

PO-CH/NL/0335

PART C



Part C.

**SECRET**

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Ends : 31/10/88



PO -CH /NL/0335



PART C

Chancellor's (Lawson) papers.

ECONOMIC FORECASTING AND  
POLICY ASSUMPTIONS FOR  
1988

DD's : 25 Years

*Andrew*

8/11/95.

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-CH

PO

PART C



SECRET

FW 12 o'clock meeting tomorrow

FROM: J S HIBBERD  
DATE: 1 JULY 1988

**CHANCELLOR OF THE EXCHEQUER**

- cc : Chief Secretary
- Sir Peter Middleton
- Sir Terence Burns
- Mr Anson
- Dame A Mueller
- Mr Phillips
- Mr Scholar
- Mr Monck
- Mr C W Kelly
- Mr Odling-Smee
- Miss Peirson
- Mr Peretz
- Mr Sedgwick
- Mr Turnbull
- Mr MacAuslan
- Mr Mowl
- Mr Allum
- Mr Call
- Mr Cropper
- Mr Tyrie

Ch  
 It might be sensible to hold a meeting on this immediately after meeting on forecast itself (@ 11AM on Tuesday). Casts overlap considerably. Good THK. *AA*

**ECONOMIC ASSUMPTIONS FOR PUBLIC EXPENDITURE**

Government departments use economic assumptions provided by the Treasury to calculate public expenditure in a number of areas where expenditure is "demand-led", ie determined by economic conditions. The most important assumptions are for prices, unemployment, and interest rates. Current arrangements for the provision of economic assumptions to Departments for their estimates of demand-led public expenditure follow the recommendations made in 1984 in the Anson report on "Monitoring and Forecasting of Demand-led Expenditure".

2. Economic assumptions are provided by the Treasury up to four times a year. The two major assumptions rounds are in March, and September/October. Assumptions reflecting the Industry Act Forecast and MTFS projections published in the FSBR are provided soon after the Budget, at the start of the annual Public Expenditure Survey. Departments' bids are based on these assumptions. Assumptions reflecting the Treasury's autumn forecasting round are provided to Departments in September/October for use in the Star Chamber negotiations, and for publication in the Autumn Statement and Public Expenditure White Paper.

3. When necessary the Treasury update some of the assumptions in July (following the Treasury's summer forecasting exercise), for use in the bilateral discussions between the Chief Secretary and Departments in September. It is particularly desirable that DHSS have the best possible assumptions for their July forecasting round, so that the

HIBBERD TO CX 1 JULY



discussions at the bilaterals are soundly based. This submission considers the extent to which the March assumptions need to be updated for the bilaterals, in the light of the results of the June forecast.

4. The purpose of giving revised assumptions to departments is to give them the best available basis for planning and control. At this time of the year, however, any revisions have normally been limited to the current year, leaving the assumptions for the later years in line with the MTFs. (This time last year we revised only the unemployment assumption.) Changes for later years have been left till September/October, when the assumptions are revised again just before final decisions on the Survey and the Autumn Statement. The assumptions decided then for unemployment and inflation are published in the Autumn Statement; and those for earnings in the GAD report in November. No assumptions are published at this time of year, and interest rate assumptions are not published at any time.

5. However, this year the June forecast has included unusually large upward changes in the outlook for the RPI, GDP deflator, and earnings for 1988 and for later years. Some of the upward revision for 1988 reflects developments that have already occurred or are now under way. Unless the forecast published in the Autumn Statement is radically different from the June forecast there is a strong possibility that we shall need, before the end of the Survey, to revise substantially the assumptions at least for 1988 and quite probably for 1989 (the years covered by the Autumn Statement forecast). The expenditure figures in the Autumn Statement will need to be consistent with the economic outlook in the forecast.

6. Experience last year underlined the difficulty of revising assumptions at the last minute, especially for the GDP deflator which is politically sensitive in relation to programmes like health, defence and overseas aid, and tends to condition the kind of settlements which are reached on running costs. On that occasion considerable difficulty was encountered in dealing with a change of  $\frac{1}{2}$  per cent in year 1 of the Survey, offset by a fall of  $\frac{1}{4}$  per cent in the then current year. This time there is, in the June forecast, an increase of over 1 per cent in the current year, followed by another 1 per cent or so in year 1 of the Survey. Changes of this order would clearly be very difficult to manage at the end of the Survey. There is a case, therefore, this year for giving departments now figures which are realistic for the current year, and which, for the coming year, are closer to those likely to be published in the Autumn Statement, although not so much higher that they would risk being revised downwards in the autumn. In this note



the main proposed assumptions are constructed on that basis. It also shows for the more contentious variables alternative assumptions which follow - more or less - the previous practice of changing only the figures for the current year.

### Unemployment

7. The assumptions issued in March had GB adult unemployment averaging 2.35 million in the current financial year. Following the usual practice of a stylised path for unemployment over the Survey period, the March assumptions also had unemployment flat at 2.35 million to 1990-91. The fall in unemployment in recent months has been a little faster than expected in March. In May, GB unemployment was down to 2.3 million. With economic growth in 1988 likely to be faster than forecast at the time of the Budget, we now expect unemployment to average 2.25 million in 1988-89 as a whole. The forecast shows a further fall in unemployment in 1989-90, to around 2.15 million. It starts slowly to increase thereafter.

8. For 1988-89 we suggest revising the unemployment assumptions down in line with latest forecast, ie to 2.25 million. For the later years the choice is probably between:

- (i) extrapolating 2.25 million, or
- (ii) assuming unemployment constant at a number likely to be reached later in the year, ie by the time of the Autumn Statement, or even our best guess for unemployment at the end of 1988-89.

The choice of assumption for the PEWP will obviously depend on whether unemployment is still falling reasonably fast in a few months time. We do not think it worthwhile to try to second guess unemployment later in the year. For the time being, therefore, an assumption of 2.25 million over the Survey period seems sensible.

	Unemployment Assumptions (GB adult, millions)			
	<u>1988-89</u>	<u>1989-90</u>	<u>1990-91</u>	<u>1991-92</u>
March assumptions	2.35	2.35	2.35	2.35
June forecast	2.24	2.15	2.20	2.24
<b>Proposed assumptions</b>	<b>2.25</b>	<b>2.25</b>	<b>2.25</b>	<b>2.25</b>



Retail prices index

9. RPI inflation is expected to be higher at the end of 1988 than forecast at Budget time. The June forecast suggests a 5 per cent increase in the RPI over the year to September 1988 (the period relevant to the April 1989 social security uprating), compared to 4½ per cent in the March assumption. RPI inflation forecasts over the medium term remain significantly higher than the MTF5 projections. A further rise to 6½ per cent (largely reflecting assumed increases in interest rates) is predicted in the year to September 1989 (relevant to the April 1990 uprating) compared with the March assumption of 3½ per cent. The June forecast has inflation in the fourth quarter of 1989 (a figure for which will be published in the Autumn Statement) still around 5½ per cent. The higher inflation profile reflects significant upward revisions to the forecasts of mortgage rates, food prices (mainly higher world prices), nationalised industry prices, petrol and other retail prices. The revisions are thus fairly widespread. (It is worth noting that if the assumed rise in base and mortgage interest rates occurs more quickly than assumed in the June forecast, RPI inflation could be higher than forecast at the end of this year and lower at the end of 1989. See Mr Sedgwick's note to you of today.)

10. For the 1989 uprating we suggest using the forecast of 5 per cent. A sharp rise in RPI inflation is almost bound to take place by September of this year now that a mortgage rate increase before then looks certain. The inflation assumption for September 1989 (to be used for the 1990 uprating) presents more problems. The figure to be published in the next PEWP will be determined in the light of the forecast in the next Industry Act Forecast in the AS. We do not want to choose a figure now that will need to be revised substantially again in September; an upward revision to the uprating assumptions at such a late stage of the Survey would cause problems.

11. On the other hand, you may not want to circulate round Whitehall now an inflation projection that is so substantially above the previous assumptions. Moreover, it could also be difficult to circulate a markedly higher assumption for September 1989, and then revert to the significantly lower MTF5 projection for 1990. This would reveal a rather bumpy pattern for inflation which may be difficult to present to departments.

12. There are thus two options. The proposed assumption is for something fairly close to (though a touch lower than) the June forecast for the next three years. A more stylised, lower inflation assumption



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for 1989, is also presented, though it is still higher than our last assumptions. The main disadvantage to this last approach is that it would mean that DHSS could understate social security expenditure.

Retail Price Index Assumptions

(Per cent increases in September on previous September)

	<u>1988</u>	<u>1989</u>	<u>1990</u>
March assumptions	4½	3½	4
June forecast	5	6	4
<b>Proposed Assumption</b>	<b>5</b>	<b>5</b>	<b>4</b>
<b>Alternative Assumption</b>	<b>5</b>	<b>4</b>	<b>4</b>
<i>Or</i>	<i>5</i>	<i>4½</i>	<i>4</i>

13. The RPI excluding housing - the assumptions for which are not published, but which are used for uprating about a third of the social security programme - is expected to rise by about 4½ per cent in the year to September 1988 and by about 4 per cent in the year to September 1989 (March assumptions were 4 and 3 per cent respectively). There should be no serious problems if we were to provide DHSS with the new forecast figure of 4½ per cent for the year to September 1988 (the May figure was already up to this level), and something close to the forecast thereafter. An alternative assumption is set out below which is identical to the March assumptions for 1989 and 1990.

Retail Price Index Assumptions excluding housing: the ROSSI index

(Per cent increases in September on previous September)

	<u>1988</u>	<u>1989</u>	<u>1990</u>
March assumptions	4	3	2½
June forecast	4½	4	3
<b>Proposed Assumption</b>	<b>4½</b>	<b>3¾</b>	<b>2¾</b>
<b>Alternative Assumption</b>	<b>4½</b>	<b>3¾</b>	<b>2½</b>
<i>Or</i>	<i>4¼</i>	<i>3½</i>	<i>2½</i>

GDP deflator

14. Analogous problems exist with the GDP deflator. The assumptions agreed in March were the same as those published in the MTFs. We are ordinarily very reluctant to issue revised assumptions at this stage, except for the current year. However, the outlook for 1988-89 presented in the June forecast points to inflation of around 5¾ per cent compared to 4½ per cent in the MTFs. If we circulated something close to our forecast for 1988-89, it would be difficult - though not impossible - to revert to the MTFs projection of 4 per cent in 1989-90,



and 3½ per cent in 1990-91. Again we have a choice. We could circulate something which gives more weight to the forecast over the period 1988-89 to 1990-91. We also present a more stylised, lower assumption. This alternative assumption includes a slightly higher figure for 1988-89 than in the FSBR/MTFS, but moves to the MTFS projections thereafter.

15. In contrast to the position with the RPI, there is no direct information on the behaviour of the GDP deflator so far this financial year. There are, however, some indications of fast price increases, eg for certain types of investment. For what it is worth the CSO's current assessment of very short term economic trends has a sharp increase in the GDP deflator between the first and second quarters of 1988. Another consideration worth bearing in mind is that the CSO's recalculation of the constant price national accounts from 1980 to 1985 prices - the results of which will be available in September - will produce a new path for the GDP deflator from 1983 onwards. This latter consideration suggests caution in changing assumptions at this stage.

GDP deflator, per cent change on previous year

	<u>1987-88</u>	<u>1988-89</u>	<u>1989-90</u>	<u>1990-91</u>
March MTFS	5	4½	4	3½
June Forecast	5	5¼	5¼	4
<b>Proposed Assumption</b>	5	5½	4¾	4
<b>Alternative Assumption</b>	5	5	4	3½
		(or 5)	(4½)	(4)

16. We need to bear in mind that the combination of past figures and revisions to assumptions for the future for the GDP deflator, along with what is presented in your Cabinet paper for real GDP growth in 1988 could give ministers some indication of revisions to our view of the future path of money GDP. They may then be able to look at the GG/GDP ratios in PEWP and FSBR to gauge the degree of potential expenditure uplift in the next two years. The growth of money GDP itself consistent with the alternative assumptions above are set out below:



## Growth of Money GDP percent on year earlier

	<u>1988-89</u>	<u>1989-90</u>	<u>1990-91</u>
MTFS	7½	6½	6
June forecast	10	8	6
<i>Complete with</i> Proposed Assumption	9½	7	6
Alternative Assumption	9	6½	5½

Average Earnings

17. The March assumptions were unchanged from those published in PEWP in October, though below what the forecasters expected at Budget time and lower than actual published numbers available then. It is even more clear now that the outturn for 1988-89 will be considerably higher than assumed; underlying whole economy average earnings rose by 8¼ per cent in the year to April. Come the autumn, we are likely to have to publish a figure close to 8½ per cent or above for the current year.

18. The actual figures to be published in the Government Actuary Department's report in November and the PEWP (for 1988-89 and 1989-90) will be decided when the assumptions are revised in September/October. It would be sensible to revise up the earnings assumptions figures for 1988-89. (The earnings assumptions have little impact on demand-led expenditure. However, GAD do use the figure and we would gain some benefit from providing a more defensible figure for 1988-89 than the current assumption.) For later years the proposed assumption moves in the direction implied by the forecast. Alternatively we could, as in the past, stick with the March assumption pro tem, and reconsider the assumptions again in September/October. But this would produce a particularly stark discontinuity between 1988-89 and 1989-90.



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Average earnings assumptions

percentage changes on previous year

	<u>1987-88</u>	<u>1988-89</u>	<u>1989-90</u>	<u>1990-91</u>	<u>1991-92</u>
March Assumptions	7½	6½	5½	5	5
June Forecast		8½	7½	7	7
Proposed Assumption		8½	7	6	5
Alternative Assumption		8½	5½	5	5

Interest Rates

	Latest (close[27]June)	<u>1988-89</u>	<u>1989-90</u>	<u>1990-91</u>	<u>1991-92</u>
<b>3-month sterling inter-bank</b>					
March assumption		9	9	8½	8
June forecast	9.8	9.1	10.5	10.5	10.5
<b>20-year gilt rate</b>					
March assumption		9	9	8½	8
June forecast	9.5	9.4	9.5	9.5	9.5
<b>6-month dollar LIBOR</b>					
March assumption		9	10	9	9
June forecast	7.9	8.3	9.6	9.1	9

19. The forecast for UK interest rates are higher than at Budget time, while the outlook for US interest rates is a bit lower. But for 1988-89 the forecast is reasonably close to the assumptions. For the moment, therefore, we prefer to leave the March assumptions unchanged. These assumptions are never published, and go to only a small number of departments. Our proposal should cause no difficulties therefore.

Effects on expenditure

20. Table 3 in the annex sets out a ready reckoner indicating the approximate effect on forecast expenditure of changes to the economic assumptions. The table below shows the changes in expenditure implied by the proposals made in this submission, compared to the assumptions issued in March, on which current departmental bids are based.



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<u>Assumptions</u>	<u>1988-89</u>	<u>1989-90</u>	<u>1990-91</u>
Unemployment	[- 240]	[- 250]	[- 260]
RPI	[ - ]	[ 210]	[ 790]
Interest rates*	-	-	-
Total	[- 240]	[- 40]	[ 550]

\* No changes to assumptions.

Conclusions

21. Annex Table 4 shows which departments receive particular assumptions. DHSS and GAD are the major customers for the assumptions on unemployment, RPI (including and excluding housing), the GDP deflator, and average earnings. DTI and ECGD are the major users of the interest rate assumptions, though they also go to Northern Ireland Office. (GEP are currently surveying whether all the departments who receive the assumptions at the moment actually need them.) But departments generally may be more alive this year to the possibility of revisions to the GDP deflator, because they will be aware of what is already happening this year. We may need to give that particular assumption to some other major departments, like Defence, who will regard the real growth of their programmes as important.

22. This submission has been discussed with Sir T Burns and Mr Anson. You may want to hold a meeting to decide the assumptions.

*Jim Hibberd*  
J S HIBBERD



## PROPOSED ASSUMPTIONS ON UNEMPLOYMENT, EARNINGS AND INFLATION\*

<u>Unemployment GB narrow (millions)</u>	<u>1987-88</u>	<u>1988-89</u>	<u>1989-90</u>	<u>1990-91</u>	<u>1991-92</u>
<u>Published</u> PEWP assumption		2.6	2.6	2.6	
<u>Unpublished</u> March assumption	2.63	2.35	2.35	2.35	
<u>Unpublished</u> June forecast	2.62	2.24	2.15	2.20	2.22
<u>Proposed Assumptions</u>		2.25	2.25	2.25	2.25

	<u>1987-88</u>	<u>1988-89</u>	<u>1989-90</u>	<u>1990-91</u>	<u>1991-92</u>
<u>Average earnings per head</u> <u>(per cent changes)</u>					
<u>Published</u> PEWP/GA assumption	7½	6½			
<u>Unpublished</u> PEWP/GA assumption			5½	5	5
<u>Unpublished</u> June forecast		8.6	7.5	7.1	7.1
<u>Proposed Assumptions</u>		8½	7	6	5

<u>RPI (per cent changes)</u>	<u>Year to</u> <u>September</u> <u>1988</u>	<u>Year to</u> <u>September</u> <u>1989</u>	<u>Year to</u> <u>September</u> <u>1990</u>
<u>Published</u> PEWP assumption	4½	3¼	
<u>Unpublished</u> June forecast	5	6	4
<u>Proposed Assumptions</u>	5	5	4
June forecast for RPI excluding housing	4¼	4	3
<u>Proposed Assumption for RPI excluding</u> <u>housing</u>	4¼	3¾	

<u>GDP deflator (per cent changes)</u>	<u>1987-88</u>	<u>1988-89</u>	<u>1989-90</u>	<u>1990-91</u>	<u>1991-92</u>
<u>Published</u> PEWP assumption	4¼	4½	3½	3	
<u>Published</u> FSBR/MTFS figures	5	4½	4	3½	3
<u>Unpublished</u> June forecast	5.1	5.7	5.2	4.0	4.1
<u>Proposed assumptions</u>		5½	4¾		3½

\* This table does not include the alternative assumptions discussed in the main note.



