.85	88.61	88.76	-2.32	4.91	0.15
5 year yield	8.8	10.6	9.4	@ 9.5	0.7	-1.1	0.1
10 year yield	8.9	10.7	9.6	@ 9.6	0.7	-1.1	0.0
20 year yield	9.0	10.5	9.5	@ 9.5	0.5	-1.0	0.0
Equities							
FTSE 100	2006	2052	1719	1748	-258	-304	29
FT All Share	1001	1075	881	* 891	-110	-184	10
Foreign exchange							
£ERI	72.1	73.8	74.4	74.3	2.2	0.5	-0.1
$/£	1.598	1.687	1.763	1.750	0.152	0.063	-0.013
DM/£	2.930	2.988	2.977	2.985	0.055	-0.003	0.008
DM/$	1.834	1.772	1.689	1.706	-0.128	-0.066	0.017
Y/$	151.65	141.30	128.75	130.35	-21.30	-10.95	1.60
Oil price ($)	18.38	19.35	16.15	16.05	-2.33	-3.30	-0.10

@ estimate
* yesterday's close

NOTE

The circulation of this memorandum has been restricted. Recipients are accordingly asked to ensure that the confidentiality of its contents and the need to know principle are strictly observed. It should not be sent outside the Private Office.

Chancellor of the Exchequer

To see and return to Sir Robert Armstrong

Copy No 4 of 4 copies

MOST CONFIDENTIAL RECORD
TO
CC(87) 5th Conclusions

ECONOMIC STRATEGY

The Cabinet considered a memorandum by the Chancellor of the Exchequer (C(87) 2) on Economic Strategy.

THE CHANCELLOR OF THE EXCHEQUER said that economic performance during 1986 had been good. Growth had been at 3 per cent, inflation had averaged 3.5 per cent, the lowest since 1967, the current account of the balance of payments had been broadly in balance, and unemployment had stopped rising and started to fall.

For 1987, the prospects were also good. Growth should again be about 3 per cent, and better balanced between consumers' expenditure, investment and exports. Inflation, as measured by the Retail Price Index should edge up towards the middle of the year, but fall back again to 4 per cent by its end. The trend of unemployment should be downwards, although that did not of course mean that the total would be lower in every single month. The current account of the balance of payments was expected to show a small deficit, but the United Kingdom's large holding of overseas assets should ensure that it created no problems. Perhaps the most striking proof of the improvement in United Kingdom economic performance was provided by international comparisons of productivity. In the 1960s and 1970s the increase in output per head in manufacturing industry had been about the lowest for the major industrialised countries. Since 1979 it had been the highest.

There were of course risks. The biggest was on inflation. The United Kingdom's position as an oil exporter meant that, unlike most of its competitors, it had had to adjust to the change in oil prices by allowing the exchange rate to fall, and this was leading to the slight upturn in inflation. But it was still very low by recent standards. Another risk was on pay. Pay increases were coming down, but only slowly and not by as much as they should. Finally, there were always great uncertainties about future prospects for world trade and pressures for protectionism.

As to fiscal prospects, the fall in oil revenues and the increase in public expenditure in the previous year's Autumn Statement had reduced the scope for tax cuts. He also believed that the following year's Public Sector Borrowing Requirement (PSBR) should be reduced below the level, 1.75 per cent of Gross Domestic Product, projected in the previous year's Medium Term Financial Strategy. There should still be room for some tax reductions, and the increase in the tax burden since 1979 showed the case for making them where possible. But the overriding need remained to maintain the prudent and consistent policies which had brought about the present favourable position.

CC(87) 5th

In discussion, the following main points were made -

a. The Chancellor of the Exchequer was to be congratulated on his economic management. Sensible and prudent policies continued over several years had led to a major improvement in economic performance. Their success had also led to a marked revival of confidence in industry. They must be maintained.

b. Table 2 in Annex 3 to C(87) 2 showed that since 1979 income tax and National Insurance Contributions had risen as a percentage of gross earnings for those on average earnings. It was a major objective to reverse that. Another objective was to ameliorate the poverty and unemployment traps which were created by the interaction of the tax and benefit systems and had a depressing effect on incentives.

c. The presentation of the case for tax cuts was important. The Opposition would certainly attack them on the ground that they would suck in imports and create jobs abroad rather than in this country. The Government must demonstrate that they were part of a strategy for creating jobs by strengthening incentives throughout the country. The economic case for concentrating on cuts in the basic rate rather than increases in allowances, if that were decided on, would also need to be strongly presented.

d. The Government had a good record on tax reform. This also was important to improving the performance of the economy, and the Government should show that it intended to go further in that direction in the longer term. But it was probably not appropriate to include proposals for major tax reform in a Budget which might be followed later in the year by a General Election.

e. Interest rate reductions were also important, on one view as important as tax cuts. They would remove the only remaining substantial grievance of industry, and help home buyers. But the effect on market confidence and possibly on inflation also had to be borne in mind, and there could be no commitment as to the size or timing of any reductions. The Government's success in reducing public borrowing meant that the relationship between the PSBR and interest rates was not as direct as when they took office: private sector borrowing was now larger than public sector borrowing by a factor of several times.

f. The Government's policies on tax and expenditure needed to be presented as a coherent whole: cuts in the Budget needed to be seen in the context of the decisions on public expenditure the previous autumn. But the argument about the relative merits of expenditure increases and tax cuts seemed to be attracting less attention than the previous year.

g. As part of further improving the performance of the economy, consideration might be given, so far as resources allowed, to measures to encourage small businesses and ownership of property and shares, and to helping North Sea oil production.

THE PRIME MINISTER, summing up the discussion, said that the Cabinet congratulated the Chancellor of the Exchequer on his management of the economy, which had produced very satisfactory results and prospects. They fully endorsed the maintenance of the prudent and consistent policies which had led to this outcome.

The Cabinet -

Invited the Chancellor of the Exchequer to take account of the discussion in preparing his forthcoming Budget.

Cabinet Office

13 February 1987

jc6

Covering SECRET

From: J ODLING-SMEE
16th February 1988

CHANCELLOR OF THE EXCHEQUER

cc Sir Peter Middleton
Sir Terence Burns

CABINET ON ECONOMIC STRATEGY: SPEAKING NOTES

I attach some speaking notes, most of which are facts which can be used to illustrate the themes of your Cabinet paper.

J ODLING-SMEE

Ch

Factual briefing below (E is good on international comparisons).

May want to draw on attached table showing development of forecasts - to counter any suggestion that you misled people last year about fiscal prospects: growth much stronger than expected (not just consumption, also investment, exports etc).

Also attached are main points on public expenditure from PEWP briefing, plus usual stockmarket table

AA

ecabspeak

SECRET

CABINET

ECONOMIC STRATEGY

SPEAKING NOTES

Strength of economy

Medium-term supply side improvement:

Manufacturing productivity growth of 4½% a year in 1980s, better than all other G7 and than in 1950s and 1960s.

Profitability recovered to 10% (non-North Sea) compared with trough of 3% in 1976 (and 1981).

Britain's share of world exports has stopped falling and import penetration has been rising less rapidly than elsewhere (eg Germany).

Changed attitudes of businessmen, including foreign businessmen thinking of investing in UK.

Short-term situation:

Strong growth in 1987 (over 4%) without resurgence of inflation (latest RPI only 3¾%).

Unemployment has fallen at fastest rate since War, since 1986.

Further steady growth in GDP forecast for 1988 (3%) with inflation remaining low (4% to Q4).

Employment growth likely to continue and unemployment should fall further - provided employers keep labour cost pressures under control.

Fiscal prospects

Public finances stronger than expected at Budget time: latest PSBR figures (£6.9 billion for April-January) suggest negative PSBR for 1987-88 - first time since 1969-70.

Reflects faster growth in tax revenues than expected: despite tax cuts in Budget, non- North Sea tax burden in 1987-88 higher for second year in succession - nearly 4% higher than 1978-79.

Conclusions

Need to be cautious because of:

- importance of sound public finances to success of economy
- uncertainties, especially world demand (v. UK demand) and exchange rates
- reputation of Government.

Tax reductions need to be compatible with further year of Budget surplus.

COMPARISON OF FORECASTS FOR 1987

	C(87)2	FSBR	AS	C(88)3	Jan Forecast
Domestic Demand	3½	3½	4	4	4
o/w Consumers' expenditure		4	5		5
Fixed Investment		4	5½		
Exports		4	5½		5¾
Imports		6	6½		7
GDP	3	3	4	4¼	4¼
o/w Manufacturing		4	5		5¾
RPI 86Q4 to 87Q4	4	4	4	4	4

3552/2.

~~the nature of the~~ Agreed; but is it still of interest that the $ is now within the bands of a range that could have been constructed by moving the central rate within the original Louvre band?

SECRET

From: Sir G.Littler
Date: 19 February 1988

MR PERETZ

c.c. Sir T.Burns
Mr Huw Evans
Miss O'Mara

EXCHANGE RATE MOVEMENTS AND LOUVRE BANDS

Your minute of 18 February to Sir T Burns prompts me to add a gloss, which you and others may not know about. It raises the interesting question whether any 'October band' ever existed!

2. I have heard Stoltenberg deny that any new DM/$ band was set in October. He was not to my mind very convincing. He spoke at least partly in defence against an accusation by Balladur that he had done a bilateral deal with Baker which was against the spirit of overall G7 cooperation. I am sure that Baker and Stoltenberg did indeed reach precisely such a deal and without consulting any other partners. (I have not checked but I think Baker said as much in one of his telephone conversations at the time with the Chancellor). But then of course it did not last for long, and it was never seriously backed up by renewed intervention or other action.

yes. on 9 Oct.

3. My conclusion is that, since the 'October band' was never seriously effective, was certainly not agreed more widely than by two participants, and is denied by one of those, we should avoid treating it as a reality in our own commentaries.

cc (Personal) Mr A Allan

(Geoffrey Littler)

FROM: P F L ALLUM
DATE: 25 FEBRUARY 1988

1. MR SEDGWICK

P.N.J 26.ii.88

2. CHANCELLOR

cc Sir Peter Middleton
Sir Terence Burns
Mr Scholar
Mr Odling-Smee
Mr R I G Allen
Mr Bottrill
Mr S J Davis
Mr Hibberd
Mr Pickford
Mr Hudson
File Z1

Many thanks. 4(a)(i) of CX's worth using. But Mr Allum has misunderstood the concept: it was really viz the longest period of uninterrupted growth @ 2½% or better. If 1984 is rounded to 2½%, that was achieved in 1983-87 – a period that was unbroken since the war. Assume 2½% (or better) for 1988.

THE UK'S RECENT GROWTH PERFORMANCE

In the run up to the budget you might find it useful to have an assessment of the UK's recent growth record in the light of earlier experience. Last year's Budget Statement incorporated the claim that by 1987 "we will have registered the longest period of steady growth, at a rate approaching 3 per cent, that the British economy has known since the war". This note reviews the record a year on.

!

2. First, however, we must be clear what we mean by "steady" growth. This assessment takes this to mean a period where growth in each year is at, or within a narrow range around, the average for the period as a whole. It is quite possible for two periods to have the same average growth rate. One period, however, might be characterised by some years of very high growth and some of very low or negative growth. The other period could have growth in each year at or about the same rate. The latter is considered here as more "steady".

3. Moreover we are interested in steady growth at a satisfactory average rate. Some past periods may have seen steadier growth than over the current upswing. But, if it was also very low growth, there is not much to claim for it.

4. The main conclusions that emerge from the attached study, and that can be confidently asserted in public, are as follows.

probably (Lower but, the same settled over other period since records began)

(a) Analysis of year on year growth for calendar years

6 year comparisons

(i) If growth in 1987 turns out at 4-4½ per cent (as we expect) the six years to 1987 will have seen the steadiest period of growth of six years or more at a satisfactory rate averaging 3 per cent since the war.

(ii) However, only if growth in 1987 turns out to be at or below 4.2 per cent (now rather doubtful) will growth over the six years to 1987 have been the steadiest period of expansion - **fast or slow** - since the war.

(iii) Some six year periods since the war (notably the six year periods to 1964 and 1965) have had higher average growth rates. Growth was also higher over the six year periods to 1937 and to 1938.

7 year comparisons

(iv) If growth in 1988 turns out close to the FSBR forecast (in fact, anywhere between 1¾ and 5½ per cent), the seven years to 1988 will have seen the longest period of steady growth at a satisfactory 3 per cent rate since the war. ?

(v) Indeed, if growth in 1988 is between 2¾ and 3½ per cent, the seven years to 1988 will have seen the longest period of steady growth - fast or slow - since the war.

(b) Analysing the quarterly path for GDP since early 1981

(v) Growth since 1981H1 has averaged 3.1 per cent. The UK is just completing its seventh year of growth at an average 3 per cent rate. A similar claim to this could have been made at almost any time between 1964 and 1969, and again in 1973.

(vi) Growth over the seven years since early 1981 has not always been steady. For example, the level of output fell (in coal strike adjusted terms) by around ¼ per cent between the first and second halves of 1985. By contrast, output increased in every consecutive half year between 1958 and 1972.

(vii) With 2½ per cent growth to the first half of 1989 proposed for Chapter 3 of the FSBR, the UK is about to enter its eighth year of growth at an average 3 per cent rate.

(c) In comparison with economic performance overseas (see also table G).

(viii) Average UK growth since 1980 has been the highest of the major EC countries. This contrasts with the previous two decades when the UK was bottom of the growth league.

(ix) UK growth over the year to 1987Q3 has been faster than in any other Major 7 economy. Growth in the first three quarters of 1987 on the same period a year earlier has also been faster than in any other Major 7 economy. (Growth in the UK for 1987 as a whole should prove higher, on the basis of WEP and IMF forecasts, than for any other Major 7 economy.)

(x) UK growth over the last three years has been comparable to or faster than in all other major industrialised countries.

5. The attached study with detailed tables and charts sets out my analysis in detail.

P F L ALLUM

ANNEX : DETAILED ANALYSIS OF GROWTH PERFORMANCE

1 Table A shows figures for GDP growth for the period since 1949 and for the years 1927 to 1938. Coal strike adjusted growth figures are shown in brackets for 1984, 1985 and 1986. GDP growth was depressed by over 1 per cent in 1984 as a consequence of the coal strike, while growth in 1985 and 1986 was boosted by around ¾ and ¼ per cent respectively as the strike effects unwound. Growth in 1984 is now recorded at 2.4 per cent, below the 2.5 per cent estimate published at the time of the last Blue Book.

TABLE A: YEAR ON YEAR REAL GROWTH RATES

(GDP(E), market prices[1])

1927	7.0	1933	1.1
1928	1.7	1934	6.8
1929	2.4	1935	3.8
1930	- 0.1	1936	3.1
1931	- 5.1	1937	4.3
1932	0.3	1938	3.0

(GDP(A), factor cost, coal strike adjusted in brackets[2])

1949	3.7	1959	4.0	1969	2.5	1979	2.7
1950	3.6	1960	5.5	1970	1.9	1980	- 2.3
1951	1.8	1961	2.7	1971	1.5	1981	- 0.9
1952	0.6	1962	1.2	1972	2.4	1982	1.6
1953	3.8	1963	4.1	1973	7.3	1983	3.3
1954	4.2	1964	5.5	1974	- 1.7	1984	2.4 (3.7)
1955	3.7	1965	3.0	1975	- 1.0	1985	3.6 (2.7)
1956	1.2	1966	1.6	1976	2.7	1986	3.1 (2.7)
1957	1.6	1967	2.2	1977	2.5	1987	4.0*
1958	- 0.2	1968	4.2	1978	2.9	1988	3.0*

*assumptions

1 From Feinstein, CH(1972) "National Income, Expenditure and Output of the UK, 1865-1965"
2 CSO National accounts. Coal strike adjusted figures unpublished.

2. The analysis of calendar year growth performance set out below compares the six year period to 1987 and the seven year period to 1988 with earlier six and seven year periods of economic expansion. Longer periods of growth were also studied though none proved steadier than the steadiest of the six and seven year periods of growth discussed below. Of course longer periods, for example of

ten years, ending in 1987 or 1988 would not be particularly steady as they would include the years in the early 1980s in which GDP fell. The analysis focuses on the average growth rate for each six or seven year period and the statistical variance[1] of growth around this average.

3. Prior to the current upswing growth is found to have been steadiest in the 1950s and 1960s. Growth was most variable in the early 1930s and 1970s. The overall least variable period of growth (of six years or longer) was over the seven years to 1972. But growth over this period averaged only 2.4 per cent. Of the periods showing a satisfactory average rate of growth of 3 per cent the seven years to 1955 proved most steady. Figures for average growth and the variance of growth for these two periods are provided below. The next five paragraphs compare the six years to 1987 and the seven years to 1988 with these earlier "best" seven year periods.

TABLE B : PREVIOUS PERIODS OF STEADIEST GROWTH

	Overall steadiest period of growth (7 years to 1972)	Steadiest period of satisfactory 3 per cent growth (7 years to 1955)
Average growth rate	2.4	3.1
Variance of growth	0.8	1.7

4. Table C overleaf shows that growth over the six years to 1987 had a lower variance (0.7) than both the previous overall steadiest period (to 1972), and the previous steadiest period of 3 per cent

---

[1] The 'variance' statistic reflects how much year by year growth has varied relative to average growth over a period. Differences between actual growth and average growth are squared (so that undershoots and overshoots of average growth both score as equivalent divergences). The sum of these squared differences is then averaged for each period in question. Because deviations from average growth are squared the variance statistic gives more prominence to single large deviations from average growth than several smaller ones of an identical cumulative size.

average growth (to 1955). (It is interesting to note that the measured 'steadiness' of the upswing in the six years to 1987 is unaffected by whether adjustment is made or not for the effects of the 1984-85 coal strike.) Chart A plots the record of average growth outturns and growth variances for all six year periods since the war. The recent combination of 3 per cent growth with steady expansion is clearly shown as a marked improvement relative to the 1970s.