## ASSUMPTIONS ON INTEREST RATES

<u>3-month sterling interbank rate</u>	<u>1987-88</u>	<u>1988-89</u>	<u>1989-90</u>	<u>1990-91</u>	<u>1991-92</u>
<u>Unpublished</u> PEWP assumption	10	10	9	9	
<u>Unpublished</u> FSBR/MTFS figures	9.3	9.0	8.9	8.5	8.1
<u>Unpublished</u> June forecast	9.3	9.1	10.5	10.5	10.5
<u>Proposed Assumptions</u>		9	9	8½	8

<u>20-year gilt rate</u>	<u>1987-88</u>	<u>1988-89</u>	<u>1989-90</u>	<u>1990-91</u>	<u>1991-92</u>
<u>Unpublished</u> PEWP assumption	10	10	9	9	
<u>Unpublished</u> FSBR/MTFS figures	9.4	9.2	8.9	8.5	8.1
<u>Unpublished</u> June forecast	9.4	9.4	9.5	9.5	9.5
<u>Proposed Assumptions</u>		9	9	8½	8

<u>6-month Dollar LIBOR</u>	<u>1987-88</u>	<u>1988-89</u>	<u>1989-90</u>	<u>1990-91</u>	<u>1991-92</u>
<u>Unpublished</u> PEWP assumption	7½	8½	9	9	
<u>Unpublished</u> FSBR/MTFS figures	7½	9¼	10¾	9½	8¾
<u>Unpublished</u> June forecast		8.3	9.6	9.1	9
<u>Proposed Assumptions</u>		9	10	9	9



## EFFECT OF CHANGES IN ASSUMPTIONS ON THE PUBLIC EXPENDITURE PLANNING TOTAL

	<u>£ million</u>			
	<u>1988-89</u>	<u>1989-90</u>	<u>1990-91</u>	<u>1991-92</u>
(a) 100,000 rise in unemployment DHSS	220	230	240	240
<u>One point rise in sterling interest rates</u>				
(b) ECGD (short rates)	55	52	48	44
(c) Housing subsidies (pool rate*0)	110	110	110	110
(d) DTI credit to shipbuilders (short rates)	9	9	9	9
<u>One point rise in dollar interest rates</u>				
(e) ECGD	12	14	17	20
<u>One per cent higher September 1988 RPI relevant to April 1989 uprating**</u>				
(f) DHSS		410	430	430

\* Housing subsidy pool rate responds with a lag to changes in short and long rates.

\*\* Ready reckoner applies to one point change in both the all items RPI and the RPI excluding housing.



## ANNEX

TABLE 4 : DEPARTMENTS RECEIVING ECONOMIC ASSUMPTIONS

<u>Unemployment</u>	DHSS, DEmp, Northern Ireland Office (NIO), GAD.
<u>RPI (including and excluding housing costs)</u>	DHSS, ECGD, NIO, GAD
<u>GDP deflator</u>	DHSS, GAD
<u>Average earnings</u>	DHSS, GAD
<u>Interest Rates</u>	DTI, ECGD, DOE, NIO, Scottish Office Welsh Office. (The last four receive these to compute housing subsidies.)
<u>Superannuation Uprating* (September to September all items RPI increases)</u>	Paymaster General, ODA, DHSS, MoD, DES, Home Office, Scottish Office and Northern Ireland.

\* Superannuation uprating assumptions go to departments paying public service pensions. Though described as superannuation uprating assumptions, the departments are well aware that they are actually the September to September RPI all items increase.



FROM: J HIBBERD  
DATE: 1 JULY 1988

1 memo  
2 for present meeting tomorrow.  
Pryp

CHANCELLOR

cc Chief Secretary  
Sir P Middleton  
Sir T Burns  
Mr Anson  
Mr Monck  
Mr H Phillips  
Mr Scholar  
Mr C W Kelly  
Mr Odling-Smee  
Mr Sedgwick  
Mr S Davies  
Mr Mowl

Thanks.  
Relevant to P&S group, Mr  
Tous: ① pl minute thanks  
then ②

RECENT DEVELOPMENTS AND PROSPECTS FOR CONSTRUCTION OUTPUT

You may be interested in the attached note on the construction sector. Evidence is building up of capacity constraints in this sector. Housing investment has been strong (and is likely to remain so) for the past two years. But there are clear indications of a substantial pick-up in commercial and industrial investment in new buildings recently. Moreover, the latest DTI Investment Intentions Survey points to very strong growth in such investment this year.

*Jim Hibberd*  
J S HIBBERD

HIBBERD  
TO  
CX  
1 JUL

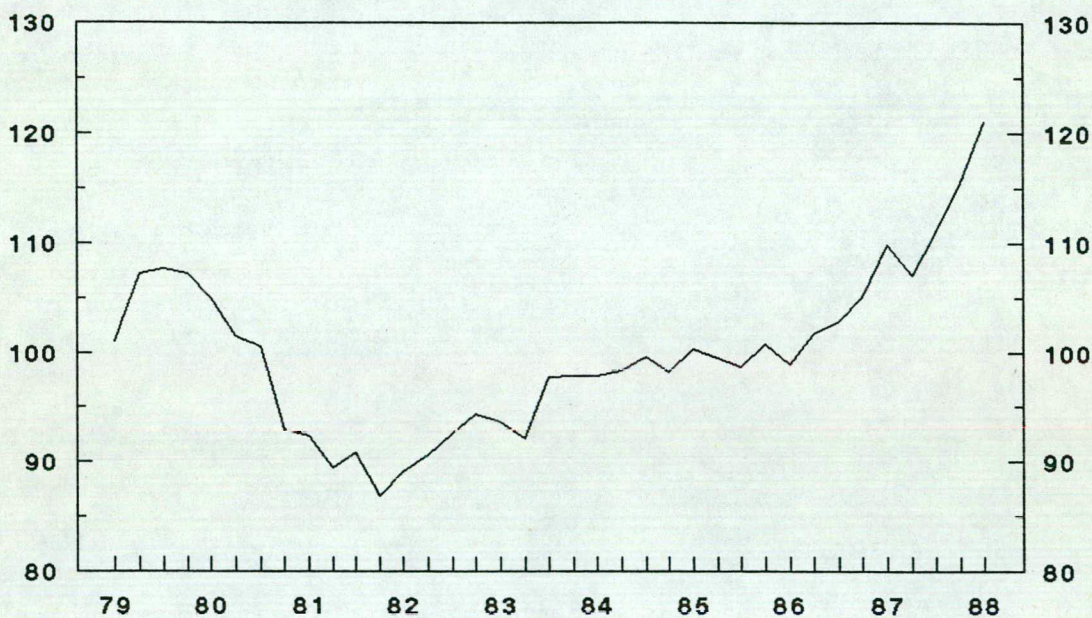


RECENT DEVELOPMENTS AND PROSPECTS FOR CONSTRUCTION OUTPUT

This note briefly surveys recent indicators and prospects for construction industry output.

Output

2. The construction sector is currently experiencing a boom. In 1987 construction output rose by 8½ per cent, to its highest level for fifteen years. This was after a severe slump in 1980 and 1981 (when output fell by a cumulative 16 per cent) and a patchy, but fairly slow, average growth of 2½ per cent over 1983-86, when recorded total output was rising by an average of almost 3½ per cent. Conceivably, the recent construction output increase could be understated, since official statistics do not measure activity in the black economy, enterprise zones etc. *Why on earth not?*

**OUTPUT OF THE CONSTRUCTION INDUSTRY (1980=100)**

(1979Q1-1988Q1)

3. It seems likely that construction output will expand strongly again in 1988. A recent NEDO assessment points to continued strong growth in construction output of 8 per cent in 1988. (We think it could be higher, up to 10 per cent.) Only six months ago NEDO were suggesting that the construction sector peaked in 1987. Their more current view reflects the inclusion of Channel Tunnel work, and "a continuing remarkable rise in commercial work".

4. The latest DTI Investment Intentions Survey (published in June) confirms the prospect for a strong rise in commercial construction. It points to a very strong investment boom, especially in new buildings

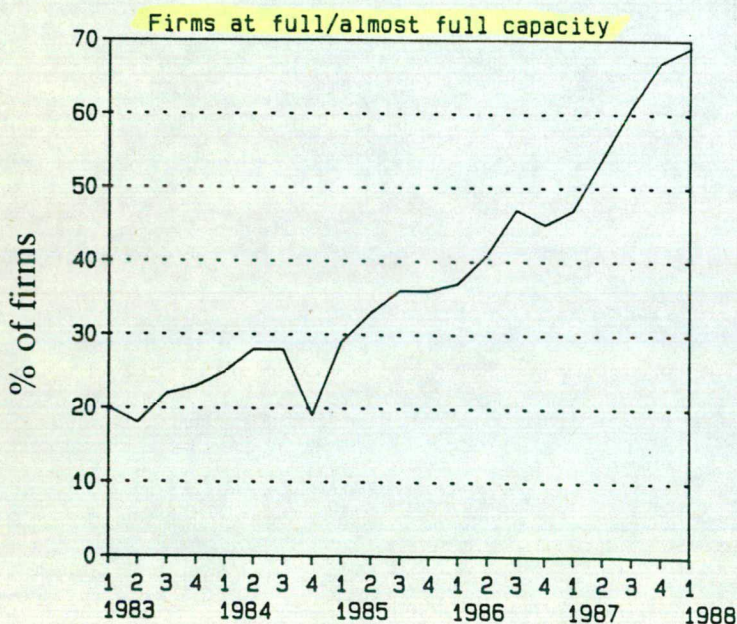


and works. Manufacturers are expected to increase such investment by 33 per cent, and selected service industries (including financial services), distribution and the construction sector itself by 9 per cent. (This also includes Channel Tunnel work.) On top of this, investment in new housing is likely to grow strongly in 1988. These developments are all consistent with a particularly sharp increase in recorded construction orders in the latter half of 1987. The increase in orders was especially strong in London and the South East, up 70 per cent on a year earlier.

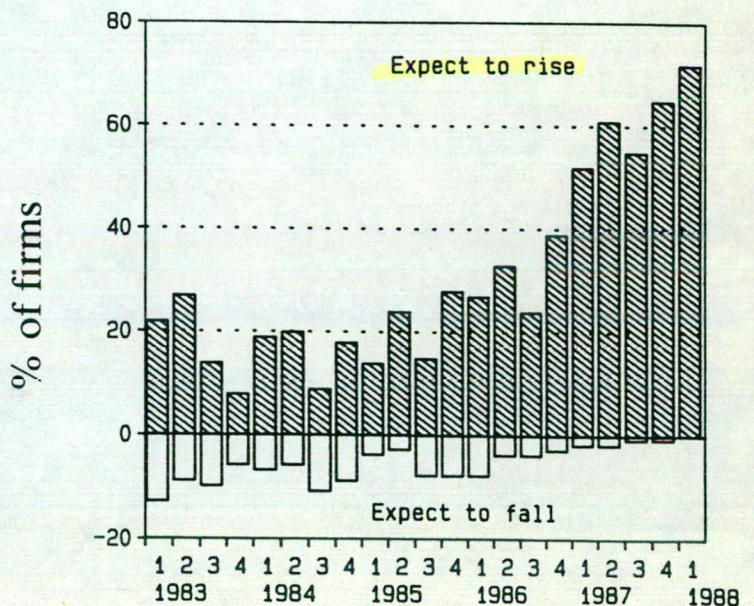
Capacity Constraints?

5. A Building Employers Confederation (BEC) Survey in March 1988 reported 70 per cent of firms operating at full capacity, compared with 47 per cent a year earlier (see charts). But other, indirect indicators are inconclusive. On the prices front, construction materials prices are currently rising at about 5½-6½ per cent per annum, 1-2 per cent faster than manufacturing output prices, and inflation generally. Construction output prices rose 7½ per cent in this year to 1987 Q4, considerably faster than other prices. However, this was dominated by new house prices, up 13½ per cent in the year to 1987Q4. Prices for other new building work rose only 4½-5½ per cent over the same period, much closer to average inflation. DOE statistics also point to a sharp increase in new road construction tender prices in 1987. In the year to 1987Q2 (the latest data available) tender prices rose by 12½ per cent after falling 3 per cent in 1986. BEC Survey evidence indicates that 72 per cent of firms in March 1988 were expecting tender prices to rise. This compares with a balance of 65 per cent in December 1987, 52 per cent in March 1987, and 26 per cent in March 1986 (see charts).

CAPACITY OF OPERATIONS



EXPECTED CHANGE IN TENDER PRICES





6. On materials shortages the evidence is patchy. Whilst more materials are being produced and delivered, there is nothing to suggest shortages of roofing tiles, concrete blocks, slates, gravel or sand. But stocks of bricks, relative to production and deliveries in 1987 are less than half the level of two years ago, and the lowest for nearly fifteen years. Moreover, a report in the Financial Times of 29 June (copy attached) notes that Blue Circle Cement are importing small quantities of cement to meet rising demand. They are also raising prices (by 6 per cent) following recent 5 per cent increases by Rugby and Castle, the UK's two other leading cement producers. BEC survey evidence also points to some shortages. In March of this year, some 64 per cent of firms reported delays due to material shortages, up 16 per cent on a year earlier. But only 5 per cent reported serious delays. In the Federation of Civil Engineers' latest survey (April), four out of five firms reported a satisfactory supply position, indicating the health of that specific sector.

7. Evidence on labour shortages is also inconclusive, with some conflict between official statistics and survey reports. There are wide, and unexpected, regional variations. Total construction employment has increased by 2½ per cent since June 1986, 1 per cent faster than in the economy as a whole. Nonetheless, employment is still 10 per cent lower than in June 1979.

#### Construction Employment and Productivity

	Employment (% change)	Productivity
1979	3.9	-3.1
1980	1.2	-6.6
1981	-5.4	-4.9
1982	-3.2	5.2
1983	0.2	3.9
1984	2.5	0.8
1985	-0.5	1.9
1986	-0.5	2.8
1987	4.2	4.0

8. Employment growth has been particularly strong in East Anglia, West and East Midlands, and Scotland. But, surprisingly, employment increases have been below average in London and the South East; construction employment actually fell by over 1 per cent in London.

*MS broken  
of Channel  
etc*

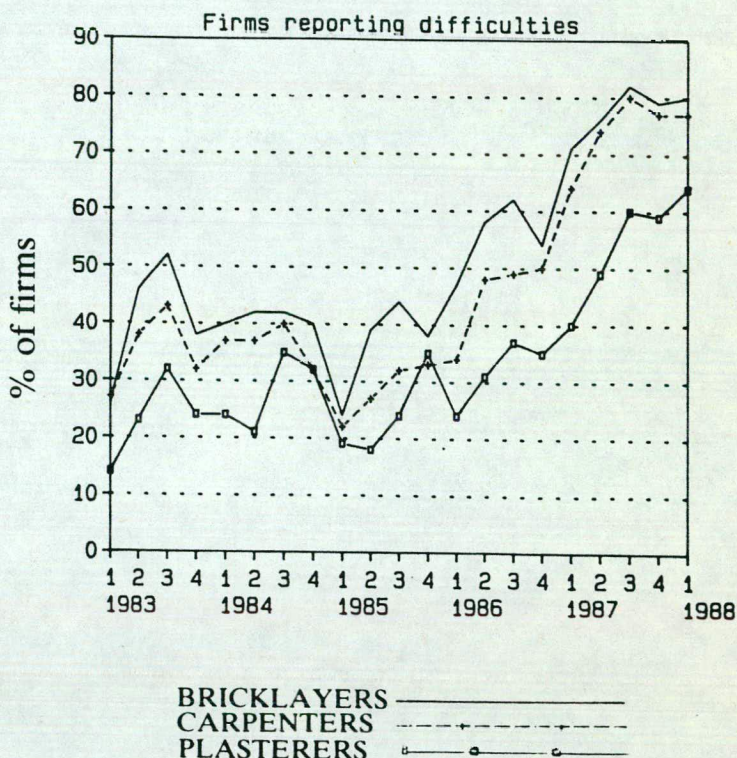


9. The regional employment differences broadly tie in with earnings developments. Average earnings rose by 12½ per cent in East Anglia between 1986 and 1987, and by 8½ per cent in London and the South East. As noted above, however, official statistics may be distorted in that they do not capture 'black economy' activity which exists in the construction sector. BEC survey evidence points to some emerging labour shortages. Around 80 per cent of firms report some difficulty in recruiting bricklayers and carpenters, compared to only 50 per cent at the beginning of 1987. This can be seen in the chart below, along with the regional data.