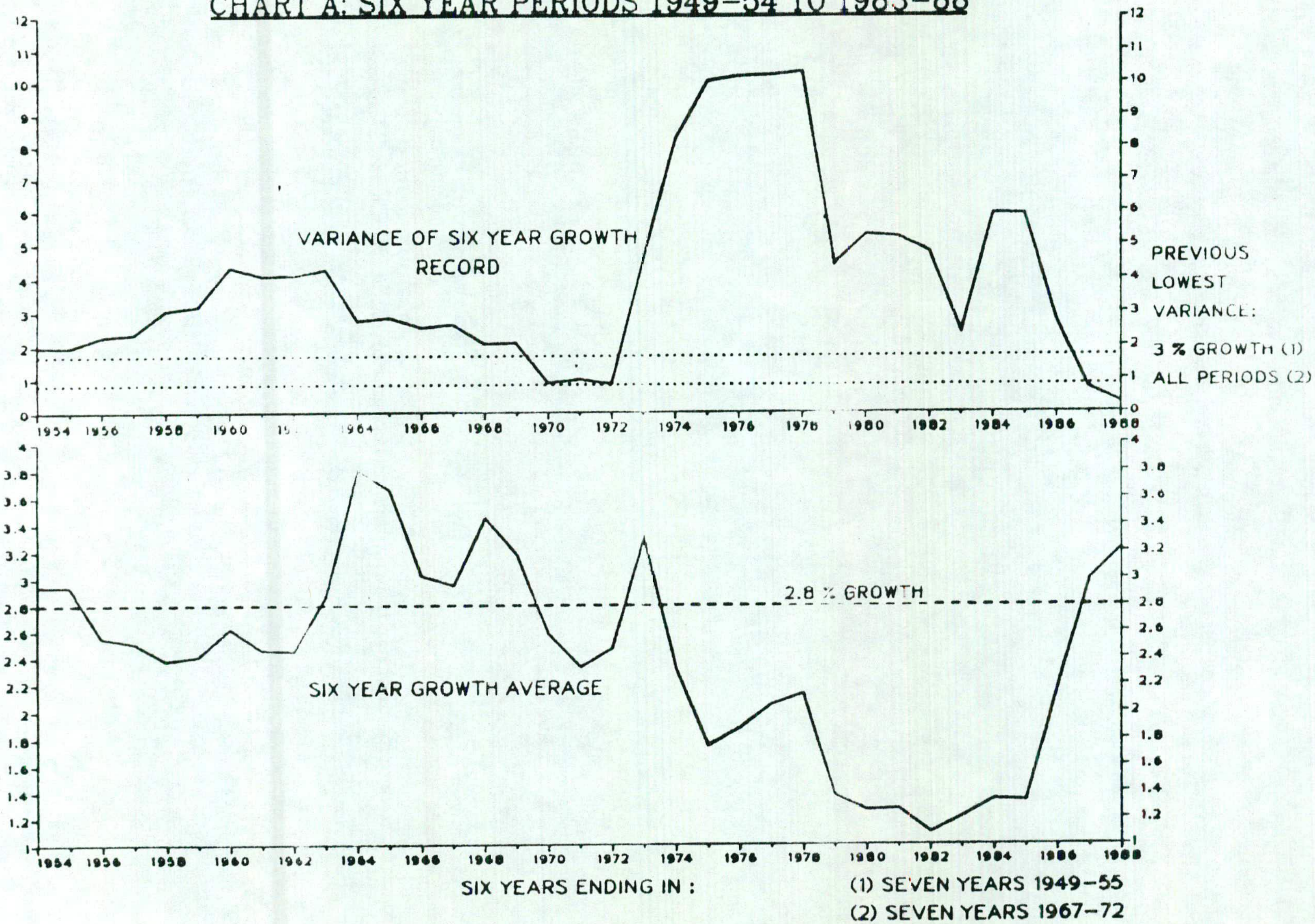
TABLE C: SIX YEAR COMPARISONS OF GDP GROWTH[1]

Six year period:	Average growth rate	Growth variance	Six year period:	Average growth rate	Growth variance
1927-32	1.0	15.5	1962-67*	3.0	2.6
1928-33	0.1	7.2	1963-68*	3.5	2.1
1929-34	0.9	14.9	1964-69*	3.2	2.1
1930-35	1.1	16.1	1965-70	2.6	0.9
1931-36	1.7	16.2	1966-71	2.3	1.0
1932-37*	3.2	5.5	1967-72	2.5	0.9
1933-38*	3.7	3.5	1968-73*	3.3	4.6
			1969-74	2.3	8.3
			1970-75	1.8	10.0
1949-54*	2.9	2/0	1971-76	1.9	10.2
1950-55*	2.9	2.0	1972-77	2.1	10.2
1951-56	2.6	2.3	1973-78	2.1	10.3
1952-57	2.5	2.4	1974-79	1.4	4.4
1953-58	2.4	3.1	1975-80	1.3	5.3
1954-59	2.4	3.2	1976-81	1.3	5.2
1955-60	2.6	4.3	1977-82	1.1	4.8
1956-61	2.5	4.1	1978-83	1.2	2.4
1957-62	2.5	4.1	1979-84	1.1 (1.3)	5.0 (5.9)
1958-63*	2.9	4.3	1980-85	1.3 (1.3)	5.7 (5.9)
1959-64*	3.8	2.8	1981-86	2.2 (2.2)	2.8 (2.7)
1960-65*	3.7	2.8	1982-87*	3.0 (3.0)	0.7 (0.7)
1961-66*	3.0	2.6	1983-88*	3.2 (3.2)	0.3 (0.3)

*average 6 year growth rate of 2.80 per cent or higher.
1 Coal strike adjusted in brackets.

5. The estimated variance for the six years to 1987 assumes a 1987 growth outturn of exactly 4 per cent. If the eventual growth estimate rises above 4.2 per cent then the steadiness of growth during the six year upswing to 1987 will be less than that over the low growth seven year period to 1972. (It seems likely, in fact, that the first CSO estimate of growth in 1987 will exceed 4.2 per cent, probably falling in the range 4¼-4½ per cent.) But growth in 1987 would have to rise above 5.5 per cent - a highly unlikely

CHART A: SIX YEAR PERIODS 1949–54 TO 1983–88



outcome for the CSO's March 18 press notice - for the six years to 1987 to prove a more variable period of growth than the seven year 'fast growth' period to 1955.

6. Table D shows that with growth in 1988 assumed to moderate to 3 per cent the variance of growth over the current upswing is reduced even further (to 0.6 for the seven years to 1987). This is again lower than for the previous steadiest periods of fast or slow growth detailed in paragraph 3. Chart B plots growth and variance outturns for seven year periods since the war. Again the recent combination of steady, 3 per cent growth is apparent.

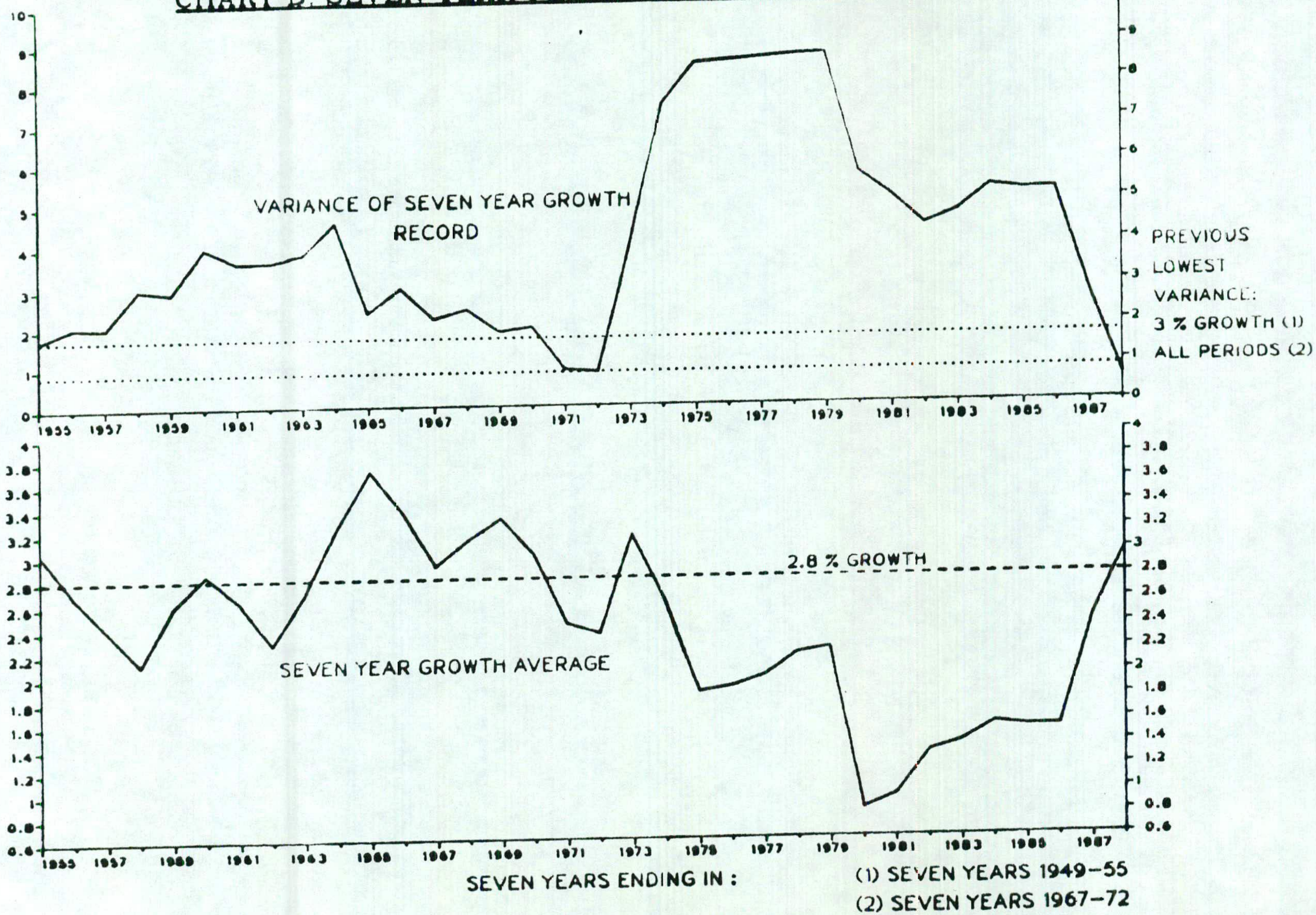
TABLE D: SEVEN YEAR COMPARISONS OF GDP GROWTH[1]

Seven year period:	Average growth rate	Growth variance	Seven year period:	Average growth rate	Growth variance
1927-33	1.0	12.9	1962-68*	3.1	2.4
1928-34	1.0	12.5	1963-69*	3.3	1.9
1929-35	1.3	13.6	1964-70*	3.0	2.0
1930-36	1.4	13.9	1965-71	2.4	0.9
1931-37	2.0	14.5	1966-72	2.4	0.8
1932-38*	3.2	4.6	1967-73*	3.2	4.0
----------	----------	----------	1968-74	2.6	7.4
			1969-75	1.9	8.4
1949-55*	3.1	1.7	1970-76	1.9	8.5
1950-56	2.7	2.1	1971-77	2.0	8.6
1951-57	2.4	2.0	1972-78	2.2	8.6
1952-58	2.1	3.0	1973-79	2.2	8.7
1953-59	2.6	2.9	1974-80	0.9	5.7
1954-60	2.9	4.0	1975-81	1.0	5.1
1955-61	2.6	3.6	1976-82	1.3	4.4
1956-62	2.3	3.6	1977-83	1.4	4.7
1957-63	2.7	3.8	1978-84	1.4 (1.6)	4.6 (5.3)
1958-64*	3.3	4.6	1979-85	1.5 (1.5)	5.0 (5.2)
1959-65*	3.7	2.4	1980-86	1.5 (1.5)	5.2 (5.2)
1960-66*	3.4	3.0	1981-87	2.4 (2.4)	2.8 (2.8)
1961-67*	2.9	2.2	1982-88*	3.0 (3.0)	0.6 (0.6)

*growth at average annual rate of 2.8 per cent or higher.
1Figures in brackets are coal strike adjusted.

7. The variance for the six year period to 1988 assumes growth outturns of exactly 4 and 3 per cent in 1987 and 1988 respectively. But even assuming that growth in 1987 is finally estimated at 4½ per cent, a 1988 outcome of between 2.7 and 3.5 per cent - in line with current forecast - would still leave the seven years to

CHART B: SEVEN YEAR PERIODS 1949–55 TO 1982–88



1988 as the most steady period of expansion since the war. Furthermore, for the same 4½ per cent growth outturn in 1987, growth would have to pick up to 5.6 per cent (or more) for growth during the seven years to 1988 to prove more variable, on average, than the fast growth period to 1955. (A less steady outturn would also be produced by growth of 0.5 per cent (or less) but this would bring average growth down to an unsatisfactory rate of under 2.7 per cent.)

8. Table E provides a detailed comparison of the growth record for the six years to 1987 and the seven years to 1988 with the record in the earlier best seven year period of rapid, steady growth to 1955. The lower statistical variance of growth over the recent past is reflected - as intuition would suggest - in a smaller difference between the lowest and highest growth outturns.

TABLE E: STEADY 3 PER CENT GROWTH PERIODS COMPARED

	7 years to 1955	6 years to 1987	7 years to 1988
Average growth	3.1	3.0	3.0
Variance	1.7	0.7	0.6
Growth outturns ranked by size:	4.2	4.0*	4.0*
	3.8	3.6	3.6
	3.7	3.3	3.3
	3.7	3.1	3.1
	3.6	2.4	3.0*
	1.8	1.6	2.4
	0.6		1.6
difference between highest and lowest growth outturn	3.6	2.4	2.4

*assumed outturns.

9. The analysis in paragraphs 1 to 8 provided relatively straightforward rankings of periods in terms of growth steadiness, both for all post war periods, and for those showing a satisfactory 3 per cent growth rate. Table F provides an alternative analysis in which 'steadiness' is traded off against average growth. Thus slightly less steady growth might rank higher if the average rate of expansion was significantly faster. Alternatively, a period showing average growth below 3 per cent might rank higher so long

as growth was significantly more steady. Three indices based on average growth and growth variance are used to rank the full set of 6 year post-war periods. 'Steadiness' is accorded 80%, 50% and 20% respectively out of the total index weighting[1]. The six year periods to 1987 and to 1988 score highest when steadiness is accorded an 80% or 50% weighting, but rank marginally below several periods in the 1960s when growth rather than steadiness is given the largest weight. (The latter result is not surprising, given average growth of 3.8 per cent in the six years to 1964). But even where growth, rather than 'steadiness' gets the highest weighting the current upswing scores higher than any period since the first oil price shock, and higher than the vast majority of earlier periods in the 1950s and 60s.

[1]A 50% growth weighting implies that an extra ½ per cent average growth is seen as a net improvement so long as the range of likely growth outturns (for 9 years in 10) is increased by no more than ± 1 per cent. An 80% growth weighting implies acceptance of ½ per cent extra growth so long as the range of likely growth outturns is increased by no more than ± 4 per cent. Thus, using an 80% growth weighting a period of 3½ per cent growth with a growth range of ± 4 per cent is seen as preferable to an alternative period of 3 per cent average growth with a growth range of ± 1 per cent.

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TABLE F: COMBINED GROWTH 'STEADINESS' SCORES[1]

(Index based on weighting of average growth and standard deviation figures; former has positive effect on score, the latter negative; resealed so that top score is 10, lowest score 0)

Weighting:	Index1	Index2	Index3
growth	50%	80%	20%
steadiness	50%	20%	80%
Six year period			
1927-32	0.1	1.7	0.1
1928-33	0.6	0.0 (MIN)	2.6
1929-34	0.0 (MIN)	1.4	0.2
1930-35	0.1	1.9	0.0 (MIN)
1931-36	1.1	3.2	0.3
1932-37	6.8	8.1*	5.5
1933-38	8.4*	9.5*	6.9
1949-54	7.9	8.0*	7.6
1950-55	7.9	8.0*	7.6
1951-56	7.1	7.0	7.1
1952-57	7.0	6.8	7.0
1953-58	6.4	6.4	6.4
1954-59	6.4	6.4	6.4
1955-60	6.2	6.8	5.8
1956-61	6.0	6.4	5.8
1957-62	6.0	6.4	5.8
1958-63	6.7	7.4	5.9
1959-64	9.0*	10.0*(MAX)	7.5
1960-65	8.7*	9.6*	7.4
1961-66	7.8	8.1*	7.2
1962-67	7.6	7.9	7.1
1963-68	8.8*	9.2*	7.9
1964-69	8.3*	8.6*	7.7
1965-70	8.1*	7.4	8.6*
1966-71	7.6	6.7	8.3*
1967-72	8.0*	7.1	8.5*
1968-73	7.3	8.5*	6.0
1969-74	4.3	5.5	3.6
1970-75	2.7	3.9	2.5
1971-76	2.9	4.2	2.5
1972-77	3.2	4.7	2.6
1973-78	3.3	4.9	2.6
1974-79	3.9	3.6	4.9
1975-80	3.4	3.3	4.4
1976-81	3.4	3.3	4.4
1977-82	3.3	2.9	4.5
1978-83	3.3	3.1	4.3
1979-84	3.3	3.4	4.1
1980-85	3.3	3.3	4.1
1981-86	6.1	5.9	6.5
1982-87	9.0*	8.5*	9.1*
1983-88	10.0*(MAX)	9.2*	10.0*(MAX)

* index of 8.0 or greater.

1 1984-1986 growth figures are coal strike adjusted.

2 measured as growth standard deviation.

TABLE G : INTERNATIONAL GROWTH COMPARISONS

Major 7 Real GDP Growth Rates

	1986Q3 -1987Q3	1986 -1987	1985 -1987	1984 -1987
UK	5.2	4¼	7¾	11½
US	3.0	3	6	9
Japan	4.3	4	6½	11½
Germany	1.4	1¾	4¼	6¼
France	2.0	2	4	6
Italy	2.2	2¾	5½	8¼
Canada	4.1	4	7¼	11¾
Major 7	3.1	3	5¾	9

EC Real Growth Rates 1980-87*

UK	17¼
Belgium	7½
France	12¼
Germany	11
Italy	14¼
Netherlands	9¼

*figures include WEP forecasts for 1987Q4 for Japan, France, Italy and Canada

CONFIDENTIAL

FROM: J S HIBBERD
DATE: 26 FEBRUARY 1988

CHANCELLOR OF THE EXCHEQUER

cc : Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Anson
Dame A Mueller
Mr Byatt
Mr Scholar
Mr Monck
Mr Culpin
Mr Evans
Mr Odling-Smee
Mr Peretz
Mr Sedgwick
Mr Turnbull
Mr R I G Allen
Mr Bottrill
Mr S J Davies
Mr Melliss
Mr C Mowl
Mr Pickford
Mr Bush
Mr Hudson
Mr Patterson

Thanks. I don't understand the PSBR line in table!

LBS FEBRUARY ECONOMIC OUTLOOK

The February issue of the LBS Economic Outlook will be released over the weekend. It is embargoed until midnight on Sunday, but a summary will appear before then in the Sunday Times.

The Outlook

2. The LBS forecasts for 1988 are very similar to the latest National Institute forecasts, reported in my minute to you of 23 February. (The two forecasts are compared in the table at the end of this note, along with the Treasury January internal forecast.) The main features of the LBS outlook are:

- **UK GDP growth** (output measure) of 4.7 per cent in 1987 (5.2 excluding oil) and 3 per cent in 1988 (3.5 per cent excluding oil).

- **RPI inflation** at 4.7 per cent in 1988Q4.

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- **Current account deficit** of £4.1 billion in 1988 compared to 2.4 billion in 1987.

- A negative **PSBR** of £½ billion in 1987-88, and again in 1988-89.

- **World trade growth (manufactures)** of about 5 per cent in 1988 compared to 3½ per cent in 1987. **World oil prices** rising to $18 pb by 1988Q4.

<u>**The forecast in detail**</u>

3. **Consumer spending** is forecast to grow by 3.3 per cent in 1988, much slower than the 5.1 per cent increase in real personal disposable income. The **personal sector savings ratio,** thus, rises fairly sharply from an average 6½ per cent in 1987 to an average 8 per cent in 1988. On **investment,** the LBS note that the January CBI survey of manufacturing industries reveals little dent to investment intentions from the stock market crash. **Private non-housing fixed investment** is forecast to rise by almost 7 per cent in 1988, after 6½ per cent in 1987. **Total investment** is projected to rise by 6½ per cent compared just over 3 per cent in 1987. **Stockbuilding** in 1988, though positive, is less than in 1987. This change in stockbuilding is sufficient to knock almost ½ per cent off projected GDP growth in 1988.