FIRMS REPORTING DIFFICULTIES (%)  
(Latest Figures only)

	Brick-layers	Carpenters	Plasterers
Scotland	43	56	01
Northern	47	51	47
North Western	68	65	37
Liverpool	77	74	57
Yorkshire	70	66	59
Midland	85	85	80
Eastern	83	84	66
South Wales	43	45	48
South Western	85	88	72
Southern	86	84	71
London	97	77	75
Nat Contractors	93	86	78
Total	80	77	64

LABOUR AVAILABILITY



BUILDING EMPLOYERS CONFEDERATION

Conclusion

10. The construction sector is undoubtedly enjoying a boom. Until recently relative earnings and price growth have not been startling, but output prices in the housing sector are rising sharply. Tender prices also seem to be nudging upwards. Materials delays do not appear to be significant, though stocks of bricks are particularly low. Labour shortages are becoming important in the South, particularly for craftsmen in the building trade. Firms are increasingly reporting capacity constraints, though this again is most noticeable in the South



and in the house building sector. Pressure on capacity is likely to increase further through 1988 as the current investment boom proceeds, though there may remain considerable under-utilised capacity in the North.



# Cement producer forced to import as demand rises

BY ANDREW TAYLOR

BLUE CIRCLE, Britain's biggest cement manufacturer, said yesterday it had had to import small amounts of cement from the Continent to meet rising demand from UK construction companies.

Blue Circle said it was increasing its cement prices by £2.65 a tonne from August 1, taking the ex-works price for ordinary Portland cement to £46 a tonne. The move will bring the group's prices into line with those at Rugby Group and Castle Cement, Britain's other remaining cement manufacturers.

Rugby and Castle have each announced increases of about 5 per cent in the last few weeks. Rugby last week said it was increasing its prices by £2.52 a tonne. Castle, which was recently acquired from RTZ, the UK mining, energy and industrial group, by Scancem, a Swedish-Norwegian joint venture, announced last month that it was raising its prices by £2.75 a tonne.

Blue Circle said these were the first increases to have been announced by all three companies for three years. Rising labour and electricity costs had forced the group to raise prices.

The group said its British cement sales during the first five months of this year were 16 per cent higher than in the corresponding period last year. The underlying increase in sales was about 10 per cent, after taking account of the effects of a mild winter on building activity.

British cement manufacturers,

which several years ago were closing works and suffering from substantial overcapacity, were now having to import small amounts of cement to satisfy demand.

Blue Circle said it had imported between 20,000 and 30,000 tonnes of Belgian cement this year. It had also imported about 132,000 tonnes of clinker, a semi-finished material used to make cement.

It warned that some Greek cement, exported by Blue Circle to the US, might also have to be diverted to Britain to meet rising demand. Blue Circle, along with Rugby and Castle, mounted a campaign two years ago to try to stop subsidised Greek cement imports from entering Britain.

Mr Jim McColgan, chief executive of Blue Circle's cement operations, said yesterday that the arrival of cut-price Greek cement had been instrumental in persuading British cement manufacturers in February last year to abandon their 53-year-old price-fixing agreement.

He said Blue Circle, as well as importing small amounts of cement and clinker into Britain, was also considering reopening two of its kilns at Aberthaw in Wales and Plymstock at Plymouth.

The cost of recommissioning the two kilns would run into several million pounds each and the group would have to be careful that demand for cement did not drop just as they were ready to open, Mr McColgan said.

# Crown Estate 'needs real financial target'

BY PAUL CHEESERIGHT, PROPERTY CORRESPONDENT

ABSENCE OF financial targets is the chief weakness of the Crown Estate's attempt to bring its management up to date, according to the National Audit Office, Parliament's watchdog over the efficiency of state agencies.

The National Audit Office considered the existing target "meaningless." It should be replaced "with a revised target based upon the inbuilt growth in the London and urban estates." There was no reason why that

# Keeping travellers i

BY ROBERT MAUTHNER, DIPLOMATIC CORRESPONDENT

IN AN EFFORT to salvage the remnants of Britain's reputation abroad after the recent bout of football hooliganism in West Germany, the Foreign Office yesterday launched a series of short television films giving advice to British travellers abroad.

The 20 to 90-second films, produced by the Central Office of Information at a cost of £150,000, are on the theme "Get it right before you go." They are being distributed for free transmission to the BBC and independent TV companies in the hope that they will be broadcast in unsold commercial air time and other breaks.

Although seasoned travellers will marvel at the simplicity of

some of the advice offered "first make sure you can get back; take enough money; beware of pickpockets" — Tim Eggar, Parliamentary Under-Secretary of State, emphasised that it was all based on experience of the trouble travellers get into.

British holidaymakers, seems, are more inclined to getting tight, rather than getting right, both before and after boarding their flights to Bermuda, Majorca and the Greek islands, although Mr Eggar claims the Spanish authorities have assured him: "They are worse than anyone else, they are just more numerous."

Numerous they certainly will

# CAA to relax group

BY MICHAEL DONNE, AEROSPACE CORRESPONDENT

CHEAPER FARES for clubs and groups of travellers are likely to be easier to obtain as a result of changes in the Civil Aviation Authority's licensing policies.

The authority is ending immediately its policy of rejecting so-called "discriminatory" fares. In the past, that meant that group travellers were unable to get discount fares, even when the airline was willing to provide them.

The CAA's decision to abandon its opposition stems from changing attitudes in the airline industry itself and among governments and regulatory bodies,

which have already led to increased deregulation.

Any group will now be entitled to approach an airline to seek a discounted rate. If the two sides agree on a price, the airline will be able to apply to the authority for approval, with a reasonable good chance of gaining it.

The CAA will want to be satisfied that the fares are not so low that they fail to cover the airline's costs.

The new policy is part of an overall review of route licensing and fares rules.

The authority says it will continue to use its powers "to cre-





FROM: A C S ALLAN

DATE: 1 JULY 1988

*pw*

*The News*

CHANCELLOR

PCC DISCUSSION OF THE FORECAST

The PCC discussion of the forecast was really pretty subdued. People seemed worried, but had little idea what to do, beyond saying that the tightening of monetary policy should take place earlier than in the forecast.

Peter Sedgwick started by saying that the forecasts he had presented had usually been generally favourable and it had been relatively easy to see the way through. This time, the forecast was more worrying, and he saw signs of things getting out of hand. There were data problems, but domestic demand was clearly rising very fast and tax cuts would only now be feeding through into pay packets.

The forecast had the investment boom coming right off in 1989 and 1990, which he thought was probably justified. But he had greater doubts over whether consumption would slow down as forecast. He noted, however, that the forecast had a very considerably tightening of the policy stance, with interest rates up to 10½% and the PSDR held constant at about 1½% of GDP.

Given the rise in output, it was remarkable how subdued inflation had been. Wages had edged up but by much less than he would have expected. There were some signs, though, that the RPI was now edging up, exacerbated by mortgage interest effects.

ALLAN  
TO  
C.Y.  
1 JUL





Colin Mowl noted that the increase in interest rates brought MO back to its target range by the end of the year. But it was not clear that it would bring any marked slowdown in the growth of consumer spending. John Odling-Smee said that simulations on the Treasury model showed that a credible half percent increase in interest rates brought about a 1% decline in money GDP.

Michael Scholar noted that the Budget forecast had money GDP slowing down from 10% to 8 $\frac{3}{4}$ %, and MO getting back to its target range fairly early. The mechanisms for this had been an increase in the savings ratio; some cyclical slowdown; and some effects from the stock market collapse. It was clear that none of these had happened. The forecast now showed some future slowdown, brought about by a tighter monetary stance. He thought it was difficult to believe fiscal policy was driving the consumption boom, but he did now wish the tax reductions in the Budget had been smaller. He thought we should be looking for an earlier tightening of monetary policy than in the forecast. We would then need to look at where we had got to around the turn of the year, when we might be pushed to a further tightening of fiscal policy.

Nick Monck noted that Terry's commentary implied that we should raise interest rates and hold the exchange rate; this implied we were more worried about inflation than about the current account. But he wondered whether this would be sustainable, and whether we could convince people that the exchange rate would not depreciate. He was concerned that there was no clear explanation of how the current account would come right, though he had no other policy recommendations.

Geoff Littler thought we should look for an earlier tightening. The company sector was buoyant and higher interest rates should do it little damage. Colin Mowl noted here that the profile of interest rates in the forecast was not necessarily what the forecasters thought ought to happen - and the forecast had been





prepared before the recent rises.

✓ John Anson noted that we had thought that a £3 billion PSDR was as high as we could go without getting irresistible pressure from colleagues for a surge in spending. He very much doubted whether, on similar grounds, we could go for a tighter fiscal policy than a PSDR of £7 billion.

Tony Wilson noted that the stock cycle seemed to have been abolished, and he did not see it coming back. The personal savings ratio was a mystery, but he thought attitudes had changed about whether it was necessary to provide for a rainy day.

Anne Mueller had worries about inflationary expectations. Earnings growth had conspicuously failed to fall with the decline in the RPI and she was worried that it might now rise again.

John Odling-Smee said that we had found that the settings of policy instruments we had thought would produce an acceptable growth in money GDP had in the event proved not sufficiently tight. Any in-year fiscal tightening was, rightly, ruled out, but he would not rule out going further in 1989-90. He agreed that the right response now was to concentrate on monetary policy tightening.

Terry spoke along the lines in his note. He agreed there was an inflation problem, but thought it should not be exaggerated: we had seen a similar pattern in 1984 and 1985. The RPI was only half a percent above the Budget profile, and import and export prices and the CBI Survey questions on prices were not particularly worrying.

The balance of payments was the area of most division, and the one where we could continue to expect public concern. It was difficult to understand the figures: the current account had deteriorated by 3% of GDP, but at the same time the residual error had increased by





2-2½%. This implied either that the current account deterioration had not been this great, or that investment had been rather stronger.

It was possible to be much too gloomy: the British and world economies were very much stronger than had been expected. There were some worries but not an immense problem. The inflation worries did require a response, which we were giving by raising interest rates.

Peter said that we could not afford to let inflation rise. There was not a huge inflation problem but we could not wait too long. He suspected that the factors which had caused the personal savings ratio to fall might remain in place longer than we thought - particularly inasmuch as it reflected general confidence. One way of getting the savings ratio up would be to shatter confidence and have more inflation: that would clearly be absurd. What we needed was to keep confidence up so that the supply-side improvements continued to flow through. He agreed that we needed a tighter monetary policy, and said that any thoughts of getting back to 3DM should be put to one side: it was clear that we had needed a realignment. He thought we should continue to bear down hard with our monetary policy. If that proved to be insufficient, we should need to look at fiscal policy in next year's Budget.

A C S ALLAN



*Lightnings but  
unpleasant*

FROM: P J CROPPER  
DATE: 6 July 1988

CHANCELLOR

cc Economic Secretary  
Sir T Burns  
Mr Tyrie  
Mr Call

ECONOMIC FORECAST

I wonder whether we all got October 19th wrong by 180 degrees. Was it not, perhaps, a signal of an upturn?

2. I recall, somewhere in economic history, that there used to be a tendency for interest rates to peak at harvest time because everybody's money was tied up in crops, and then gradually subside as people realised the value of their crops and turned them into money.

3. Could it be that 19th October happened because of a creeping awareness that the American economy was not heading for a pre-election doldrum, but that it was about to get its second wind? And that the UK was about to take off, too. So people started selling stocks and shares, in order to raise the liquidity that would be needed to finance the unexpected surge in the real economy. And once the selling started everybody had to join in, because everybody was becoming conscious that GDPs were starting to rise abnormally fast and they would need cash. Which may have explained the sheer speed of the thing: we were not dealing with a cyclical down-turn at all: it was something quite different.

(??)

*P J Cropper*  
PP  
P J CROPPER



Sarah,  
for your files?

→ ~~personal folder~~  
pnp.

FROM: MRS M HENSON  
DATE: 8 JULY 1988

PS/FINANCIAL SECRETARY  
PS/ECONOMIC SECRETARY

cc PS/Chancellor  
PS/Chief Secretary  
PS/Paymaster General  
PS/Sir P Middleton  
Mr Odling-Smee  
Mr Sedgwick  
Mr Gieve

**LETTER FROM PROFESSOR PETER HALL (HARVARD UNIVERSITY)**

Professor Hall has written identical letters to the Financial Secretary, the Economic Secretary and Sir Terence Burns inviting them to discuss issues raised in his research for his study of the formulation of macro-economic policy in the 1970-88 period. No other copies of the letter have come to light in the Treasury.

2. This appears to be a serious study and Sir Terence Burns proposes to agree to see Professor Hall. Sir Peter Middleton's view is that one meeting with the Treasury seems quite sufficient, unless the Financial Secretary or Economic Secretary would particularly like to see him. Sir Terence intends to reply to Professor Hall indicating that he is willing to talk to him on behalf of the Treasury. I should be grateful for confirmation that the Financial Secretary and Economic Secretary are content with this response.

I agree that  
no need for FS/EST  
to look into this.

Meena Henson  
MRS M HENSON  
Private Secretary

? Re 9 team you  
x Re 9 fac you

passed on  
to Meena

Mp



HARVARD UNIVERSITY  
CENTER FOR EUROPEAN STUDIES

5 BRYANT STREET  
CAMBRIDGE, MASSACHUSETTS 02138  
617/495-4303

Flat 3,  
62 Chesterton Road,  
London W10 6ER  
29 June 1988

Sir Terence Burns,  
Chief Economic Advisor,  
H.M. Treasury,  
Parliament Street,  
London SW1P 3AG

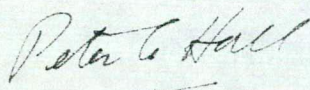
Dear Sir Terence,

I am currently in London completing the research for a major study of the formulation of British macroeconomic policy in the 1970-88 period. The purpose of the volume is to provide a better understanding of the opportunities and constraints that face economic decision-makers, as they formulate policy in the face of changing economic conditions. It is a follow-up to my last book, Governing the Economy which won the Woodrow Wilson award for the best work on politics or international affairs published in America in 1986.

As part of the research, I have spoken to a large number of officials at the Treasury, the Bank and in the Governments of the period on an off-the-record basis. Since you have observed the process of economic policy-making from a unique vantage point in recent years, I would especially appreciate an opportunity to discuss some of the issues raised in the research with you.

Accordingly, I am writing to ask if we might arrange a brief meeting. I can be reached in London at 969-6660. Alternatively, I hope you won't mind if I call to see if we can arrange an appointment. I do hope we will be able to meet.

Sincerely,



Peter A. Hall  
Paul Sack Associate Professor  
of Political Economy



# UK Economic Research Studies

22nd July, 1988

## Demand pressure approaches 1973 peak

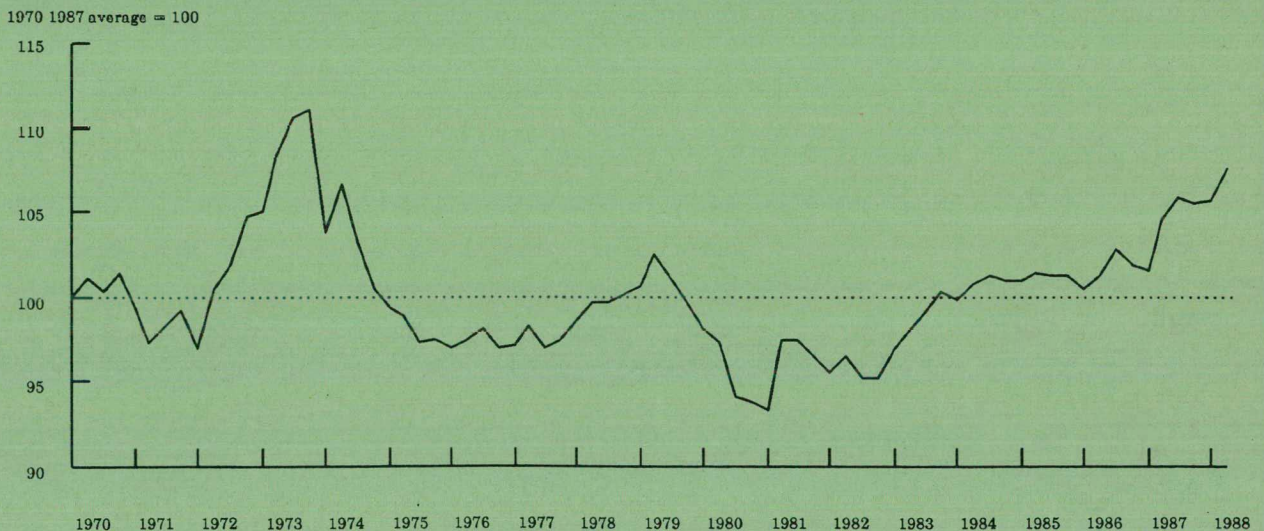
After the traumas of 1974/75 and 1980/81 it is hardly credible that the UK should stand, once again, at the threshold of an inflationary resurgence. Yet there is every economic indication that this is so. Demand pressure appears to be almost as severe now as in late-1973. Rather than a short-term aberration from a consistent anti-inflationary strategy, the 1988/89 episode is likely to represent a more worrying departure, perhaps culminating in an inflation rate of close to 10% by late 1989.

This prospect can be traced to a phase of monetary expansion which began around the beginning of 1986. While the acceleration in the broader monetary aggregates was well-defined, it also coincided with sharp fall in the inflation rate. The resulting extra impetus to demand, in an economy already experiencing a steady rate of growth, tipped the scales towards an inflationary boom.

In an earlier study, "Intense overheating with inflation to follow", dated 5th February, an index of demand pressure in the UK was presented. This study updates the index, identifies

particular pressure points and suggests a chronology for the interest rate response and retail price inflation. The index has been recalibrated such that the base value of 100 represents a "normal" degree of demand pressure. Looking at the chart of the series, the stability of the index between mid-1983 and mid-1986 is striking. The average growth of the economy during this period was a healthy 2.8% per annum and there were few indications of any undue strain on industrial capacity. Since mid-1986, eleven of the fifteen constituent series of the demand pressure index have risen noticeably. Two more were broadly unchanged by the second quarter of 1988, while two others (the company liquidity ratio and a measure of the government's net fiscal stance) were rather lower. On balance, there is now overwhelming evidence that the economy suffers from over-heating. Indeed, the Chancellor would hardly have raised interest rates by 3% in six weeks if he did not agree. The only questions that remain concern the extent of future interest rate rises, the peak of the inflation rate and the length of time before that peak is reached.

### An index of demand pressure in the UK economy



*X*

*I had to  
grapple for a  
while on this  
background - calculated  
mkx.*

*Also An  
updated index  
on SLH's  
track record on  
inflation  
forecasting*



## Recent behaviour of the components of the demand pressure index

The demand pressure index consists of fifteen separate indicators drawn from the markets for goods and services, labour, capital, property and financial assets. Each has an equal weight in the index. Due to constraints on data availability, 1970 was chosen as the starting point of the analysis and therefore the benchmark value of 100 represents an average of index values for the period 1970-1987. (For details of the precise definitions, sources and method of calculation of the fifteen component series the reader is referred to the original research study.)

In this section the recent history of each indicator is tabulated, together with its extreme values. The first five series are representative of the economic temperature in the market for finished goods and services. In terms of recent activity, the import ratio for intermediate and capital goods has been the strongest contributor to the overall index within this category. While imports of consumer goods have risen little faster than personal consumption, in volume terms, during the past year, capital goods' imports have shown phenomenal (17% to 20%) annual growth rates.

Liquidity measures for the personal and corporate sectors attempt to capture latent demand for goods and services. At high real rates of interest, money invested in so-called "savings" accounts is unlikely to be released as spending power in the economy. But as fears of higher inflation take hold, consumers may be tempted to bring forward planned expenditure to avoid imminent price rises. In column 2, personal liquidity is shown to be very high at present in relation to the value of consumer spending. In contrast, corporate liquidity has declined, albeit from an 18-year peak, as companies have embarked on heavy capital expenditure programmes in order to remedy perceived shortages of physical capacity. In the final column is an estimate of the government's fiscal policy stance, net of adjustments for assets sales, North Sea revenues and cyclical factors. While retaining many flaws as a measure of fiscal policy, the series reflects the relative tightness of policy (in that its value in the most recent period is well below 100) but also the slackening of the policy stance as a result of the 1988 Budget. (On later pages, a version of the demand pressure index excluding the net fiscal stance is also used.)

Table 1: Constituent series of the demand pressure index

1970-1987 average = 100		1 Import ratio, consumer goods	2 Personal liquidity ratio	3 Import ratio, capital goods	4 Corporate liquidity ratio	5 Net fiscal stance
1983	Q1	99.2	100.2	100.9	100.7	103.2
	Q2	101.2	101.5	98.9	102.2	97.9
	Q3	106.8	100.6	96.4	104.1	98.0
	Q4	102.1	101.8	101.7	110.9	95.1
1984	Q1	102.9	102.8	100.0	107.9	99.2
	Q2	99.3	103.8	106.2	102.0	100.3
	Q3	103.0	105.9	106.3	104.2	96.1
	Q4	98.1	106.6	106.9	105.2	98.0
1985	Q1	97.0	106.2	104.0	105.0	98.0
	Q2	98.4	108.5	100.2	104.5	97.5
	Q3	98.0	107.6	100.5	106.0	94.8
	Q4	96.2	108.3	101.8	105.4	92.9
1986	Q1	94.7	109.2	99.2	105.5	95.0
	Q2	95.5	110.7	98.0	111.3	95.4
	Q3	98.9	109.6	104.9	110.6	94.3
	Q4	98.2	109.9	104.9	109.1	88.3
1987	Q1	92.4	111.1	97.5	106.0	97.0
	Q2	96.3	112.5	101.8	106.2	97.1
	Q3	98.9	110.7	106.9	107.1	91.8
	Q4	98.8	110.7	107.3	108.6	85.5
1988	Q1	93.4	111.8	106.0	102.8	92.3
	Q2	97.3	113.0	110.2	104.1	92.1
Range		83.8	86.2	79.4	81.7	79.1
		to 113.7	to 113.0	to 117.0	to 111.3	to 116.9



The series which fill columns 6 to 9 relate to the labour market. While the first three are particular to activities included under the "industrial production" rubric, unfilled vacancies is a whole-economy measure of demand pressure. Unemployment is not included because of the great difficulty of distinguishing the "structural" from the "cyclical" and "frictional" elements of the total. These four selected labour market indicators show unambiguous signs of excess demand pressure during the past 18 months.

The percentage of firms citing skill shortages as a short term constraint on output (column 6) is the least impressive of the four in terms of its absolute level. However, with about 20% of manufacturing firms complaining of this problem, a lack of skilled employees is arousing increasing concern. Next Tuesday's CBI survey will provide further evidence on this issue.

Indicators 7 and 8 complement each other in that the percentage utilisation of labour describes the *quality* of effort and net overtime hours, the *quantity* of effort. Beyond the fourth quarter of last year, the figures for P.U.L. are our own estimates, but a marked increase in utilisation during 1987 was already apparent. The net overtime hours index dipped in the second quarter, but remains close to its 18-year high. Insofar as employers have reached the point where the hiring of new employees cannot be avoided, given the strength of demand for the final product, overtime working would be expected to subside.

Unfilled vacancies (column 9) were particularly high in late 1973, and this degree of pressure has not yet been repeated in the present phase of rapid growth. Nevertheless, unfilled vacancies have been abnormally buoyant for over a year and are indicative of a supply constraint on the economy.

Columns 10 and 11 represent capacity utilisation in relation to manufacturers' capital stock. The CBI question regarding firms' proximity to full capacity working, shown in column 10, is one of the most striking pieces of evidence of excess demand pressure. In all the 30 years that this question has been asked, never have so many firms operated close to full capacity. Repeated denials of capacity shortages by the CBI, when commenting on their survey, stand in stark contrast to what their members appear to be saying.

Table 1 (continued)

1970-1987 average = 100		6	7	8	9	10
		Skill shortages	Percentage utilisation of labour	Net overtime hours	Unfilled vacancies	Capacity utilisation
1983	Q1	90.9	102.5	95.1	93.0	90.5
	Q2	92.2	108.2	95.8	97.2	93.2
	Q3	93.5	107.0	99.2	98.7	96.6
	Q4	93.5	113.5	101.9	98.2	98.0
1984	Q1	94.2	109.5	100.9	96.0	98.0
	Q2	94.8	107.4	101.8	99.1	102.0
	Q3	95.5	105.0	102.1	99.3	105.4
	Q4	95.5	103.8	103.3	98.7	104.7
1985	Q1	96.8	107.0	103.4	96.9	105.4
	Q2	97.5	107.0	103.5	100.5	105.4
	Q3	99.5	101.0	104.8	101.0	111.5
	Q4	99.5	99.4	104.6	100.9	108.8
1986	Q1	96.2	105.8	103.5	99.2	105.4
	Q2	98.2	102.6	103.1	103.2	103.4
	Q3	97.5	96.6	104.4	107.6	109.5
	Q4	97.5	95.8	104.2	104.4	108.8
1987	Q1	95.5	95.4	105.1	104.7	108.1
	Q2	97.5	98.6	106.7	110.0	108.8
	Q3	101.5	101.4	107.6	112.0	111.5
	Q4	102.2	107.1	109.6	109.5	114.2
1988	Q1	102.8	109.1	110.4	108.6	118.2
	Q2	102.2	110.7	109.6	110.9	120.3
Range		90.9	81.8	77.3	87.6	85.1
		to 123.5	to 113.5	to 110.4	to 119.1	to 120.3



In a question analogous to that for skill shortages, the extent to which a shortage of fixed productive capacity is actually a *constraint* on output is the source for the data in column 11. Once again, a steep increase in the index has occurred during the past year or so, suggesting that part of the strength of imports over the period may reflect a dearth of domestic supply capacity.

Two measures of demand pressure in UK financial markets are presented in columns 12 and 13. The dramatic ascendancy of real company share prices during the first seven months of 1987 carried this indicator to its 18-year peak. Despite the equally dramatic collapse of equity prices in October of last year, the series still registers an abnormally high degree of demand pressure. The reverse yield gap, contrasting the dividend yield in equities with the redemption yield on gilt-edged securities, fell much more sharply after the Crash as investors switched from the former class of investments to the latter, as well as into more liquid assets. It is difficult to escape the conclusion that last year's peaks are unlikely to be seen again for some considerable time and that the contribution of the financial variables to the overall index is liable to fade over the short-term.

The final pair of indicators relate to domestic property markets. In column 14, the house price to average earnings ratio documents the severity of demand pressure in the residential market. At 120.3 this series stands rather higher than in the property boom of 1972/73. Direct measures of the rates of return to industrial and commercial property tell a similar story. The most recent estimate of the Investors Chronicle-Hillier Parker research group is of a 47.0% return in the year to May 1988, a figure bettered only by the 54.7% of 1973. Column 15 shows the behaviour of property share prices (relative to the all-share index), which is less impressive but nevertheless indicative of a build-up of pressure in this market.

In summary, during the first few months after the stock market crash, a moderate increase in demand pressure in the real economy was cancelled out by much weaker readings on the financial variables. Now that these have stabilised at a lower level, at least for the time being, the demand pressure index is surging upwards again. By all accounts, the tightening of monetary policy which began in June will not take full effect until much later in the year. It is to be expected, therefore, that the next two quarterly values for our index will continue upwards.

Table 1 (continued)

1970-1987 average = 100		11 Capacity constraint	12 Real company share prices	13 Reverse yield gap	14 House price to earnings ratio	15 Property share price relative
1983	Q1	90.0	96.7	96.5	94.4	98.9
	Q2	94.3	97.8	95.3	96.1	97.1
	Q3	97.6	98.2	96.5	95.9	96.2
	Q4	99.8	98.0	94.8	95.8	98.9
1984	Q1	96.5	99.6	96.6	95.7	97.8
	Q2	100.8	99.6	98.2	97.6	98.6
	Q3	100.8	99.2	96.9	97.3	100.5
	Q4	101.9	101.0	95.9	94.7	99.3
1985	Q1	100.8	102.9	98.0	95.7	96.2
	Q2	105.2	102.8	97.5	96.0	96.8
	Q3	101.9	102.5	95.2	96.5	98.0
	Q4	104.1	104.1	96.2	98.7	97.3
1986	Q1	99.8	106.3	92.1	98.7	95.4
	Q2	99.8	108.1	92.2	102.2	94.4
	Q3	100.8	107.7	100.6	103.7	95.3
	Q4	99.8	107.9	99.7	103.5	95.9
1987	Q1	101.9	112.4	97.3	104.8	94.6
	Q2	112.8	116.2	99.0	106.4	98.1
	Q3	109.5	119.8	103.3	109.2	97.3
	Q4	111.7	110.6	95.3	111.8	99.3
1988	Q1	108.4	110.0	93.5	116.2	101.1
	Q2	113.9	110.3	92.4	120.3	105.0
Range		87.8	88.1	87.6	88.6	87.3
		to 120.4	to 119.8	to 119.0	to 120.3	to 123.6



## 2. Demand pressure, interest rates and inflation: historical precedents

The ultimate purpose of constructing the demand pressure index is to provide advance warning of a future rise or fall in inflation. Every episode of economic expansion has its own individual characteristics, but there are some striking similarities between the (incomplete) Lawson boom and the two completed peaks of demand pressure since 1970. The surge in non-oil commodity prices was specific to the 1972/74 boom, while on both previous occasions oil prices soared. This has led some commentators to attribute the inflation experiences of 1974/75 and 1980/81 almost entirely to the behaviour of primary product prices, and enables them to dismiss the threat of substantially higher inflation in present circumstances.

As far as oil prices are concerned, it is instructive to note that on each occasion demand pressure built up *before* the price changes occurred. In the Barber boom the index had reached its peak by the fourth quarter of 1973, the quarter in which oil prices were raised fourfold. In the less dramatic climax in 1979, again, the second quarter was the peak on the index and the period in which the oil price hike began. Hence, it is plausible to suggest that oil prices merely compounded a domestic inflationary process which was already underway.

The chronology of excess demand pressure, interest rate increases and mounting inflation is remarkably similar in 1973/75 and 1979/80. Interest rates averaged 13.0% in the first three months of 1974, up from 8.4% a year earlier. *Inflation did not hit its peak until eighteen months after the highest value on the demand pressure index.* Healey's mini-boom provoked a short-term interest rate of 17% six months after the peak of demand pressure, after it had averaged 11.4% in the fourth quarter of 1978. Once again, inflation reached a climax fifteen months after the index.

Both these episodes suggest that, firstly, interest rates in 1988 have almost certainly not yet risen by a sufficient margin to choke off excess demand and, secondly, that the path of inflation is likely to be upwards for well over a year to come. Supposing that the demand pressure index establishes a peak in the third or fourth quarter of this year, it is well within the breadth of recent experience to suggest that base rates could reach 13% or 14% in the early part of 1989. The 12% figure, first mooted in our *Quarterly UK Macroeconomic Forecast* of October 1986, looks eminently plausible. (This assumption was originally applied to the whole of 1988 rather than late 1988 and 1989 speaks. The unpleasant acceleration of inflation which is in progress could have been partly avoided if interest rates had been raised to 12% at the start of the year.)

### (i) The Barber boom

		Demand pressure index	Demand pressure index, excluding fiscal stance	Interest rates %	Inflation %
1972	Q1	96.9	97.4	4.5	11.4
	Q2	100.5	100.5	4.6	11.4
	Q3	101.8	101.9	6.6	9.4
	Q4	104.7	104.7	7.1	8.7
1973	Q1	105.1	105.7	8.4	8.8
	Q2	108.3	108.4	8.7	7.1
	Q3	110.6	110.8	9.7	6.6
	Q4	111.0	111.4	12.0	9.3
1974	Q1	103.7*	104.0*	13.0	10.1
	Q2	106.6	106.3	12.3	15.0
	Q3	103.1	103.0	12.0	20.0
	Q4	100.5	99.3	12.0	21.1
1975	Q1	99.4	98.5	11.4	27.8
	Q2	98.8	97.8	9.7	30.0
	Q3	97.3	96.5	9.8	27.7
	Q4	97.4	96.4	10.9	24.8

\* 3-day week in February 1974

Interest rate is clearing banks' base rate. Inflation rate is annual growth of the price deflator for gross domestic product.



The inflationary outlook for 1989 looks considerably worse than for 1988, but is not as disastrous in comparison with either of the previous episodes detailed above. If it is accepted that inflation is set to rise for the remainder of this year and, probably, throughout most of 1989, then an eventual doubling of the annual rate to the 8% to 10% region does not seem far-fetched. The notion that the UK is experiencing only a temporary "blip" in its inflation rate finds little support from historical precedent. The danger in this view is that interest rates will continue to be increased gradually and begrudgingly, thus prolonging the boom and delaying the adjustment period.

In conclusion, it is suggested that a further tightening of monetary policy will be required before the Lawson boom is brought under control. Excess demand pressure is already on a similar scale to that of the 1972/73 economic expansion and it should not be assumed that the UK will escape the inflationary consequences because of the current strength of the exchange rate or the benign influence of dollar oil prices. The resurgence of domestic inflation follows the excessive expansion of both nominal and real money since the beginning of 1986. It should come as no surprise, to either policy-makers or the markets.

### (ii) The Healey mini-boom

		Demand pressure index	Demand pressure index, excluding fiscal stance	Interest rates %	Inflation %	
Peak in activity	1977	Q3	96.9	97.1	8.0	12.5
		Q4	97.4	97.3	6.4	11.7
	1978	Q1	98.5	98.1	6.5	13.3
		Q2	99.7	99.6	8.4	12.1
		Q3	99.6	99.4	10.0	12.4
	1979	Q4	100.2	100.0	11.4	11.8
		Q1	100.6	100.1	12.9	9.8
		Q2	102.5	102.4	12.4	12.4
		Q3	101.0	100.6	15.5	13.1
	1980	Q4	99.6	99.3	17.0	15.5
		Q1	98.1	98.2	17.0	17.9
		Q2	97.2	96.6	17.0	18.9
Q3		94.1	93.5	16.0	19.6	
	Q4	93.8	93.1	15.2	19.0	

### (iii) The Lawson boom

Peak in activity	1986	Q1	100.4	100.8	12.3	4.1
		Q2	101.2	101.6	10.4	3.2
		Q3	102.8	103.4	10.0	2.7
		Q4	101.9	102.8	10.9	1.5
	1987	Q1	101.6	101.9	10.8	3.1
		Q2	104.5	105.1	9.4	4.6
		Q3	105.9	106.9	9.6	5.0
		Q4	105.5	106.9	9.2	5.0
	1988	Q1	105.6	106.6	8.5	5.3
		Q2(e)	107.5	108.6	8.8	5.7
	1989	Q3 ?			10.5	6.5
		Q4			12.0	6.7
		Q1			12.0	7.5
		Q2			12.0	8.5
		Q3			12.0	9.3
		Q4			12.0	9.0

assumptions/forecasts





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From: J ODLING-SMEE

29th July 1988

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary  
 Financial Secretary  
 Paymaster General  
 Economic Secretary  
 Sir Peter Middleton  
 Mr Anson  
 Sir Terence Burns  
 Sir Geoffrey Littler  
 Mr Byatt  
 Mr Monck o.r  
 Mr Phillips  
 Mr Scholar  
 Mr Culpin  
 Mr Evans  
 Mr Kelly  
 Mr Peretz  
 Mr Sedgwick o.r  
 Mr Spackman  
 Mr Turnbull  
 Mr S Davies  
 Mr Grice  
 Mr Matthews  
 Mr Melliss  
 Mr Parsonage  
 Mr Riley

a

Stuff on inflation in paras 30 & 31  
 looks somewhat rum to be sending  
 rounds to departments, but can I  
 suppose be justified on the grounds  
 that it's simply routine updating  
A earlier work

*AS*

*OK*

### MACRO-ECONOMIC ASSUMPTIONS FOR THE LONGER TERM

There are a number of exercises in which we need to make assumptions about macro-economic developments in the longer term, ie beyond the end of the MTF5 period. Recent examples include the funding strategy, long-term tax and expenditure projections, and pension fund surpluses. In addition, we are often asked by other departments for our views on long-term economic developments.