4. The LBS suggest that the deterioration in the current account through 1987 offered the clearest evidence of overheating. For 1988, they see some slowdown in the growth of **exports of goods and services** to just under 5 per cent (compared to 6½ per cent in 1987). This reflects slower growth in world demand and activity, with no offsetting gains in competitiveness. **Imports of goods and services** also slow down, they increase by about 7 per cent in 1988, after almost 8 per cent growth in 1987. As a result, **the current account deficit** widens from £2.4 billion in 1987 to £4.1 billion in 1988.

5. The year-on-year growth of the **output measure of GDP** slows to 3 per cent in 1988 (3.5 per cent excluding oil). Growth also slows through the year so that, by 1988Q4, GDP is only 2¼ per cent higher than a year earlier (2.9 per cent excluding oil). **Manufacturing output** rises 4¼ per cent in calendar 1988 (2¾ per cent in the year to 1988Q4).

The LBS see scope for some further growth in **employment** in 1988 (including a marginal increase in manufacturing employment). However, given the slowdown in economic activity, employment is expected to rise at a slower rate than in 1987. Growth in **manufacturing labour productivity** slows to 4 per cent in 1988 (after almost 7 per cent growth last year). **Whole economy productivity** rises 1 per cent in 1988, after a 3 per cent increase in 1987. The LBS forecast of UK adult unemployment looks not just pessimistic but already quite wrong. They say that it should "drift lower, but at a very slow pace from now on". By end-1988 they predict 2.6 million unemployed. But it was down to 2.61 in December 1987 and the January figure, released this week, was down further, to 2.56 million.

6. **Whole economy average earnings growth** is expected to abate from 8¼ per cent at end-1987 to 8 per cent at end-1988. This too, reflects slower growth in activity and some fall back in overtime working and earnings. **Producer price inflation** is likely to be constrained close to present levels (about 4 per cent) by a firm sterling exchange rate. **RPI inflation,** less affected by international competition, is expected to rise to 4.7 per cent by end-1988.

LBS on the Budget Judgement

7. The economic viewpoint section discusses the "Budget Judgement"; concentrating on the policy implications of the current account balance of payments deficit and fast growth of nominal GDP. The authors argue that the current account deficit in 1987 reflected primarily excessive growth of demand in the UK rather than inadequate growth in the rest of the world: they say that the world economy is growing roughly on track at around 3 per cent. They argue that the UK is unlikely to be able to finance a continuing balance of payments deficit, and that domestic demand needs to be reined back so as to bring the current account deficit back to zero. (They acknowledge that the true current account deficit is probably less than the published statistics suggest.)

8. MO growth within the one to five per cent range established last year and a stable exchange rate should be sufficient to bring inflation down towards 3 per cent. Accompanying this, a tightening of fiscal policy (relative to the 1987 MTFS) should reduce the current account deficit. The authors suggest that the PSBR adjusted for assets sales should be set at 1 per cent of GDP: ie the recorded surplus PSBR should be £0.5 billion. They estimate that this will allow tax cuts of £3.5 billion.

Other articles

9. There are two other articles in the outlook. The first is titled **"Global Interdependence and Policy Coordination"**. The second is a note in the LBS Focus series called **"Why has the Stock-output Ratio Fallen?"** A commentary on these is attached at Annex A.

Lines to take

Positive. The LBS believe that the outlook is for continued strength of UK economy.

Defensive. Unemployment not falling further. The fall in unemployment through 1987 was much faster than outside commentators expected this time last year. Large room for error. The January figure for UK adult unemployment is already slightly lower than the LBS forecast. Prospects for unemployment depend on moderate wage settlements as well as steady growth.

Balance of Payments deteriorating in 1988 - sign of overheating. There are no widespread signs of overheating.

Jim Hibberd

J S HIBBERD

TABLE 1:

COMPARISON OF LBS, NIESR AND TREASURY FORECASTS

	LBS FEBRUARY FORECAST 1987	1988	NIER FEBRUARY FORECAST 1987	1988	TREASURY INTERNAL FORECAST 1987	1988
per cent changes on previous year						
Gross domestic product (output measure)	4.7	3	4.7	2.9	5	3
Consumers' expenditure	4.9	3.3	4.9	4.3	5	4½
Total fixed investment	3.2	6.7	3.1	5.2	3½	6½
General government consumption	0.3	1.7	0.4	1.8	½	1½
Change in stockbuilding (contribution to GDP)	0.3	-0.4	0.3	0.2	0	0
Exports of goods and services	6.3	4.8	6.3	4.2	5½	3
Import of goods and services	7.9	7.1	7.9	7.6	7	6½
Manufacturing output	5.6	4.2	5.6	3.8	6	4½
World trade in manufactures	3.6	4.9	3.0	3.4	4½	4¾
RPI in Q4	4.1	4.7	4.1	4.5	4	4½
Current account (£ billion)-	- 2.4	- 4.1	-2.7	- 4.2	- 2½	- 4½
PSBR (£ billion financial year)	1	1	-2.0	- 2.6	- 3	- 3½

ANNEX A - LBS FEBRUARY ECONOMIC OUTLOOK - OTHER ARTICLES

There are two other articles in the latest Outlook. These are reviewed below.

Briefing Paper: Global Interdependence and Policy Coordination

The outlook contains a briefing paper by Paul Levine. The punchy introduction draws attention to recent strains in the world economy and successive declarations on policy cooperation from international meetings. The rest of the paper, however, is a thorough, rather stolid summary of recent academic literature. The emphasis throughout is on analytical and econometric model simulations, and on the further work that needs to be done to find simple, robust rules that perform reasonably well across a range of different views of how the world works. Little is said on policy implications for the G7 and nothing on policy conclusions for the UK.

2. Levine's introduction takes an unduly gloomy view of tensions in the world economy. The imbalances of the three major economies are certainly a serious issue, and there are no grounds for complacency. But progress on reducing them has already been made and more is in prospect. He erroneously interprets the Tokyo and Venice Summits as pointing the way to "more far reaching coordination of monetary and fiscal policy by approving a set of economic indicators which could, in principle, form the basis of international agreement". This is the US view of policy coordination: we see it much more modestly. As the Chancellor's recent speeches have emphasised, further developments should include arrangements to monitor the performance of the group as a whole, so as to ensure that the group maintains a non-inflationary policy stance.

3. Following the Louvre Accord, the Chancellor's emphasis has been on exchange rate stability as the focal point of policy coordination, backed up by suitable fiscal and monetary policy commitments and monitored by indicators. The empirical literature surveyed by Levine suggests that there can be gains, of up to 2 per cent of GNP, from more formal cooperation, especially if governments have a reputation for

pre-commitment. But these gains do depend on very stylised models that fail to capture the uncertainties of the real world; and on unrealistic assumptions about the ability of governments to put optimal policies in place.

Focus: Why has the stock output ratio fallen? - Chris Higson and Sean Holly

4. Between the mid-1960s and end-1970s stock-output ratios were cyclical but trend-free; in the 1980s stock-output ratios have declined steadily. Higson and Holly use accounting data for about 450 firms to investigate this phenomenon in the manufacturing sector. In their sample a good deal of the decline is explained by composition effects, reflecting the fact that, in their sample, firms with faster falling stock-output ratios increased their shares of total sales. The composition effect accounts for about one third of the decline in the stock output ratio in their sample between 1978 and 1985.

5. The rest of the decline is attributed to financial factors and changes in technology. The most valuable part of the note is the calculation of different measures of the cost of holding stocks which differs in any year according to whether the firm was tax-exhausted or tax-paying. Whichever class a firm belonged to, it would have experienced a marked increase in the cost of holding stocks in the 1980s compared with the late 1970s. Only firms which switched from being tax-exhausted to tax-paying in 1980 would have avoided such an increase. In fact, of course, the proportion of tax-exhausted firms increased rapidly in the early eighties; firms switching in this direction experienced particularly large increases in their stock holding costs.

6. Higson and Holly claim, on the basis of an "illustrative" regression equation, that the tax subsidy (the difference between the tax-exhausted and tax-paying costs of stock holding) explains part of the decline in the stock output ratio. But the description of their empirical work is too brief and incomplete to allow us to evaluate it properly. Nevertheless, such a result would not be a surprise.

Thanks. Important to sign re Economic what from re CSO chaff.

FROM: S J DAVIES
DATE: 26 February 1988

1. SIR T BURNS
2. CHANCELLOR

cc Chief Secretary
Financial Secretary
Paymaster General
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Mr Cropper
Mr Tyrie

I agree with the general message of this paper. This is a useful piece of analysis which brings together a lot of information. It is directly relevant to the economic background to the Budget. It could also form the basis for a speech in the Spring/Summer which explored the reasons for the relative stability of output growth in recent years.

TB.

NB/ This is well worth thinking about

IS THE UK HEADING FOR A CYCLICAL DOWNTURN?

I attach a note about the current cyclical position of the UK economy. It draws extensively on a detailed survey of the evidence written by Peter Edmonds.

2. It seems to me that for technical reasons it is quite likely that early 1988 will eventually be recorded as a cyclical turning point. However, this is perfectly consistent with a continuing reasonable growth rate in the non-oil economy, and there are not now the tensions and imbalances in the economy on the scale experienced at past cyclical peaks.

Ch
CSO will be determined to find a cyclical 'peak' soon – far too long since you last had one & that clearly makes them uncomfortable

AA

SJD

S J DAVIES

IS THE UK HEADING FOR A CYCLICAL DOWNTURN?