2. Our views are embodied in a set of consistent numbers, with ranges representing 70 per cent confidence intervals, which we review every two years. We have just completed this year's review, and for information I attach the paper which has resulted.

3. The main change since the last review in 1986 is that we have revised up our view of the long-term supply performance of the economy: we are now assuming a GDP growth rate of 2½ per cent beyond



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1992, compared with 2 per cent (beyond 1990) in the 1986 review (details in Annex 3). Apart from the upward revision in supply performance (affecting the growth of productivity, productive potential and real earnings as well as GDP), the only significant change in assumptions is that we now expect a lower dollar effective rate, hence a higher sterling/dollar rate. This reflects the fall in the dollar since 1986.

4. We shall be circulating the attached paper to other government departments in the usual way, as the basis of our advice to them about long-term developments. We do not, however, insist that they always use our numbers - we have no monopoly on the truth - although in practice they usually do.

*Obs*

J ODLING-SMEE



**MACROECONOMIC ASSUMPTIONS FOR THE LONGER TERM****I Introduction**

1. This note sets out assumptions for certain key macroeconomic variables over the next decade. It represents an updating of IDGLT(86)1 to take account of how the economy has developed over the last two years and the economic projections underlying the MTF5 given in the 1988 FSBR and covering the years to 1991-92.

2. The methodology used in this note remains the same as before. To emphasize the uncertainty which attaches to projections up to ten years ahead ranges for the variables of interest are given. These are based on the observed variability of growth rates across output cycles over the past. For this purpose data for the period 1856 to 1987, less the war years, have been used. The cycles are dated by taking peak to peak movements in output, with the period 1979 to 1987 being taken as one complete cycle. On the basis of the FSBR forecast it seems unlikely that 1987 will represent a cycle peak, but for present purposes it has been treated as such so as to enable inclusion of data for the period after 1979 in the calculation of the measures of variability. In general, this last period has little effect on the calculated standard errors<sup>(1)</sup>. Detailed figures for past growth rates, the derived statistics and methods of calculation are given in Annex 1.

3. In previous IDGLT long term assumptions papers the figures for the central case were not given explicitly. In the present note these numbers are shown for the convenience of users. This departure should not be taken as indicating that there is less

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(1) A minor change in the method of calculating the average growth rates has been made. In IDGLT(86)1 the simple arithmetic means of the growth rates was taken. In this exercise the growth rates have been weighted by the lengths of the cycles. The previous procedure tended to overweight shorter cycles.



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uncertainty about the projections or less need to consider alternative assumptions.

4. This is the third biennial paper in the present series, and it is possible to compare the assumptions in the 1984 paper (IDGLT(84)4) for 1983-88 with outturns and the FSBR forecast for 1988. The numbers are shown in Annex 2. For a number of important variables, including GDP and the labour force, the outturn was near or above the top of the ranges given, reflecting a better supply performance than expected. This reinforces the need to give consideration to uncertainty in using the figures.

5. The ranges used for the main real variables, output, employment, productivity, labour supply, productive potential, real earnings and labour share are designed to have a width of about two standard deviations. They should therefore be interpreted as representing 70 per cent confidence intervals. The ranges given take account of the historical correlations between these variables. Because of this, and the identities relating these variables, it is not possible to combine the extremes of the ranges for all the variables to produce consistent high and low growth scenarios. However it is possible to choose independently the paths of any four of the seven variables with the remaining three being determined by identity. For the other variables considered, inflation, interest rates and the exchange rate the ranges given also represent 70 per cent confidence intervals.

6. In presenting the assumptions figures are given separately for the periods 1987-1992 and 1992-1997. The figures for the latter period abstract entirely from cyclical factors, although as indicated below the element of cyclical recovery embodied in the former period is also small. It follows that, since 1992 and 1997 are assumed to represent similar positions in the output cycle, the growth rates in this period can be applied to years beyond 1997 unless otherwise stated. For a projection horizon much in excess of ten years it is likely that the economy would converge towards its long term trend, implying that the probability that outcomes lie within the range increases as the horizon is extended.



**Table 1: Average Growth Rates for Sub-periods 1856-1987**

	Output <sup>(1)</sup>	Productivity	Employment	Working Population
<b>Sub Periods 1856-1987</b>				
1856-1913	1.9	1.0	0.9	0.9
1924-1937	2.2	1.0	1.2	1.2
1951-1973	2.9	2.6	0.4	0.3
1973-1987	1.6 (1.2)	1.7 (1.3)	0	0.6
<b>Sub Periods 1973-1987</b>				
1973-1979	1.3 (0.6)	1.1 (0.4)	0.2	0.6
1979-1983	0.4 (0.0)	2.2 (1.8)	-1.8	0.0
1983-1987	3.3 (3.4)	1.9 (2.0)	+1.3	1.1
1979-1987	1.8 (1.7)	2.1 (1.9)	-0.2	0.5
	Productive <sup>(2)</sup> potential	Labour share	Real Earnings per head <sup>(3)</sup>	Participation Rates
<b>Sub Periods 1856-1987</b>				
1856-1913	1.9	0.1	1.1	-0.1
1924-1937	2.2	-0.1	0.9	0.5
1951-1973	2.9	0.0	2.6	0.2
1973-1987	2.3	-0.3	1.4	0.1
<b>Sub Periods 1973-1987</b>				
1973-1979	2.7	0.1	1.2	0.2
1979-1983	2.2	-0.8	1.4	-0.5
1983-1987	3.0	-0.6	1.3	0.5
1979-1987	2.6	-0.7	1.4	0

Non-North Sea figures in brackets

(1) Average measure of GDP

(2) Productive potential = Productivity plus working population.

(3) Real earnings per head = productivity plus labour share

(See Annex 2)



## II General Economic Background

7. In comparison with previous IDGLT long term assumptions exercises the present one starts from a point where both the growth of output has been relatively steady for a number of years and the immediate prospect is not strongly influenced by the cyclical recovery in output. In the absence of major demand or supply shocks either overseas or at home it is therefore assumed that the major determinant of output growth over the medium term is the growth of productive potential. This would represent a rather slower rate of growth than occurred from 1983 to 1987.

8. The growth of non-North Sea productive potential since 1979 has averaged 2.6 per cent a year, only a little less than the average for the twenty years to 1973. In the 1983-87 period growth was about the average of the earlier period. Non-North Sea productivity has also recovered compared with 1973-1979, although it remains on a trend basis below the average from 1951 to 1973 (see table 1). Thus the evidence has accumulated that underlying productivity growth has recovered, and that this is no longer mainly a feature of the manufacturing sector. This is the main reason for the upward revisions to the assumptions for productivity and GDP compared with those given in IDGLT(86)1. Annex 3 sets out the main assumptions in the current exercise alongside those in IDGLT(86)1.

9. The rate of inflation (GDP deflator) has averaged 4½ per cent over the past four years. A gradual decline in inflation over the medium term is assumed in line with the assumptions in the MTF5. It is assumed that further labour market adjustment, as reflected in declining unemployment and the absence of any further rise in producers' margins, enables this to occur while output grows at a rate similar to that of productive potential.



### III The Projections in Detail

#### Domestic Output

10. The MTFS projections assume that output growth in the non-North Sea economy averages 3 per cent in the years 1988-89 to 1991-92. Whole economy output growth is assumed to be  $\frac{1}{2}$  per cent less, reflecting the projected decline in North Sea production. (In 1987 for the first time the non-North Sea economy grew significantly -  $\frac{1}{2}$  per cent - faster than the whole economy.) For the period 1987 to 1992 as a whole it is assumed that non-North Sea growth averages 3.1 per cent, reflecting the strong growth forecast in 1988. Projected growth is close to the average from 1951 to 1973, see table 1, and significantly above the average since 1856 and the last twenty years.

11. For the period 1992 to 1997 a slowdown in labour supply growth is assumed. This is the main reason for the assumed reduction in growth in non-North Sea GDP to  $2\frac{3}{4}$  per cent.

12. The Department of Energy's latest assessment of North Sea oil production implies that North Sea production would have a negative impact on GDP equivalent to  $\frac{1}{4}$  per cent a year, compared with  $\frac{1}{2}$  per cent up to 1992. Projections for North Sea production are subject to uncertainty, but this has been ignored in constructing the ranges for whole economy and non-North Sea GDP, which are taken to be the same for both.

#### GDP Assumptions

Average annual % growth

	Low	Central	High
<b>Whole Economy</b>			
1987-1992	2 $\frac{1}{8}$	2 $\frac{3}{4}$	3 $\frac{3}{8}$
1992-1997	1 $\frac{7}{8}$	2 $\frac{1}{2}$	3 $\frac{1}{8}$
<b>Non-North Sea</b>			
1987-1992	2 $\frac{1}{2}$	3 $\frac{1}{8}$	3 $\frac{3}{4}$
1992-1997	2 $\frac{1}{8}$	2 $\frac{3}{4}$	3 $\frac{3}{8}$



Productivity

13. The growth of productivity since 1856 has averaged about 1½ per cent, with growth up to 1937 of 1 per cent, and from 1951 to 1987 of about 2¼ per cent. Within the latter period the years 1973 to 1979 had unusually low productivity growth, much of which can be associated with adverse supply shocks (see table 1). Trend productivity growth has been rising through the 1980's and it is assumed that this higher rate is sustained up to 1992. This results in average productivity growth in the non-North Sea economy of 2½ per cent, compared with the average for 1979 to 1987 of 2 per cent, and close to the average for the 1950s and 1960s. After allowing for the decline in oil production, whole economy productivity is projected to grow by 2 per cent a year to 1992. Over the following five years non-North Sea productivity is assumed to grow at 2¼ per cent, 2 per cent whole economy, close to the average of the whole of the post war period.

Output per person employed (whole economy(1))

Average annual % growth

	Low	Central	High
1987-1992	1¼	2	2¾
1992-1997	1¼	2	2¾

(1) Non-North Sea productivity is ½ per cent higher 1987-1992 and ¼ per cent higher 1992-1997.

14. The figures differ compared with those given in the IDGLT(86)1 in that the central assumptions have been revised up by ½ per cent a year (see Annex 3). This reflects both the evidence of two more years of high productivity growth and the fact that from now on there is less re-absorption of unemployed workers who are assumed to be of less than average productivity.

15. Historical data suggest that medium term periods of low output growth also tend to have low productivity growth, and similarly with high output growth periods.



Employment

16. The growth in employment is equal to the difference between the growth rates of output and productivity. The range for this variable is determined by the ranges for employment and productivity and the correlation between them such that the higher the correlation the smaller the range. The correlation between output and productivity was about 0.8 over all cycles from 1856 to 1987, and in the post war cycles. A correlation of 0.75 has been used in working out the range underlying the figures below.

Employment

Average annual % growth

	Low	Central	High
1987-1992	$\frac{1}{4}$	$\frac{3}{4}$	$1\frac{1}{4}$
1992-1997	0	$\frac{1}{2}$	1

17. Growth in employment averaged about  $1\frac{1}{4}$  per cent from 1983 to 1987. This was a reflection both of the cyclical recovery in output and of declining real unit labour costs to which the abolition of the National Insurance Surcharge contributed significantly. Over the future the growth in the labour supply is less than over the past four years and the special factors which have contributed to lower unit labour costs will be absent. The growth in employment compatible with a path of declining inflation is therefore less.

Labour Supply

18. The central assumption for labour supply uses the latest projections from Department of Employment, published in the March 1988 Employment Gazette. In preparing these, Department of Employment make allowance for the effect on activity rates of social and demographic factors assuming a constant level of unemployment ( $2\frac{1}{2}$  million). This procedure has also been adopted for the present exercise by taking Department of Employment figures at the average level of unemployment. This implies a rate of growth which averages  $\frac{1}{2}$  per cent 1987 to 1992 and 0.2 per cent 1992 to 1997. However these figures mask a gradual reduction in



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growth over the decade. Variation in working population growth over the past has mainly been associated with changes in participation rates, see table 1. The data point to a fairly small range of  $\frac{1}{2}$  per cent and this is reflected in the figures below.

Labour Force Growth

Average annual % growth

	Low	Central	High
1987-1992	$\frac{1}{4}$	$\frac{1}{2}$	$\frac{3}{4}$
1992-1997	0	$\frac{1}{4}$	$\frac{1}{2}$

19. Compared with the figures given in IDGLT(86)1 growth in the labour force in the first period is lower (Annex 3). This is due to the actual reduction in unemployment in 1986 and 1987 being larger than projected, so that the increase in participation rates in those years has brought forward the rise in labour force growth.

20. Labour force growth above the centre of the range will tend to be associated with employment growth toward the top end of its range, and also if real wage growth is at the top end of its range.

Unemployment

21. In principle assumptions about employment and labour force growth determine the path of unemployment. However there is considerable variability in unemployment not accounted for by changes in the growth rates of either employment or the labour force. The number of claimants not seeking work (excluded from the labour force estimates), the number of non-claimant unemployed (included in the labour force) and the effects of special unemployment measures would need to be considered for a precise assessment. For present purposes the approximation involved in ignoring these factors is acceptable and the figures below assume that claimant unemployed is a constant proportion of the gap between the labour force and employment.



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Unemployment rate

Annual change in percentage points

	Low	Central	High
1987-1992	$-\frac{3}{4}$	$-\frac{1}{2}$	$-\frac{1}{4}$
1992-1997	$-\frac{1}{2}$	$-\frac{1}{4}$	0

22. In the first period there has been a fall of 1.5 percentage points between the average rate in 1987 and current (April 1988) levels so that if there were no further reduction from now on the fall in unemployment would be close to the top end of the suggested range.

Productive Potential

23. Productive potential growth is defined as the sum of the growth of trend output per head and the labour force. The central projection shown below has been obtained in this way. The range depends on the ranges for output per head and the labour force and the correlation between the two. It has been assumed that this correlation is -0.6, consistent with the historical correlation of peak to peak cycles for these variables. This gives rise to a range of  $1\frac{1}{4}$  per cent.

Productive Potential

Average annual % growth

	Low	Central	High
1987-1992 <sup>(1)</sup>	2	2 $\frac{5}{8}$	3 $\frac{1}{4}$
1992-1997	1 $\frac{5}{8}$	2 $\frac{1}{4}$	2 $\frac{7}{8}$

(1) Trend productivity is projected to grow at  $1/8\%$  a year faster than output per person employed and this has been allowed for in calculating productive potential.

24. The reduction in productive potential growth in the second period is the result mainly of the slowing down of labour force growth, implying that the transition to the lower rate of growth would be gradual. The above figures apply to the whole economy. On a non-North Sea basis productive potential growth is  $\frac{1}{2}$  per cent



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faster for the first and  $\frac{1}{4}$  per cent faster for the second period. On a non-North Sea basis the central assumption for the first period is similar to the estimate of the growth in productive potential from 1983 to 1987, but the contribution from trend productivity is about  $\frac{1}{2}$  per cent higher and that for labour force growth  $\frac{1}{2}$  per cent lower than in the earlier period.

### Real Earnings and Employment Income Share

25. Real earnings are taken to be real income from employment (including employers' National Insurance and other contributions) per employed person. This is definitionally equal to the product of the share of income from employment in GDP and output per head. The share of income from employment has fallen by about  $\frac{1}{2}$  per cent a year since 1979 - up to 1983 mainly as a result of a reduced share taken by wages and salaries, and after 1983 mainly as a result of lower contributions. In 1987 the share was about  $2\frac{1}{2}$  per cent lower than at any post war cyclical peak. On a non-oil basis the decline in the labour share since 1979 was only about half as large, suggesting that, arithmetically, the bulk of the rise in the share of oil profits - which peaked in 1984 - was at the expense of the share of income from employment. Since 1984 the share of oil profit has declined substantially, but there has been no corresponding increase in the labour share. Consistent with this, the central projection is for the labour share to remain constant. The further fall in oil profits (which in 1987 only represented  $2\frac{1}{2}$  per cent of GDP) implicit in the projected decline in oil production is therefore assumed to be reflected in a rise in non-oil profits.

### Share of Income from Employment

Average annual % change of share

	Low	Central	High
1987-1992	$-\frac{1}{4}$	0	$\frac{1}{4}$
1992-1997	$-\frac{1}{4}$	0	$\frac{1}{4}$

26. In IDGLT(86)1 the implied central projection for the first period was for a rise in the labour share, mainly as a consequence



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of a projected fall in North Sea profits. Much of this fall in oil profits has already taken place.