Since early 1981 the UK has experienced seven years of sustained growth. Until the last year, the rate of growth has not matched the better periods of the 1950s and 1960s; but at the same time there has been no sharp downturn in activity such as those experienced twice in the seven years before 1981. Even the milder but more protacted growth recessions that were a regular feature of the 1950s and 1960s have been absent.

2. The CSO has tentatively diagnosed "a cyclical peak in economic activity in early 1985 followed by a mild trough in early 1986". It is hardly worth getting involved in arguments about whether this diagnosis is likely to be confirmed. Clearly the rate of growth of the economy did slow for a while. But underlying developments were obscured not only by the coal strike, but also by the impact of the 1984 corporate tax changes on the profile of investment, and by the flattening out of North Sea oil production after the beginning of 1985. To the extent that there was an underlying slowdown, it was not broadly based but was concentrated in a few sectors, particularly electrical engineering; and was almost certainly related to the slowing down of US investment activity after a boom in 1984. Whether or not one accepts the CSO's provisional classification, the period from 1985 to early 1986 was no more than a minor interruption to the expansion of the economy of the last seven years.

3. There are some signs that the period of extremely steady growth could be coming to an end. Firstly, non-North Sea output grew by 6 per cent over the year to the third quarter of 1987. Secondly, the CSO's longer leading indicator - which in the past has anticipated the cycle by about a year on average - appears to be pointing to a cyclical downturn starting in the middle of 1988. This movement principally reflects the downturn in the stock market, but one other component of the CSO's longer leading indicator - business optimism - has also turned down quite sharply since July of last year. The Treasury's January forecast

is consistent with a cyclical peak in the first half of 1988 and a downturn (a mild growth recession) lasting for the remainder of the period covered by the forecast; although this reflects in part falling North Sea output.

4. Table 1 sets out the history of cycles as recorded by the CSO since the mid-1950s. Up to the early 1970s, the tendency was for upswings to be short lived, with rates of growth well above the cyclical average; while the downswings lasted longer, but with growth rates only a little below the cyclical average. More recently, this pattern has changed, with relatively violent downswings and longer but more sedate upswings.

Table 1: Reference cycles since the mid-1950s

Peaks	Troughs	Peak to peak (length in years)	Trough to trough (length in years)
1955Q1	1958Q4		
1960Q1	1963Q1	5	4¼
1964Q4	1967Q2	4¾	4¼
1969Q2	1972Q2	4½	5
1973Q2	1975Q3	4	3¼
1979Q2	1981Q2	6	5¾

Average growth rates and lengths of upswings and downswings

Upswings	Growth rate	Length (years)	Downswings	Growth rate	Length (years)
			1955Q1-1958Q4	1.2%	3¾
1958Q4-1960Q1	6.8%	1¼	1960Q1-1963Q1	1.5%	3
1963Q1-1964Q4	6.2%	1¾	1964Q4-1967Q2	2.2%	2½
1967Q2-1969Q2	3.1%	2	1969Q2-1972Q2	2.0%	2
1972Q2-1973Q2	7.6%	1	1973Q2-1975Q3	-1.7%	2¼
1975Q3-1979Q2	3.5%	3¾	1979Q2-1981Q2	-2.3%	2
1981Q2-present	(3.1%)	6¾+			

What is the cycle?

5. There are many theories about what gives rise to the fluctuations in the economy that are represented by the CSO's reference cycles. Some see business cycles as originating on the supply side of the economy; some on the demand side. Some draw attention to the importance of private sector behaviour; some see Government policy actions as primarily responsible.

6. It seems unlikely that the fluctuations in activity observed at business cycle frequencies primarily reflect supply side influences. Factors such as the diffusion over time of important technological innovations may cause the rate of growth of productive potential to vary. An important new technology may push up the rate of growth of productivity over the period that it takes for it to be fully exploited; thereafter productivity growth reverts to a lower rate. This could give rise to the economy displaying a cyclical path. However this sort of explanation is more plausibly advanced to explain lower frequency cycles - "long waves". The importance of demand side influences is shown by the wide swings over the cycle in variables related to utilization of available resources.

7. The most common idea of the cyclical process is probably that of demand shocks hitting the economy and causing it to move away from a level of capacity utilization that is sustainable in the medium to long term. This brings into play corrective mechanisms which will tend to return the economy towards a normal rate of capacity utilization (they may push the economy too far back in which case a further stage of the cycle will be set in play, and so on). An example would be a positive shock to demand which leads to a rise in activity and inflation; the rise in inflation reduces real wealth, pushes up savings and leads to a weakening in the economy; possibly as economic activity weakens stock output ratios might tend to rise, and the correction of the stock build up then pushes the economy into recession.

8. One feature of the economy that contributes to its cyclical behaviour is the important relationship between certain stocks and flows: often referred to as "accelerator" mechanisms. Because the net capital stock is around 16 times the annual flow of investment the adjustment of the capital stock to a higher level of output requires much more than a 1 per cent increase in investment in the short term for each 1 per cent increase in output. Thus if firms suddenly revise up their expectations about future output the

consequence is an increase in investment which is necessarily larger in the short term than in the long term. For similar reasons spending on consumer durables may overshoot when real personal disposable income changes.

9. An important influence on the cyclical behaviour of the economy is the way the private sector forms expectations about the future. Expectations derived as simple extrapolations of the recent past are an obvious potential source of instability. If the private sector has become more sophisticated in the way it forms expectations, this could tend to dampen the cycle. For example, if people spend on the basis of expected future income, fluctuations in consumer durable spending will be smaller if they take relatively little notice of fluctuations in actual income in forming their views about future income than if they always expect recent rates of increase in income to continue indefinitely.

10. The UK cycle has in the past been closely related to the cycle in the rest of the world: the turning points in OECD industrial production shown below are generally close to cyclical turning points recorded for the UK.

Table 2 Turning points in UK and OECD industrial production

Peaks		**Troughs**	
UK	OECD	UK	OECD
1964Q4	1966Q2	1967Q2	1967Q2
1969Q2	1969Q2	1972Q2	1971Q3
1973Q4	1973Q4	1975Q3	1975Q2
1979Q2	1979Q4	1981Q2	1982Q3
(?1985Q1)	1984Q4	(?1986Q2)	1987Q1

11. This relationship between the UK and the OECD cycle can be accounted for in several ways. One is that some major shocks have hit all OECD countries simultaneously (the obvious examples being the three oil shocks). Another is that monetary conditions tend to move in line across OECD countries because the working of foreign exchange markets causes interest rate changes to be transmitted from one country to another. A further point is that

cycles in demand in the rest of the OECD cause cycles in UK exports and that these fluctuations in UK exports have an important effect on the timing of the UK cycle. This last explanation may be less relevant since the demise of Bretton Woods, as fluctuations in sterling might now dampen the effect of fluctuations in foreign demand. Recently the UK cycle has tended to lead the cycle seen in other industrial countries.

? a statistical artefact.

12. "Political business cycle" theory argues that the cycle is a consequence of government rather than private sector actions. The idea is that governments manipulate the economy to try and achieve relatively fast growth and low unemployment at election time; the economy is then deflated in the post election period to cure the inflationary consequences of the pre-election excesses.

13. This theory appears to derive support in the case of the UK from the proximity of cyclical peaks to elections. But as the timing of UK elections is (within reason) in the hands of the government the direction of causation may run from the state of the cycle to the election date rather than the other way round. It is possible that on some occasions in the past economic policy has been consciously edged in a more expansionary direction after the middle of a government's term in office; and that governments have proved more willing to take tough economic measures when the date of the next election is relatively distant. But while government policy may have some responsibility for cyclical fluctuations, the correlation between activity in the UK and in other industrial countries suggests that government action has never been the dominant influence on economic fluctuations in the UK.

14. A set of tables in an annex at the end of this note sets out some key statistics on recent upswings including the present one. The next two sections of the note summarise the main features of upswings and the main differences between the current upswing and previous upswings.

Previous upswings and cyclical peaks

15. Although past upswings have varied considerably in speed and composition of growth, the following general points can be made about recent upswings prior to the present one:

- They have taken place at times of strong growth in world trade, and have involved strong growth in UK exports. During the three previous upswings, the average annual growth in developed countries' manufactured exports was over 9 per cent, and UK exports grew at a similar rate.

- Higher stockbuilding made an important contribution to growth over the upswing: typically adding about 2 per cent to the level of GDP as between the previous trough and the peak of the upswing. The rate of stockbuilding was particularly high around (both just before and just after) cyclical peaks. At the 1973 peak, in particular, stockbuilding was averaging around 2¼ per cent of GDP, compared with an average rate over the cycle of a little over ½ per cent of GDP.

- Fixed investment made a substantial contribution to growth over most upswings; however its impact around the cyclical peak is damped by the different phasing of residential and nonresidential investment. Residential investment tends to lead the cycle (housing starts are one of the components of the CSO's longer leading indicator) while nonresidential investment lags the cycle (manufacturing investment in plant and machinery is one of the CSO's lagging indicators).
- The current account of the balance of payments has shown no regular cyclical features: although imports typically rise fast over the upswing, in some cycles the impact of higher imports on the current account is more than offset by strong growth of world trade and hence exports.

- At the last two cyclical peaks there has been substantial deterioration in the company sector's financial position, with rising rates of company spending coinciding with an acceleration of company costs.

- Inflation does not show up as having a very regular cyclical pattern although it tends to lag the output cycle. It fell during the 1975 to 1979 upswing, as it has fallen over the present upswing; in earlier, sharper upswings inflation normally rose. In general, the worst point for inflation comes after the cyclical peak.