27. The correlation between the labour share and the growth of output per head is low historically. A figure of -0.15 has been assumed in calculating the range for real earnings consistent with the ranges for employment share and output per head.

Real Earnings Assumption

% per annum

	Low	Central	High
1987-1992	1½	2	2¾
1992-1997	1½	2	2¾

Inflation

28. The long-term historical averages for inflation are set out in table 2. These are perhaps a less good guide to future inflation than for the variables that have been considered so far. For example the period from 1968 to the first half of the 1980's was typified by high and variable inflation, the 1950's and 1960's by low and relatively steady inflation. The average of this would be a poor guide to the future.

Table 2: Historical Data for Inflation and Real Interest Rates

Sub period 1871-1987	Inflation (GDP deflator)	Real Interest Rates (1)
1871-1913	0.0	3.0
1924-1937	-0.7	4.8
1951-1968	3.8	1.5
1968-1987	10.2	2.1
<b>Sub periods 1968-1987</b>		
1968-1973	7.5	2.4
1973-1979	15.9	-0.4
1979-1983	10.9	2.1
1983-1987	4.5	5.7

(1) Defined as nominal rates on 20 year gilts less inflation over the previous year.



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29. The assumptions shown below take as the main case the assumptions in the 1988-89 FSBR up to 1991-92. The ranges over this period broadly take account of the margins of error associated with published Treasury forecasts. These were taken from a period when inflation was higher and more variable than it is today. Nevertheless the figures shown can be taken to represent the 70 per cent confidence interval.

	<u>Inflation (GDP at Market Prices Deflator)</u>			% per annum
	Low	Central	High	
1987		5		
1988	3½	4½	5	
1989	2½	4	5	
1990	2	3½	5	
1991	1½	3	5½	
1992	1¼	2¾	6	
1997	0	2	7½	

30. For the 1992-1997 period it is assumed for the main case that inflation will decline further. This would be consistent with the continuation of the gradualist policy stance adopted by the present government. It is assumed that inflation will remain above zero in the long term despite the objective of price stability because there will be a tendency for policy to be slightly more accommodating to positive inflationary shocks than to negative ones.

31. The low case can be regarded as consistent with the same policy regime and a preponderance of, negative inflationary shocks, or with a tightening of the policy framework, or some combination of these two. The high case can be seen, for the period beyond 1992, as the result of there being some adverse combination of more inflationary shocks and a more accommodating policy stance. Because inflation has now stabilized at low levels for a number of years and the consensus against inflationary policies has strengthened the high case has been reduced by 2½% in the final year compared with the corresponding assumption given in IDGLT(86)1.



32. The assumptions for 1997 can be taken also to apply to the years beyond. The alternative inflation assumptions are compatible with any configuration of assumptions for the real economy with the exception that high inflation and high real growth are unlikely to be combined for a prolonged period.

### Real Interest Rates

33. The assumptions set out below relate to the real rate of interest on long term government stock 20 year gilts. Real rates of return on other types of financial assets, eg. equities, may diverge considerably. The real rates of interest have been constructed using current rather than forward looking rates of inflation.

34. The historical data on real interest rates are set out in table 2. On the basis of the definition of the real interest rate being considered here, real long rates are currently about 5 per cent, slightly below the average of the last four years. This compares with average real interest rates of 2.1 per cent in 1968 to 1987 and 1.8 per cent in 1950 to 1987. It is assumed as a central assumption that there is little change from the present level up to 1992. Thereafter it is reasonable to assume that there is a modest decline towards a level a little above the post war average. The main reason for expecting future real interest rates to remain above the average is that unanticipated increases in inflation (as in 1973-79) lowered this average.

35. There are a number of uncertainties which may impinge on the real rate of interest. For example, higher inflation might be associated with either higher or lower real interest rates. Historically the lowest real rates have usually occurred when there was unanticipated inflation (eg. in world wars and the 1970s). World interest rates will also tend to influence UK real interest rates. Because of the complexity of the associations a range for the real interest rate is given below to present the general uncertainties involved.



Long Term Real Interest Rates

	Low	Central	High
1987		5	
1992	3	5	7
1997	1	3	5

These figures are slightly higher than those given in IDGLT(86)1. Figures towards the top end of the range would be consistent with a deterioration in the inflation prospect matched by a tightening of policy and or high world interest rates. Low real interest rates might come about as a result of low inflation alongside slow output growth, or a rise in unanticipated inflation not fully matched by a rise in nominal interest rates.

Real Exchange Rate

36. The methodology used in deriving assumptions about the real exchange rate in this and previous IDGLT exercises is to examine the data from the mid-1950s to establish both the long term trend and the appropriate ranges. In previous exercises the assumption of a constant real exchange rate was used, supported by an examination of trends in the real exchange rate from 1953 to the early 1970s. Including data up to the early 1980s tends to lead to distortions because of oil effects. But the finding of constancy of the real effective exchange rate is confirmed when the data are extended to the end of 1987. The decline in oil prices and North Sea production both reduce the likelihood that there remains an oil premium in the current exchange rate. The equilibrium real exchange rate towards which the actual exchange rate is assumed to converge is taken as the average value for the period 1955 to 1987.

37. In a departure from previous IDGLT practice the figures set out below are now presented in terms of 1987 based figures, so that the nominal and real rates coincide in that year.



Real Exchange Rate Assumptions

	Low	Effective central 1987=72.6 <sup>(1)</sup>	High	Low	\$/£ central 1987=1.64 <sup>(1)</sup> \$/£	High
1986		70.8			1.48	
1987		72.6			1.64	
1988 H1		76.5			1.82	
July 1988		76.5			1.74	
1990	67	75	83	1.40	1.65	1.90
1992	64	72	80	1.40	1.65	1.90
1997	64	72	80	1.40	1.65	1.90

38. The central assumption is that for the period to 1990 there will be little change in the effective rate, followed by a small decline so that the average historical level (72) is reached in 1992.

39. In the light of the large swings of sterling against the dollar in recent years, and because trends in the real dollar rate appear to be sensitive to the period chosen, it is more difficult to establish both the equilibrium sterling-dollar rate and where the current rate is in relation to it. On the basis of the data for 1955-1987 as a whole some trend depreciation of the dollar in both effective terms and against sterling is indicated. However, since 1972 it is difficult to discern any significant trend in the dollar effective rate, primarily because of the switchback that occurred between 1980 and 1987, see Chart 2. In relation to the long term trends the dollar in the first half of 1988 looked especially weak. For the medium term it is assumed that the dollar effective rate recovers to a level about the same as the average from 1973 to 1980 - see Chart 2. Combining this assumption with that of the sterling effective rate gives a real sterling dollar rate of 1.65, which it is assumed is reached by 1990.

40. It can be seen from Chart 3 that the very high levels of the dollar in 1984, and sterling in 1979-81 would lie outside these



SAGE REALTY  
08/7/88

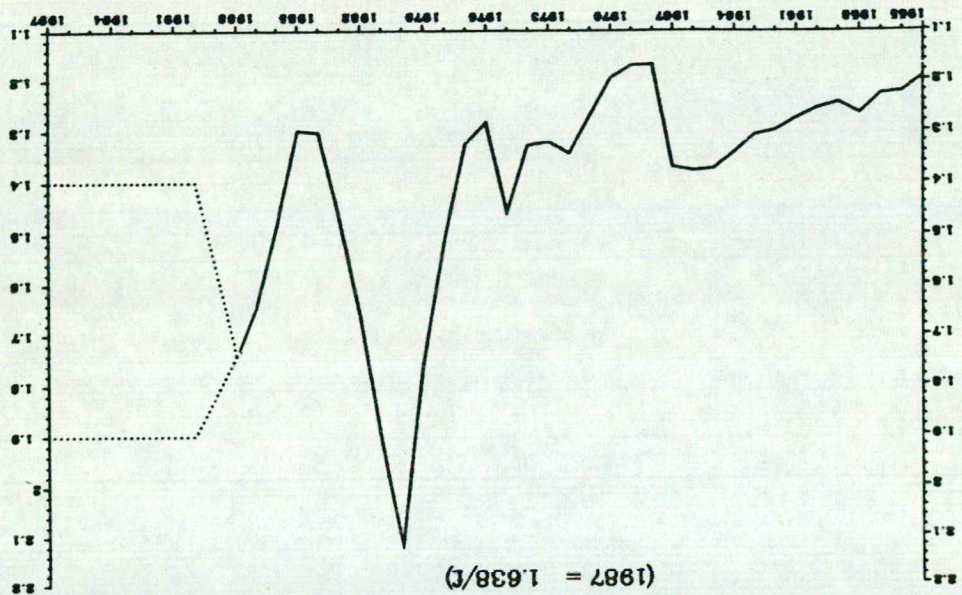


CHART 3 REAL STERLING/DOLLAR EXCHANGE RATE

SAGE REALTY  
2/7/88

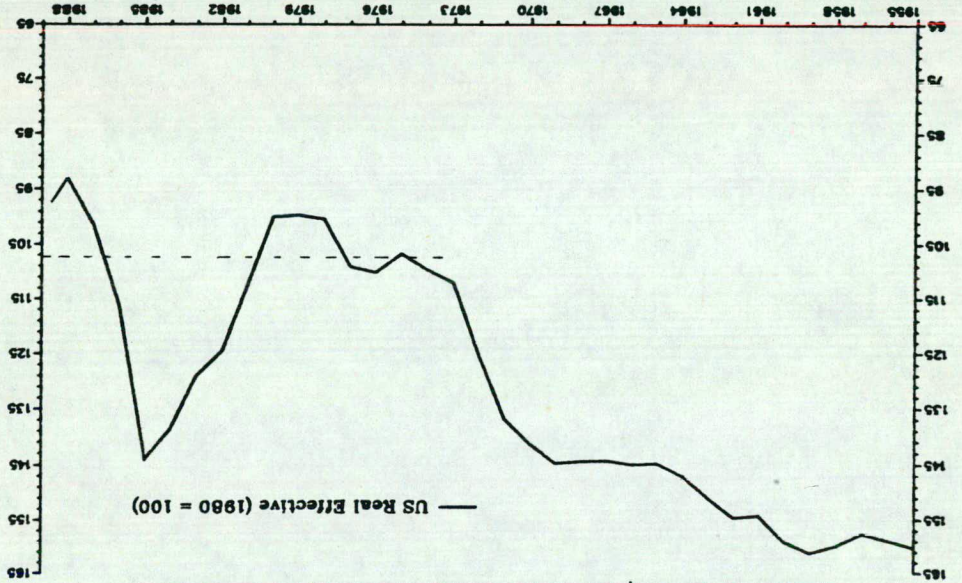


CHART 2 US \$ REAL EFFECTIVE EXCHANGE RATE

SAGE REALTY  
08/7/88

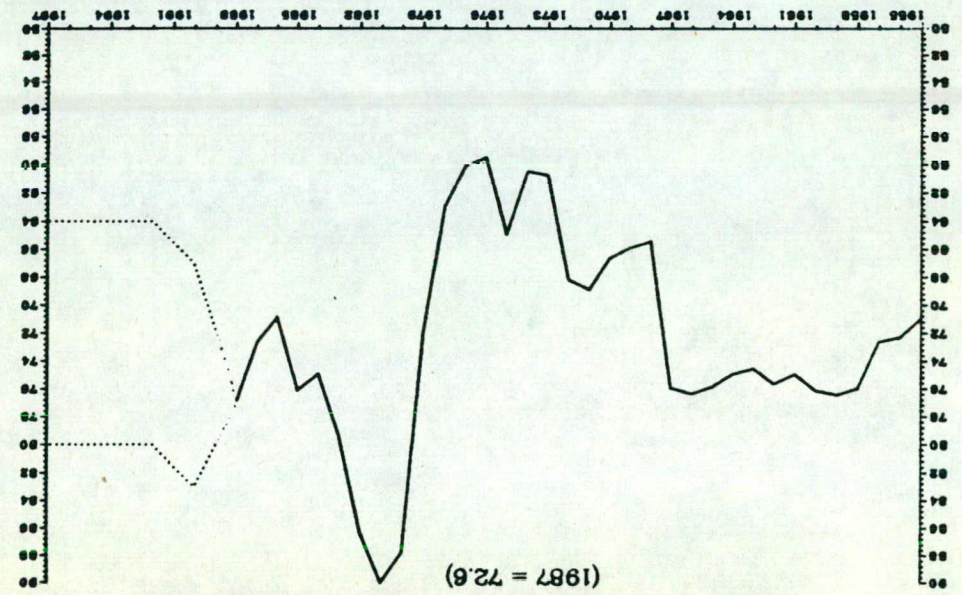


CHART 1 REAL EFFECTIVE EXCHANGE RATE



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ranges. The range for the dollar is proportionately larger than for the effective rate, reflecting the greater uncertainty about the former and the possibility that a further decline in the dollar rate may occur against other currencies. The ranges can be taken as the 70 per cent confidence intervals in the absence of any exceptional events such as those which occurred in the 1979-81 and, to the dollar, in 1984-85.



### CONSTRUCTION OF THE RANGES FOR VARIOUS VARIABLES

1. This annex explains in more detail how the ranges for seven of the variables - growth in output, productivity, employment, labour supply, productive potential, real earnings and labour share - have been constructed.

#### Notation

2. Q - GDP  
 P - output per head  
 N - employment  
 L - labour supply  
 C - productive potential  
 W - real earnings  
 S - labour share  
 Y - real employment income  
 $\sigma_q$  - standard deviation of output growth  
 $r_{qp}$  - correlation coefficient between output and productivity growth rates (and similarly for other variables).  
 lower case letters denote logs.

#### Identities

3. These 7 variables are related by the following identities:

$$P = Q/N \quad (\text{Definition of output per head}) \quad (1)$$

$$C = P.L \quad (\text{Definition of productive potential}) \quad (2)$$

$$W = Y/N \quad (\text{Definition of real earnings})$$

$$= \frac{Y}{Q} \frac{Q}{N}$$

$$= S.P \quad (\text{from the definitions of labour share and output per head}) \quad (3)$$



Taking logs and first differences we get:

$$\Delta p = \Delta q - \Delta n \quad (1')$$

$$\Delta c = \Delta p + \Delta l \quad (2')$$

$$\Delta w = \Delta s + \Delta p \quad (3')$$

which represent linear relationships between the growth rates.

4. It is therefore only necessary to specify, independently, projections of four of the seven variables. The approach used in the paper was to take judgements on the central paths for output, productivity, labour supply and the labour share, and then to calculate the remaining variables by identity.

#### Ranges

5. The three identities also imply the following relationships between the standard deviations and correlations:

$$\sigma_n^2 = \sigma_q^2 + \sigma_p^2 - 2\sigma_q \sigma_p r_{qp} \quad (4)$$

$$\sigma_c^2 = \sigma_p^2 + \sigma_l^2 + 2\sigma_p \sigma_l r_{pl} \quad (5)$$

$$\sigma_w^2 = \sigma_p^2 + \sigma_s^2 + 2\sigma_p \sigma_s r_{ps} \quad (6)$$

These three equations involve three correlation coefficients and the standard deviations of each of the seven variables. In principle therefore it would be possible to choose each of the seven ranges independently but, if they were chosen arbitrarily, the correlations implied by equations (4) to (6) might then be inconsistent with observed statistical correlations. A better procedure is to specify seven of the ten statistics by examining the historical data. We chose to look at the data for output, productivity, labour supply and labour share. On the basis of this we were able to establish plausible values for  $\sigma_p^2$ ,  $\sigma_q^2$ ,  $\sigma_l^2$ ,



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$\sigma_s^2$ ,  $r_{pq}$ ,  $r_{pl}$ ,  $r_{ps}$  and then to calculate  $\sigma_n^2$ ,  $\sigma_c^2$  and  $\sigma_w^2$  using (4) to (6).

6. The historical data and sample statistics for these variables are set out in Tables 2 and 3. The approach used was to examine the variability and correlations between peak to peak movements in output, productivity, labour supply and the labour share.

7. The standard deviations and correlations which were assumed for the purposes of constructing the ranges in the paper are summarised in Table 1.