- Cyclical peaks are associated with a substantial proportion of firms' saying that their output is constrained by shortages of skilled labour, other labour, plant capacity, and materials. Table 3 shows peak and trough figures for the proportion of firms in the CBI industrial trends survey quoting factors limiting output (and, for comparison, corresponding figures from the January 1988 survey).

Table 3: Factors limiting output at peaks and troughs*

Total ex plant cap		Skilled labour	Other labour	Plant capacity	Materials	Total heat score (Temperature, °F)
11	1963 T	8	2	7	1	18
71	1964 P	41	18	25	12	96
24	1967 T	18	3	8	3	32
63	1969 P	32	14	26	17	89
15	1972 T	10	1	11	4	26
141	1973 P	51	27	32	63	173
18	1975 T	9	1	7	8	25
45	1979 P	27	6	16	12	61
3	1981 T	2	0	2	1	5
(32)	January 1988	20	4	21	8	(53)

*Proportion of firms citing factors as limiting output in CBI industrial trends survey. Figures given are at the turning points of the CBI data, which are not always in the same quarter as the CSO's turnings points.

Shortage of plant capacity cuts two different ways in terms of its effect on growth. On the one hand it creates inflationary pressures which may cause the government to adopt restrictive policies. On the other hand it will tend to encourage firms to raise investment, and hence adds to demand. Shortages of other factors fairly unambiguously act as a constraint on further growth. Directly they limit the potential for further increases in output; indirectly, they add to inflationary pressure and may cause a restrictive policy response.

- Real interest rates tend to rise over the course of upswings. Nominal interest rates rose sharply just before the 1973 and 1979 cyclical peaks. In 1973 three month interest rates rose from 5¼ per cent a year before the peak to 12¾ per cent the quarter after the peak. They rose from 9 per cent a year before the 1979 peak to over 14 per cent the quarter after that peak.

- The real exchange rate moved very differently before the peak of the two upswings completed since the breakdown of Bretton Woods: it fell sharply before the 1973 peak (and continued to fall after the peak), but rose before and after the 1979 peak.

16. In spite of the differences between cycles some summary can be attempted of the developments that typically bring upswings to an end. These include a build up of inflationary pressures as seen in shortages of capacity (though most of the effect of these pressures may be seen in retail prices only after the cyclical peak). These pressures may be related to movements in world prices (eg in 1973) as well as to domestic cost pressures. The rise in costs, together with a rise in interest rates, puts pressure on companies to reduce outgoings at a time when they are building up stocks at an unsustainable rate, and also spending at a high rate on fixed assets. In 1973, but to a much lesser extent

in other upswings, supply constraints acted to slow down the growth of output, so that the timing of the 1973 cyclical peak may have primarily reflected supply rather than demand influences.

The current upswing

17. The current upswing differs in several respects from earlier upswings. The differences include:

- the growth rate during the upswing has been lower (until the past year)
- there has been much lower growth in world trade: an average annual rate of growth of only 3 per cent (a third of that in the average of the previous three upswings)
- the relative weakness in the world economy has reduced the strength of the UK upswing, but also contributed to the low inflationary pressures that have helped the upswing to continue: it has also contributed to a deterioration of the current account of the balance of payments as the upswing has progressed
- there has been much lower stockbuilding, and stock output ratios have fallen almost continuously, at least until the middle of 1987
- restraint of inflation during the upswing has not depended on holding back pay by incomes policy as it did in the three previous upswings
- although shortages of plant capacity are currently at relatively high levels, shortages of skilled and other labour have not developed on the scale seen around previous cyclical peaks

- real interest rates have been very high for most of the upswing, but there has been no tendency for nominal interest rates to rise in the latter part of the upswing

- the upswing has been accompanied by a recovery in corporate profitability, so that the corporate financial position is very healthy

- there has been a large fall in personal sector saving, which is likely to be partly reversed at some point.

18. The low level of stockbuilding in the current upswing reflects probably both the effect of abolition of stock relief on the cost of stockholding and the adoption of new techniques of inventory control that would probably have been introduced even in the absence of the abolition of stock relief. The reduction in the stock output ratio has implications both for the speed and durability of the present upswing and for the degree of cyclical fluctuations in the future. Firstly because the adjustment to a lower desired stock output ratios has occurred during an upswing phase of the cycle the process itself has contributed to stabilising the economy. It has been tending to reduce growth when growth is anyway relatively strong; as the stock adjustment process slows down and comes to a halt, growth will for a time be higher than it would otherwise have been. Secondly, now that the economy has a lower normal stock output ratio, it may be permanently somewhat less prone to cyclical fluctuations than it used to be; fluctuations in stockbuilding will be smaller in relation to total GDP.

19. The current high level of utilization of plant capacity is a reason for expecting the upswing to continue rather than the reverse, as it should support fixed investment at a high and rising level; while shortages of other factors are well below levels seen at previous cyclical peaks. However, the apparent lack of labour shortages will not necessarily prevent the economy from behaving as if there were shortages of labour. In 1979, a pay explosion took place against the background of a labour market that was not particularly stretched by the standards of earlier

cyclical peaks (though the problems built up by three and more years of incomes policy were of course an important cause of the problem). The power of those already in employment has clearly been increased by the strength of the economy over the last year, and it remains to be seen whether they will be willing and able to exploit this power to an extent that could threaten growth.

20. Particularly since the events of last October, attention has focused on the risk of downturn in the world economy. The latest CBI industrial trends quarterly survey showed a marked downturn in export optimism (partly reversed in the subsequent monthly survey): this apparently related to worries about the level of world demand, rather than about UK competitiveness, as there was no sign of a rise in the number of firms quoting prices as a factor limiting export orders. It remains to be seen whether the decline in export optimism reflects hard information that companies have about demand abroad, or whether it reflects the general speculation about the risk of world recession following the October crash. A severe downturn in export markets would, of course, directly reduce growth, and could also make sterling more vulnerable to worries about the current account position.

21. Taking all the evidence together, and in spite of the substantial uncertainty over the world economy, there is little to suggest that the economy is in the sort of situation that has typically prevailed at cyclical peaks. Inflationary pressures are not rising noticeably, company finances are very healthy, there have been no unsustainable developments in company spending - indeed company spending can be expected to be very buoyant over the immediate future.

22. However, there is still a considerable possibility that the CSO will eventually record 1988 as a cyclical peak. CSO's methodology in constructing the reference cycles means that if the economy enjoys a period of relatively fast growth a downswing is likely to be recorded when growth moderates. The very fast growth in the economy recorded in 1987 therefore has raised the

likelihood that the CSO will eventually announce a cyclical peak for some time in 1988. This likelihood is compounded by the prospect of a significant fall in oil output over the next two years.

ANNEX

Table A1

Growth rates in cyclical upswings (annual rate, per cent %)

Variable (volumes)	**67Q2-69Q2**	**72Q1-73Q2**	**75Q3-79Q2**	**81Q2-87Q3**
1. GDP	3.5	8.1	3.4	3.1
2. Consumers expenditure	1.2	6.0	3.6	3.8
3. Govt. consumption	-0.8	3.6	1.6	0.9
4. Fixed investment	1.7	5.7	1.1	4.4
5. Exports	11.8	8.2	8.0	3.8
6. Imports	6.3	9.5	5.5	7.3
7. Final expenditure	3.0	8.1	4.0	3.9
8. Developed countries' exports of manufactures	11.2	12.1	7.3	2.9
9. Real disposable income	3.4	8.8	4.1	2.4

Changes in cyclical upswings

11. RPI inflation (change of annual rate in % points)	2.7	1.4	-16.1	-7.4
12. Manufacturing earnings (change of annual rate in % points)	n/a	2.4	-9.7	-3.4
13. Short interest rate (change in % points)	+2.4	+3.8	+2.1	-2.5

horrible statistics

Table A2

Value of physical increase in stocks and work in progress at cyclical turning Points

Turning Point	Nature	Stockbuilding 5 quarter centred moving average £m, 1980 prices	per cent of GDP	changes
1967Q2	Trough	195	0.5	
				0.7
1969Q2	Peak	484	1.2	
				-1.2
1972Q1	Trough	-9	0.0	
				2.2
1973Q2	Peak	1022	2.2	
				-3.4
1975Q3	Trough	-562	-1.2	
				2.4
1979Q2	Peak	626	1.2	
				-2.7
1981Q2	Trough	-728	-1.5	
				1.9
1987Q2	Latest	263	0.4	

Table A3

Balance of payments on current account at turning points in GDP series
£m, 5-quarter centred moving average

Turning Point	Nature	Current balance in real terms	Current balance at current prices	(as % of GDP)	(changes)
1967Q2	Trough	-105	-24	-0.2	
					0.9
1969Q2	Peak	337	82	0.7	
					0.4
1972Q1	Trough	545	170	1.1	
					-2.2
1973Q2	Peak	-593	-203	-1.1	
					0.1
1975Q3	Trough	-542	-289	-1.0	
					1.0
1979Q2	Peak	-19	-15	0	
					2.6
1981Q2	Trough	1481	1626	2.6	
					-3.3
1987Q2	Latest	-454	-683	-0.7	

Table A4

Company profits variables in 1986-87 and at previous cyclical peaks

	Financial surplus of ICCS, in real terms	Gross trading profits excluding oil companies' profits and stock appreciation in real terms £m
1968Q2	277	5157
1968Q3	525	5550
1968Q4	-676	4967
1969Q1	489	5369
1969Q2 (peak)	498	5185
1969Q3	423	5232
1972Q2	1009	5335
1972Q3	1396	5269
1972Q4	1635	5703
1972Q1	494	6674
1973Q2 (peak)	974	5845
1973Q3	-118	5261
1978Q2	152	5380
1978Q3	938	5800
1978Q4	-337	4920
1979Q1	-617	4706
1979Q2 (peak)	574	5256
1979Q3	-359	4912
1986Q1	863	7997
1986Q2	1038	8267
1986Q3	2091	8532
1986Q4	51	7974
1987Q1	1517	8631
1987Q2	2031	9528
1987Q3	1434	9878