Table 1: Standard Deviations, Correlation Coefficients and Ranges for Growth Rates of Various Variables

	Standard Deviation ( $\sigma$ )	Width	Ranges	
			1987-92	1992-97
Output (q)	0.625	1.25	21/8 to 33/8	17/8 to 31/8
Productivity (p)	0.75	1.5	1 1/4 to 2 3/4	1 1/4 to 2 3/4
Employment (n)	0.50	1.0	1/2 to 1 1/4	0 to 1
Labour Supply (l)	0.25	0.5	1/4 to 3/4	0 to 1/2
Productive Potential (c)	0.625	1.25	2 to 3 1/4	15/8 to 27/8
Real Earnings (w)	0.75	1.50	1 1/4 to 2 3/4	1 1/4 to 2 3/4
Labour Share (s)	0.25	0.50	-1/4 to 1/4	-1/4 to 1/4

Correlation Coefficients

Output and Productivity	0.75
Productivity and labour supply	-0.625
Productivity and labour share	-0.17



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Table 2: Historical Trends in Output, Productivity, Labour Share and Labour Supply

(Average % change per annum)

Peak to peak	Output	Productivity	Labour share	Labour supply	
				Working population	Participation rate
1856-60	1.8	0.5	0.0	0.8	0.2
1860-65	2.0	1.3	-1.1	0.7	0.1
1865-73	2.3	1.5	0.3	0.7	0.0
1873-82	1.9	1.3	0.5	0.7	-0.3
1882-89	2.2	1.2	0.3	1.0	0.0
1889-99	2.2	1.1	-0.1	1.1	-0.2
1899-1907	1.2	0.4	0.3	1.0	-0.2
1907-13	1.6	0.4	0.3	0.9	-0.1
1913-24*	-0.1	0.2	1.3	-0.4	-0.7
1924-29	2.6	1.4	-0.7	1.2	0.4
1929-37	2.0	0.8	0.2	1.2	0.6
1937-51*	1.7	1.0	0.6	0.2	0.1
1951-55	3.1	2.3	-0.2	0.7	0.7
1955-60	2.4	2.0	0.0	0.5	0.2
1960-64	3.4	2.6	0.4	0.8	0.0
1964-68	2.8	2.9	0.2	0.1	0.0
1968-73	3.1	3.0	-0.3	0.2	0.3
1973-79	1.3	1.1	0.2	0.6	0.2
1979-87	1.8	2.1	-0.7	0.5	0.0

Statistics

Average peak to peak growth rate

1856-1987	2.1	1.4	0.0	0.8	0.1
-----------	-----	-----	-----	-----	-----

Average peak to peak growth 1951-1987

1951-1987	2.4	2.2	-0.1	0.5	0.2
-----------	-----	-----	------	-----	-----

SE of peak to peak growth:

1856-1987	0.56	0.74	0.42 (0.32) <sup>+</sup>	0.29	0.27
-----------	------	------	-----------------------------	------	------

1951-1987	0.73	0.61	0.37	0.22	0.22
-----------	------	------	------	------	------

Percentage of cycles since 1856 where growth rate outside +1 SE

35	41	18	29	23
----	----	----	----	----

\* The war periods 1913-24 and 1937-51 have been omitted from the calculation of the statistics

+ Omitting the period 1860-65



Table 3: Correlation Coefficient Estimated from Data in Table 21856-1987

Peak to peak movements in output and productivity	0.82
Peak to peak movements in productivity and labour share	-0.18
Peak to peak movements in productivity and labour supply	-0.71

1951-1987

Peak to peak movements in output and productivity	0.83
Peak to peak movements in productivity and labour share	-0.13
Peak to peak movements in productivity and labour supply	-0.50



## COMPARISON OF OUTTURN AND PROJECTIONS

1. In this annex comparison is made between the ranges given in IDGLT(84)4 for the period 1983-88. For the outturn for 1988 the forecast values from the FSBR forecast have been used.

Table 1

Growth Rates % 1983-88	Low	High	Outturn	
GDP	1½	3	3.3	
Non-North Sea GDP	1¾	3¼	3.5	
Output per employed person, whole economy	7/8	2 3/8	2.2	
Employment	0	1¼	1.3	
Unemployment <sup>(1)</sup> (average change in percentage points)	0.2	-0.5	-0.4	
Labour force <sup>(1)</sup>	0.3	0.6	1.2	
Real earnings	¾	2¼	1.8	
Labour share	-½	0	-0.4	
Productive Potential	1 3/8	2 7/8	3	
Real Effective Exchange Rate (1953-83 = 100)				
1988	93	102	101	
Inflation (GDP deflator)				
	Low	Central	High	Outturn
1988 <sup>(2)</sup>	0	3	8	5

(1) These were presented as 000s and have been converted to % for this annex.

(2) Outturn refers to June 1988.

2. The outturn figures use observed values, and identities used in constructing the projections do not hold exactly.



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3. In assessing these figures it is important to bear in mind that the projections are based on historical data, with some additional weight being given to the most recent past. The pattern of errors suggests that the strength of the supply performance was not fully foreseen. Productivity growth was towards the top end of its range. Labour force growth was well above the top end of the suggested range, and this also contributed to productive potential growth lying outside its suggested range. The fact that unemployment has fallen, despite employment growth at about the same rate as the labour force is mainly the result of the fall in the proportion of the gap between the labour force and employed labour force who are claimants. With both employment and productivity at the top of their respective ranges GDP was above the top end of its range. Further support for the view that supply side factors, including productivity and labour force growth were the main factors behind GDP being above the top end of its range is provided by the outturn for inflation, which was well within the assumed range, and the real effective exchange rate, which was at the top end of its range.



## COMPARISONS WITH IDGLT(86)1

The table below sets out the central case assumptions contained in the present paper alongside the corresponding figures given in IDGLT(86)1. Detailed comment is given where necessary in the main text of the paper.

	First period		Second period	
	IDGLT(86)1 assumptions (1985-90)	IDGLT(88)1 assumptions (1987-92)	IDGLT(86)1 assumptions (1990-95)	IDGLT(88)1 assumptions (1992-97)
Growth % of:				
GDP: whole economy	2½	2¾	2	2½
non-North Sea GDP	2¾	3 <sup>1</sup> / <sub>8</sub>	2½	2¾
Productivity	1½	2	1½	2
Employment	1	¾	½	½
Labour supply	¾	½	¼	¼
Productive potential	2½	2 <sup>5</sup> / <sub>8</sub>	1¾	2½
Share of income from employment	¼	0	0	0
Real earnings	1¾	2	1½	2
Change in unemploy- ment rate (% points per year)	-¼	-½	-¼	-¼
Inflation	3 (1989)	3 (1991)	2½ (1995)	2 (1997)
Long-term real interest rate (level)	-	5 (1992)	2½ (1990 onwards)	3 (1997)
Real exchange rate:				
effective (1987=72.6)	83 (1990)	75 (1990)	73 (1995)	72 (1997)
\$ (1987=1.64)	1.40(1990)	1.65(1990)	1.40(1995)	1.65(1997)



FROM: S J DAVIES  
DATE: 4 August 1988

PS/CHANCELLOR - 12/2 Ch.  
Content for  
Mr Davies to write to  
proposed? 25/8/88

cc Sir P Middleton  
Sir T Burns  
Mr Scholar  
Mr Odling-Smee  
Mr Peretz  
Mr Sedgwick, o/r  
Mr Hibberd

**STATISTICS SCRUTINY: USE OF OFFICIAL STATISTICS IN ECONOMIC POLICY**

As part of the scrutiny of government economic statistics Stephen Pickford has asked the Treasury to provide a note on why it matters to us to have good statistics and the costs of bad statistics.

2. I have discussed the attached note with Sir Terence Burns and others and am proposing to send it to Stephen Pickford, if the Chancellor is content. The note covers the use of statistics in policy, giving examples of particular deficiencies as an illustration of the problems caused by bad statistics; it does not attempt to provide a comprehensive list of problems. We will be covering the range of problems that we have much more fully in discussion with Stephen Pickford.

X

OK. In the discussion (X)  
it will be important to give  
Mr Pickford a clear idea of  
what your points are. We will  
have the discussion then ASAP.

SJD

S J DAVIES



## USE OF OFFICIAL STATISTICS IN MACROECONOMIC POLICY

The Government makes use of official statistics on the economy in formulating, implementing, and monitoring economic policy. The description in this note of the role of statistics in policy-making is set within the current approach to policy but an equivalent story could be told for other approaches.

2. Policy is set in a medium term framework, so that the Government does not react to what the statistics show about short term movements in the economy by adjusting fiscal instruments to "fine tune" the economy. However, the Government does continually monitor monetary conditions: if developments seem to be out of line with the path set at budget time, the Government can take steps to bring things back on track by varying interest rates. Moreover, the judgments that the Chancellor makes at budget time and the annual reformulation of the Medium Term Financial Strategy are affected by what the official statistics suggest about the recent performance and prospective course of the economy.

3. The Government's ability to keep monetary conditions on track is only as good as its ability to assess what is currently happening in the economy. The unreliability of money GDP data for the recent past and the history of downward bias in early estimates of GDP growth mean that the Government has to rely primarily on other indicators in assessing monetary conditions: the targeted monetary aggregate (M0), the exchange rate, asset prices etc. Given that a range of indicators have to be used, and that taken together they still only provide an imprecise indication of monetary conditions, the faster availability of accurate data on money GDP would assist monitoring of outturn against the Government's objectives.

### Internal coherency of statistics

4. Both assessment and control of monetary conditions and the fiscal decisions taken at Budget time require a coherent picture of what is going on in the economy. If the whole range of statistics on the economy are internally inconsistent it becomes



very difficult to have confidence in those statistics that are of most direct importance to policy, and the basis for taking decisions is undermined. Such inconsistency has been a major problem in the recent past. In particular, the large discrepancies between the income, output and expenditure based estimates of GDP growth and the associated unidentified flows in the sectoral financial accounts cause major problems in interpreting recent developments.

5. The residual error has recently been around 2 per cent of GDP (ie the income estimate of GDP has exceeded the expenditure estimate by this amount). The output estimate is relatively close to the income estimate and so points to underrecording of expenditure rather than overrecording of income. Thus consumer spending and/or investment have probably been substantially higher in the recent past than currently estimated; or the balance of payments current account has been much stronger than the published figures have shown. These inaccuracies make it impossible to have confidence in any particular interpretation of private sector behaviour sector that may be advanced to explain what has happened to the current account in the last 2 years. Is the current account deficit (if there really is one) a counterpart almost entirely of a domestic investment boom? Or to what extent is it the counterpart of unusually high consumer spending (stimulated by the 1980s bull market in equities, increased availability of credit or whatever)? These are basic questions that simply cannot be answered with any certainty at present.

6. There have also been very large revisions to the official estimates of personal saving in the last two years. For example, the personal saving ratio for 1986 was estimated at 11 per cent when national accounts for the whole of 1986 were first published; the latest figures put the 1986 saving ratio at just 7.2 per cent. The discrepancies in the financial accounts for the personal sector have led some commentators to suggest that personal saving may be higher than shown in the latest statistics. However, the effect of increasing the figure for personal saving would be to add further to the required adjustment of the figures for the



company sector or for the current account. For example if the latest statistics are understating personal saving by 2 per cent of GDP over the last year, the total adjustment required to the company sector and overseas sector figures - which could take the form of higher domestic investment and an improved current account - would rise to 4 per cent of GDP.

### Medium term projections

7. The annual updating of the MTFIS necessarily involves :

- the assessment of recent economic performance (in particular the rate of growth of money GDP) in relation to the path set a year earlier;
- a revised assessment of the future path of money GDP that is consistent with the Government's objectives of eventually eliminating inflation.

This latter process involves, for example, taking some view of the real rate of growth that the economy is likely to be able to sustain over the medium term, and the level of inflationary pressures currently in the economy. The view of sustainable growth is inevitably based to a considerable extent on estimates of recent developments in the economy: the rate of growth of productivity, the rate at which capacity is growing. These estimates in turn depend on figures for output, employment, investment and the capital stock which are all subject to considerable uncertainty and liable to substantial revision.

8. Revisions to investment on the scale that paragraphs 5 to 6 have suggested is possible could have a significant effect on projections of actual and potential output growth; and this could affect the formulation of policy in various ways. If it turned out that investment had been running at a much higher rate than the statistics currently show, it could well be appropriate to revise up estimates of future potential growth and hence of the path of money GDP that would be consistent with the Government's objectives for reducing inflation. And any data revisions which



changed the projections of saving and domestic investment would have implications for the mix of fiscal and monetary policies that would be needed to achieve a particular path for money GDP.

### Budget forecasts

9. Budget forecasts of the level of public sector borrowing in the year ahead are heavily influenced by the statistics available at the time of the Budget. The clearest example is the forecast of corporation tax that is made at Budget time. Because of the lag between profits being earned and tax being paid on them, the forecast of corporation tax receipts for the year ahead is crucially dependent upon the estimate of profits over the most recent year. More generally, the lags involved in many economic relationships, eg between personal income and consumption, mean that forecasts of the level of economic activity, income, expenditure, and hence tax receipts on income and expenditure, are highly dependent on estimates for the recent past. Likewise, the forecast of public expenditure on those areas where spending is not cash limited also depends in part on economic statistics for the recent past; although here the Reserve is available to cope with unanticipated developments.

10. Recent statistics have an important influence on the wide range of short term economic projections shown in the Industry Act Forecasts (published in the Financial Statement and Budget Report and in the Autumn Statement). Inaccurate data for the recent past can be an important source of error in these projections. An example is the substantial underforecast of growth in 1987 in the 1987 FSBR: the projections of 3 per cent growth in GDP and 4 per cent growth of manufacturing output were well below the currently estimated outturns of almost 4½ per cent and 5½ per cent growth respectively. This error was attributable in part to understatement of the buoyancy of recent economic activity in the statistics available in early 1987. Figures for manufacturing output published in February 1987 showed 1 per cent growth between the third and fourth quarters of 1986; this estimate has subsequently been revised up to 2.5 per cent. The preliminary (output based) estimate of GDP in 1986Q4, published in February



1987, showed output broadly unchanged between the third and fourth quarters of 1986; as now revised the statistics for the average estimate of GDP show a  $1\frac{1}{4}$  per cent increase between the third and fourth quarters of 1986.

### **Effects on markets**

11. Quite apart from their direct effect on policy formulation, the official statistics can affect the economy and policy through their effects on markets. For example, at times the markets pay a great deal of attention to statistics for the current account of the balance of payments. While the monthly visible trade figures are normally regarded as relatively accurate, the overall balance of payments figures often contain large discrepancies and are subject to very substantial revision. Moreover, as noted above, the size of the residual error in the national accounts may well reflect in part errors in the current account statistics. The risk certainly exists of markets' reacting to inaccurate figures in such a way that the Government has to take measures which it would not have to take if accurate figures were published.



FROM: P N SEDGWICK  
DATE: 15 September 1988

CHANCELLOR

cc Chief Secretary  
PCC  
Mr Moore  
Miss Peirson  
Mr Peretz  
Mr Turnbull  
Mr Hibberd  
Mr Mowl  
Mr Potter  
Mr O'Donnell

*Thanks. Control for the time being  
not exception. The year  
from the former Budget  
measure to implement  
[?] may be more with  
to incorporate in the  
account forecast.  
recognise  
this implies  
in the 2  
our normal  
practical  
with  
much  
the  
confusion  
& not  
(2 may be  
then) when  
the cost  
transit  
re-  
provision  
PSOR  
Subj  
& Budget  
prognosis*

POLICY ASSUMPTIONS FOR THE FORECAST

I attach a note, which was discussed at PCC earlier this week, on the policy assumptions for the forthcoming internal forecast. I would be grateful if you could let me know if you are content with these.

P.N.J.  
P N SEDGWICK

Ch  
All pretty standard - only new point is para 10 on ECJ/VAT.  
Terry will need to keep you in close touch re assumptions (eg mortgage rate rise in Feb 89).

*(I will also  
discuss this  
in my report,  
final assumption)*

*AA*

SEDGWICK  
TO  
CH/EX

15 SEPT



## POLICY ASSUMPTIONS FOR THE AUTUMN FORECAST

## Note by EA and PSF

This note sets out the assumptions for the internal autumn forecast. Assumptions for the published Autumn Statement forecast will be considered nearer the time. The internal forecast will cover the next two full years ie. to end 1990 (to 1990-91 for public finances). The main forecast report will be circulated by Friday 14 October.

**Monetary Policy**

2. The level of interest rates will be determined by the forecast path for money GDP, the forecast of M0 relative to its target ranges, and other indicators of monetary conditions, particularly movements in the exchange rate relative to recent levels. The WEP will probably project real exchange rates for the main countries constant at recent levels. With relatively small inflation differentials, a constant nominal sterling index would imply little change in bilateral sterling exchange rates.

3. Assumptions about intervention will be made in the light of forecast pressures on the exchange rate. Some 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.

4. It will be assumed that from 1988-89 onwards the PSBR is fully funded through debt sales outside the banking and building society sectors, unless significant foreign exchange market intervention is projected towards the end of 1988-89, in which case some carry over 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 will reflect the introduction of a new product later this year.

5. During the forecasting exercise the forecasters will consult Sir Terence Burns and Mr Scholar on the precise implementation of these assumptions on monetary policy.



**Fiscal Policy**

6. The forecast will include a revised assessment of the PSDR in 1988-89, taking into account both the latest monthly information and fresh information on likely developments in the rest of the financial year. In the summer the Budget forecast of a PSDR of £3¼ billion was revised up to £7½ billion, 1½ per cent of GDP. Latest information shows the PSDR running above the profile that would be consistent with a total of a £7½ billion for the year.

7. The summer forecast adopted the working assumption that the PSDR (as a share of GDP) would remain in 1989-90 and 1990-91 at the level forecast for 1988-89. The new forecast will initially make the same assumption. The final assumption for the PSDR will be reviewed with Sir Terence Burns and Mr Scholar, and will take account of its implications for money GDP, the current account, interest rates and the implied size of tax cuts.

8. The assumed level of the PSDR in 1989-90 and 1990-91 may involve some assumed changes in taxes (from an indexed base) after making allowance for the forecasters' best view of the likely path for public expenditure and of the buoyancy of government revenues. Any tax cuts will be assumed to be allocated to reducing the basic rate of income tax.

**Taxation and other government receipts**

9. The forecast for pre-fiscal adjustment taxes will assume full revalorisation in the 1989 and 1990 Budgets of all the income tax allowances and thresholds, and of specific duties.