Table A5

Growth of components of total final expenditure at cyclical peaks
(percentage increase on 4 quarters earlier)

Quarter	GDP	Fixed investment	Exports	Imports
68Q2	3.3	1.0	8.0	7.2
68Q3	4.8	4.0	13.9	9.2
68Q4	4.7	11.5	23.3	2.8
69Q1	2.2	-2.1	6.0	3.4
69Q2(peak)	2.7	0.5	13.2	4.6
69Q3	2.0	2.5	10.3	1.2
72Q2	2.2	0.0	-1.4	6.3
72Q3	2.1	-1.2	-9.8	6.6
72Q4	4.5	0.0	9.3	16.7
73Q1	10.4	10.2	9.0	13.3
73Q2(peak)	7.8	5.0	11.3	12.0
73Q3	7.6	5.0	24.0	15.9
78Q2	3.6	3.3	2.3	-1.1
78Q3	3.3	3.3	3.4	5.8
78Q4	2.6	-1.7	3.5	5.8
79Q1	2.0	0.6	-5.5	1.3
79Q2(peak)	3.3	1.3	9.7	15.8
79Q3	2.8	4.2	5.6	10.6
86Q2	2.1	0.4	0.9	4.0
86Q3	3.1	2.4	4.5	9.9
86Q4	4.2	4.7	8.2	11.1
87Q1	3.5	1.9	9.0	6.1
87Q2	4.0	6.3	4.4	8.7
87Q3	5.3	3.4	7.4	8.8

Table A6

Inflation rates at cyclical peaks
(% points change over year earlier)

Quarter	Retail price inflation	GDP deflator	Manuf earnings growth
68Q2	4.5	2.6	
68Q3	5.6	3.5	
68Q4	5.6	3.4	
69Q1	6.4	3.4	n/a
69Q2(peak)	5.4	3.4	
69Q3	4.9	3.4	
69Q4	5.3	3.8	
72Q2	6.1	11.5	11.8
72Q3	6.5	9.4	12.6
72Q4	7.7	8.8	14.8
73Q1	7.9	9.0	13.3
73Q2(peak)	9.4	7.2	12.7
73Q3	9.2	6.7	13.3
73Q4	10.4	9.2	13.5
78Q4	7.7	11.6	15.7
78Q3	7.9	12.2	16.2
78Q4	8.1	11.6	15.2
78Q1	9.6	9.8	14.7
79Q2(peak)	10.6	12.4	15.2
79Q3	16.0	13.1	13.7
79Q4	17.2	15.6	18.8
86Q2	2.8	3.0	7.5
86Q3	2.6	2.4	7.2
86Q4	3.4	1.6	8.0
87Q1	4.0	3.5	7.8
87Q2	4.2	4.7	7.7
87Q3	4.3	4.9	8.4

Table A7

Current account and interest rates at cyclical peaks

	Current balance £m	3 month nominal interest rate(%)	3 month real interest rate(%)
68Q4	-81	8.5	3.9
68Q3	-20	7.7	2.1
68Q4	-51	7.5	1.9
69Q1	36	8.6	2.2
69Q2(peak)	119	9.4	4.0
69Q3	180	9.8	4.7
72Q2	166	5.2	-0.9
72Q3	-98	7.8	1.3
72Q4	1	8.1	0.3
73Q1	-229	10.3	2.3
73Q2(peak)	-106	9.2	-0.2
73Q3	-290	12.2	3.0
78Q2	469	9.0	1.3
78Q3	130	9.7	1.8
78Q4	492	11.6	3.5
79Q2(peak)	2	12.2	1.7
79Q3	180	14.1	-1.9
86Q2	138	10.2	7.4
86Q3	-856	10.0	7.4
86Q4	-989	11.2	7.8
87Q1	572	10.6	6.6
87Q2	-659	9.2	5.0
87Q3	-1146	9.0	4.7

The real interest rate is the nominal rate minus the rate of retail prices inflation

Table A8

Values of stockbuilding at cyclical peaks

	(£bn, 1980 prices)	As % GDP
1968Q2	654	1.65
1968Q3	781	1.97
1968Q4	537	1.27
1969Q1	624	1.61
1969Q2 (peak)	602	1.49
1969Q3	292	0.71
1969Q4	367	0.85
1972Q2	-21	-0.05
1972Q3	9	0.02
1972Q4	85	0.18
1973Q1	1369	2.99
1973Q2 (peak)	1390	3.00
1973Q3	1360	2.98
1973Q4	906	1.98
1978Q4	760	1.54
1978Q3	372	0.74
1978Q4	584	1.13
1978Q1	227	1.77
1979Q2 (peak)	978	1.88
1979Q3	483	0.92
1986Q2	-30	0.05
1986Q3	-187	-0.33
1986Q4	357	0.62
1987Q1	-216	-0.37
1987Q2	19	0.03
1987Q3	899	1.49

RM6.20

CONFIDENTIAL

FROM: MOIRA WALLACE
DATE: 29 February 1988

MR ALLUM

cc Sir P Middleton
Sir T Burns
Mr Scholar
Mr Sedgwick
Mr Odling-Smee
Mr R I G Allen
Mr Bottrill
Mr S J Davies
Mr Hibberd
Mr Pickford
Mr Hudson

THE UK'S RECENT GROWTH PERFORMANCE

The Chancellor was grateful for your minute of 25 February. He has commented that it is clearly worth using the line at 4(a)(i) - that, assuming 87 growth turns out as we expect, the six years to 1987 will have seen the steadiest period of growth of six years or more, at a satisfactory rate (averaging 3 per cent), since the War.

2. The Chancellor also notes that, if 1984 is rounded to 2½ per cent, the 1983-87 period was the longest period of uninterrupted growth at 2½ per cent or better each year since the War. Assuming 2½ per cent or better for 1988, we will, it seems, probably have bettered any other period since records were first kept.

MOIRA WALLACE

3. The Chancellor ~~has~~ also agrees with ~~noted~~ Mr Allen's suggestion ~~comment~~ that it ~~charts A and or B are very helpful and~~ might be worth including one of your two charts in a future EPR.

FROM: MOIRA WALLACE

DATE: 29 February 1988

MR ALLUM

cc Sir P Middleton
Sir T Burns
Mr Scholar
Mr Sedgwick
Mr Odling-Smee
Mr R I G Allen
Mr Bottrill
Mr S J Davies
Mr Hibberd
Mr Pickford
Mr Hudson

THE UK'S RECENT GROWTH PERFORMANCE

The Chancellor was grateful for your minute of 25 February. He has commented that it is clearly worth using the line at 4(a)(i) - that, assuming 87 growth turns out as we expect, the six years to 1987 will have seen the steadiest period of growth of six years or more, at a satisfactory rate (averaging 3 per cent), since the War.

2. The Chancellor also notes that, if 1984 is rounded to $2\frac{1}{2}$ per cent, the 1983-87 period was the longest period since the War of uninterrupted growth at $2\frac{1}{2}$ per cent or better each year. Assuming $2\frac{1}{2}$ per cent or better for 1988, we will, it seems, probably have bettered any other period since records were first kept.

3. The Chancellor also agrees with Mr Allen's suggestion that it might be worth including one of your two charts in a future EPR.

MW.

MOIRA WALLACE

CONFIDENTIAL

FROM: J S HIBBERD
DATE: 29 FEBRUARY 1988

CHANCELLOR OF THE EXCHEQUER

cc : Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Anson
Dame A Mueller
Mr Byatt
Mr Scholar
Mr Monck
Mr Culpin
Mr Evans
Mr Odling-Smee
Mr Peretz
Mr Sedgwick
Mr Turnbull
Mr R I G Allen
Mr Bottrill
Mr S J Davies
Mr Melliss
Mr C Mowl
Mr Pickford
Mr Bush
Mr Hudson
Mr Patterson

LBS FEBRUARY ECONOMIC OUTLOOK

There were unfortunately three errors in Table 1 of my minute. The LBS outlook for the PSBR in 1987-88 and 1988-89 should be -£0.4 billion in each year. The current account should be a **deficit** of £4 billion not as the table implies, a surplus. The text references to these numbers were correct. I attach a revised Table 1. These errors are regretted.

Pete Allen

for J S HIBBERD

fst
lbs-feb26

TABLE 1:

COMPARISON OF LBS, NIESR AND TREASURY FORECASTS

	LBS FEBRUARY FORECAST		NIER FEBRUARY FORECAST		TREASURY INTERNAL FORECAST	
	1987	1988	1987	1988	1987	1988
per cent changes on previous year						
Gross domestic product (output measure)	4.7	3	4.7	2.9	5	3
Consumers' expenditure	4.9	3.3	4.9	4.3	5	4½
Total fixed investment	3.2	6.7	3.1	5.2	3½	6½
General government consumption	0.3	1.7	0.4	1.8	½	1½
Change in stockbuilding (% contribution to GDP)	0.3	-0.4	0.3	0.2	0	0
Exports of goods and services	6.3	4.8	6.3	4.2	5½	3
Import of goods and services	7.9	7.1	7.9	7.6	7	6½
Manufacturing output	5.6	4.2	5.6	3.8	6	4½
World trade in manufactures	3.6	4.9	3.0	3.4	4½	4¾
RPI in Q4	4.1	4.7	4.1	4.5	4	4½
Current account (£ billion)-	- 2.4	-4.1	-2.7	- 4.2	- 2½	- 4½
PSBR (£ billion financial year)	- .4	- .4	-2.0	- 2.6	- 3	- 3½