10. The effects on VAT revenue of implementation of the European Court of Justice ruling that certain zero VAT rates (non-domestic construction, energy, water supplies etc) are illegal will be scored as Budget changes in the next FSBR. Internal forecasts would not usually anticipate Budget changes at this stage of the year. However the forecast is attempting to anticipate the outcome of the public expenditure Survey which will make provision for the expenditure consequences of the abolition of zero rating of non-domestic construction, quantitatively the most important of



the changes. So that the treatment is the same for both sides of the accounts it is proposed to allow in the revenue forecast for the abolition of all the zero rates covered by the ECJ ruling.

11. National insurance contribution rates will be assumed to remain at current levels. The lower and upper earnings limits will be assumed to be increased in April 1989 and April 1990 in line with the forecast increase in the RPI in the year to the previous September (a reasonably accurate estimate of the September 1988 outturn for the RPI will be available by the time the forecast is finished).

### Public Expenditure

12. The forecast of public expenditure for 1988-89 will take account of information on expenditure and borrowing so far this year, GEP's latest assessment of claims on the Reserve, and the effects of changes in economic assumptions and other pressures on spending.

13. The forecast of public expenditure in 1989-90 and 1990-91 will take account of the existing plans, the expected outcome of the current Survey, changes in economic assumptions implied by the rest of the forecast, and other pressures on expenditure.

14. As usual detailed public expenditure judgements and assumptions will be discussed during the forecast with the appropriate Treasury divisions.

(i) Social security benefit rates will be assumed to be updated in April 1989 and 1990 in line with the forecast rise in the RPI (or RPI excluding housing costs) in the year to the previous September.

(ii) The forecast will assume that the Treasury Supplement to the National Insurance Fund, currently 5 per cent, will be abolished with effect from 1 April 1989. This will require primary legislation - the maximum change without legislation is 2 per cent a year.



- (iii) Privatisation proceeds in 1988-89 will be the best available estimate assuming that BSC is sold before the end of the year. Proceeds will be assumed to be £5 billion a year in 1989-90 and 1990-91. For the purposes of adjusting EFLs the following timing of new privatisations will be assumed:

1988

November	BSC
February/March	Girobank

1989

November	Water
----------	-------

1990

Summer	Electricity Distribution
Autumn	CEGCO

1991

Winter	Scottish Electricity
Summer	GENCO

- (iv) The forecast will take account of the introduction of the Community Charge in Scotland in April 1989 and England and Wales in April 1990. Account will also be taken of the introduction of the National Non-Domestic Rate in April 1990. It will be assumed that business rate poundages will be fully indexed to the RPI in 1990-91, after allowing for the downward step in poundages to offset the upward re-estimation of rateable values now underway.

The level of Exchequer grant to local authorities in 1989-90 will be assumed to be as announced in July. For forecast purposes it is also necessary to make a working assumption about grant in 1990-91 for which there are no agreed plans, either published or unpublished. It is proposed to assume that Exchequer grant and (forecast) business rate revenue together



will be sufficient that, at forecast levels of expenditure, the Community Charge is broadly unchanged in real terms from local domestic taxes (rates or CC in Scotland) per head in 1989-90.

- (v) The forecast of nationalised industry prices is being discussed with PE in order to reflect the likely outcome of the Survey.

**Changes from Summer Forecast**

15. The main monetary and fiscal policy assumptions are unchanged. Some of the detailed tax and public expenditure assumptions have been revised, notably that relating to the Treasury Supplement to the National Insurance Fund. This is now assumed to be abolished from next year rather than phased out by annual reductions of 2 per cent.



*PN*

FROM: P N SEDGWICK  
DATE: 22 SEPTEMBER 1988

CHANCELLOR

*[Red handwritten scribble]*

cc Chief Secretary  
Economic Secretary  
Sir P Middleton  
Sir T Burns  
Mr Scholar  
Mr Odling-Smee  
Mr Peretz  
Mr Gieve  
Mr O'Donnell  
Ms Turk

**RECENT ECONOMIC PERFORMANCE AND PROSPECTS FOR 1988**

As background for your meetings in Berlin I attach a paper that assesses recent economic developments and summarises our tentative conclusions on 1989 from our current forecasting exercise. Our judgements on 1989 could change by the time we send you the report on the forecast.

2. The paper contains details of the August trade figures, hence the very restricted circulation at this stage.

*P.N.S*

P N SEDGWICK



## SUMMARY

(i) World trade and output appear to have risen very strongly in the year to the first half of 1988. There may have been some easing of G7 growth in 1988Q2. More recently commodity prices have fallen back from their peak level reached in June. The prospect is for more moderate - though still satisfactory - growth of trade and output and a moderate rise in consumer price inflation.

(ii) Despite continuing difficulties in interpreting the national accounts it is clear that in the UK real demand and output in 1988 have been running ahead of the June forecast and well ahead of the FSBR.

(iii) RPI inflation has been edging up during 1988, even when mortgage interest rates are excluded. Other measures of inflation such as the GDP deflator for 1988-89 are likely to be higher than previously expected. Money GDP growth in 1988-89 could be 10½-11½ per cent compared with the 7½ per cent in the FSBR.

(iv) The current account in 1988 is very likely to be well over £10bn., at about 3 per cent of GDP. Only in 1974 was there a larger deficit.

(v) In 1989 growth of GDP and domestic demand should ease off considerably following the recent interest rate rises. These rises will, if sustained exacerbate the peak in RPI inflation, which could be 7-8 per cent by mid year. With world and domestic growth both lower, the current account deficit could be close to this year's outturn.

## A : THE WORLD ECONOMY

Table 1 summarises recent developments and our preliminary views of prospects.



Table 1: Activity and inflation in the major economies

(Percentage changes on year earlier)

	IMF WEO		Latest WEP	
	1988	1989	1988	1989
G7 real GNP	4.1	3.0	4 to 4½	2½ to 3½
G7 industrial production			5¼ to 5¾	4 to 5
G7 consumer prices	3.2	3.5	3 to 3½	3½ to 4½
Real industrial materials prices			16 to 20	0 to 5
Real oil price			-15 to -17	-5 to -10
Total world trade	7.0	5.4	7 to 8	5 to 7
World trade in manufactures			9 to 10	6 to 9

(a) Recent DevelopmentsActivity

3. Real GNP in the major industrialised countries grew strongly in the second half of 1987 and in the first quarter of 1988. There are some signs that growth was slower in the second quarter, but G7 GNP in 1988Q2 was still around 4½ per cent higher, in real terms, than a year earlier. The strengthening of activity was widespread, including continental Europe, though Japan grew markedly faster than the average. Latest figures show that unemployment rates have fallen over the last year in the United States, Japan and the UK.

World trade

4. Faster than expected growth outside the G7 has also contributed to an acceleration in world trade. Imports by the four Asian NIEs rose particularly strongly in 1987 and look like doing so again in 1988. But other developing countries are also now increasing their imports after several years of cutbacks. Within total trade, trade in manufactures has grown by close to 10 per cent for only the second time in the last twelve years.

Prices

5. Consumer price inflation in the G7 has been around 3 per cent for over a year. There were large increases in non-oil commodity



Prices during 1987 and the first half of 1988, but they have had little direct effect on G7 consumer prices. There are signs, from the Economist index, that commodity prices have fallen back recently, though they are still almost 30 per cent higher than a year ago in SDR terms. Oil prices have weakened significantly in recent weeks following reports of high levels of production by OPEC in August. Spot North Sea prices have recently tended to be between \$13 and 14 per barrel.

#### Current accounts

6. The last few months' figures show the US current account deficit and the Japanese surplus falling, but the German surplus appears to have levelled off and may even be rising again.

#### Exchange rates and interest rates

7. The dollar strengthened in July and August and is now almost 10 per cent in effective terms above its low point at the end of 1987. Its latest values (21 September) are \$1=Yen 134 = DM 1.87, compared to \$1 = Yen 154 = DM 1.83 at the time of the Louvre Agreement. The recent rises in interest rates have left short term rates 1½ per cent higher in the US and Germany and ¾ per cent higher in Japan than at the beginning of the year.

#### (b) Prospects

8. No major changes in announced fiscal policy are expected in the major countries.

- The US Federal deficit is expected to be around \$150-\$160 billion in FY1989 (roughly the same as in FY1988, which ends on 30 September) because the Presidential election is inhibiting any action by the present Administration and Congress and action by their successors is unlikely to take effect before FY1990.
- In Japan income tax cuts are due to be implemented in October. These will be followed, if Parliamentary approval is forthcoming, by the introduction of a 3 per cent general sales tax in 1989.
- In Germany this year's income tax cuts are to be followed in 1989 by increases in various expenditure taxes, producing a fall in the budget deficit. No further income tax cuts will occur until 1990.



9. The monetary authorities in Japan and Germany appear content for now with present interest rates, though an acceleration of their monetary aggregates or renewed downward pressure on their exchange rates could lead to further rises. On balance this does not seem likely. In the United States, the Fed are giving priority to the control of inflation, but remain keen to avoid tightening policy by more than the minimum necessary. Further interest rate rises seem improbable in the near future, but if demand and output continue to grow strongly further interest rate rises could occur after the Presidential Election.

10. Prospects for the oil price depend in part on OPEC's ability to restrict production, and prices could fluctuate widely over the next 18 months. The ending of the Iran-Iraq war, if anything, increases the risk of lower prices. The forecast will probably assume an average North Sea oil price close to \$14 per barrel over the period to end-1990.

11. G7 GNP growth is forecast to be around potential growth in the second half of 1988, and remain around that level in 1989, as the present boom in business investment slows down, in part because of recent rises in interest rates.

12. Consumer price inflation is expected to rise moderately - in part because of rises in indirect taxes in Japan and Germany, but also because of recent demand pressures in the US. The rise in inflation is expected to be short-lived, but if GNP growth remains above potential, there is a risk of a more sustained period of higher inflation.

13. Outside the G7 activity has also been fairly buoyant and this is reflected in the strength of world trade. Our current view is that trade growth will slow down in line with activity in the G7. But trade could grow faster than forecast if developing countries with favourable current account positions (eg the Asian NIEs) increase imports more rapidly, or if commodity prices rise further in real terms. On the other hand, weak oil prices and higher interest rates will tend to reduce imports by oil producers and debtor countries.



: THE UK

(a) Recent developments

14. Despite a very odd figure for the expenditure measure of GDP in 1988Q2 developments since the June forecast have if anything suggested that activity in 1988Q3 is running ahead of expectations, implying an even greater divergence from the FSBR forecast. Annex 2 shows the extent to which developments so far in 1988 have diverged from the FSBR.

Output and the Labour Market

15. Latest estimates of manufacturing output and GDP(O) point to continued strong growth in 1988. The apparent pause in the growth of manufacturing output in early 1988 revealed by first CSO estimates (and which conflicted with CBI evidence at the time) has now been revised away.

Table 2: Output and productivity indicators  
(percent growth on year earlier)  
(Output per head in brackets)

	<u>Manufacturing</u>		<u>GDP(O)</u>	
1986	0.9	(3.0)	2.9	(2.3)
1987	5.8	(7.3)	4.7	(2.9)
1987Q1	3.6	(6.2)	3.9	(2.7)
Q2	6.2	(8.0)	4.4	(2.7)
Q3	7.7	(8.6)	5.2	(3.3)
Q4	5.7	(6.3)	5.3	(3.1)
1988Q1	8.3	(8.4)	6.2	(4.1)
Q2	6.1	(6.4)	5.7	(3.8*)
1988 July	6.7	(7.2)		

\* Forecast

16. Against this background labour productivity has continued to grow strongly. Nonetheless unemployment has fallen sharply. By August, unemployment (seasonally adjusted, excluding school leavers) had dropped to 2.27 million, about 560,000 lower than a year earlier.



Table 3: Recent Personal Sector Demand Indicators (Seasonally adjusted)

	<u>Retail sales volume</u>		<u>New car registrations</u>		<u>Private housing completions</u>	<u>Consumers' expenditure</u>	
	(1980=100)	Percentage change on year earlier	Thousands per month	Percentage change on year earlier	(Thousands per month)	(£billion 1985 prices)	Percentage change on year earlier
1987 1	125.5	5.1	159	5.3	14.2	58.0	4.5
2	128.6	5.8	164	3.1	14.3	59.0	4.2
3	131.7	6.6	176	10.1	14.4	60.2	5.4
4	133.4	5.6	175	20.1	14.1	61.2	6.4
1988 1	135.3	7.8	176	10.7	16.4	62.0	6.8
2	136.7	6.3	178	8.5	15.1	62.2	5.4
April	136.4	5.0	166	12.9	15.6		
May	136.8	8.3	193	12.9	15.2		
June	136.8	5.8	175	4.8	14.6		
July	140.1	6.9	176	9.3	19.2		
August	140.8	6.6	202	16.8	n/a		



Domestic demand

17. **Personal sector spending** (see Table 3) has remained strong through 1988, though first estimates of total consumption indicate only slow growth between the first and second quarters of 1988. We are inclined to discount this (the same phenomenon was apparent in first estimates in 1986 and 1987), and expect upward revisions as later information is incorporated. **Spending appears to have risen sharply so far in 1988Q3.**

18. The **1988 business investment boom** predicted by the last two DTI Investment Intentions Surveys (December 1987 and June 1988) and recent CBI Trends Enquiries is **confirmed by latest data.**

**Table 4 : Investment Growth**  
(per cent growth on year earlier)

	<u>Manufacturing incl leased assets</u>	<u>Non-manufacturing excl leased assets</u>	<u>Total GDFCF</u>
1987 1	- 12.3	11.9	3.7
2	12.1	16.5	6.2
3	9.0	11.9	4.6
4	13.6	23.6	7.6
1988 1	13.2	15.8	8.7
2	13.9	14.7	10.5

\*Construction, distribution and financial industries.

19. Table 5 summarises the latest estimates of **real GDP growth** (published on Wednesday, 21 September). Once again the expenditure based **GDP measure** presents an implausibly low picture of recent growth. The **output measure** is still thought, even by CSO, to present the most reliable guide over the past year. It points to very rapid growth, even faster than the **income measure**, which tracked the output measure reasonably closely in 1987. The **residual error** has risen sharply in the first half of 1988 to about 4 per cent of GDP. (See the Chart in Annex 1.)



Table 5 : Real GDP growth  
(per cent change on year earlier)

	<u>GDP(E)</u>	<u>GDP(I)</u>	<u>GDP(O)</u>	<u>GDP(A)</u>
1987	3.6	4.4	4.7	4.2
1988Q1	2.3	5.0	6.2	4.5
Q2	2.2	4.2	5.7	4.0

### Inflation

20. Inflation indicators have trended up so far through 1988. The all items RPI rose quite sharply in August, entirely due to increased mortgage interest rates. But, even excluding MIPS, there has been an increase in the RPI inflation rate in recent months.

21. The housing market has been extremely active in 1988. House prices seem set to rise by around 25 per cent over the year as a whole, and mortgage lending is 20 per cent up on a year earlier. There are now signs that this exceptional growth may be tailing off. Building society mortgage commitments have been around 30 per cent lower in the six weeks since the beginning of August than in July, and although the July figure was boosted by the ending of double MIRAS relief, some of this fall does probably represent a response to higher mortgage rates. Additionally, while national house price inflation continues to accelerate, anecdotal evidence, plus estate agent reports by the Royal Institute of Chartered Surveyors, suggests that the market has slowed considerably in London and the South East, the area regarded as the 'leading sector' in the housing market.



Table 6: Inflation Indicators  
(per cent change on year earlier)

	<u>Manufactures output prices</u>	<u>RPI*</u>		<u>GDP market price Deflator</u>
		<u>All items</u>	<u>Less MIPS</u>	
1987	3.9	4.2	3.7	4.8
1988 Q1	3.8	3.4	3.7	5.4
Q2	4.3	4.3	4.4	6.0
1988 Jan	3.8	3.3	3.7	
Feb	3.8	3.3	3.6	
March	3.9	3.5	3.8	
April	4.2	3.9(3.6)	4.2(3.9)	
May	4.2	4.2(3.9)	4.4(3.9)	
June	4.4	4.6(4.2)	4.7(4.1)	
July	4.7	4.8(4.2)	5.0(4.2)	
August	4.9	5.7(4.3)	5.0(4.2)	
September		5½**	5½**	

\*FSBR profile in brackets

\*\*DE's estimate

#### The balance of payments

22. The current account deficit for the eight months to August is provisionally estimated to have been £9.2bn. considerably higher than had been expected by us and commentators at the time of the Budget, and rather more than implied by the June forecast which envisaged a deficit for the whole year of £9¼bn.

23. The visible deficit has reached £12.9bn. in the first eight months of the year. Imports of manufactured goods in the eight months to August are up 18 per cent in volume terms compared with the same period in 1987, as a consequence of rapid growth in domestic demand, a decline in competitiveness, and growing capacity constraints in some industries. Manufactured exports may have been adversely affected in a similar manner by the last two factors, but overseas demand has been quite buoyant. In the first eight months of this year the volume of manufactured exports rose by 6 per cent compared with the same period a year earlier, only a little below our estimate of growth in world trade in manufactures, notwithstanding a loss of competitiveness and probably



Greater capacity constraints than abroad. In the last two years the oil surplus has been declining slowly with North Sea production. The Piper Alpha disaster has temporarily exacerbated this trend. The overall effect of Piper Alpha on the current account is now estimated at £½bn. in 1988 and a little less in 1989.

Table 7 : Balance of Payments: Recent Developments

(£ billion, s.a.)

	1987	January to August 1988
<u>(a) Visibles</u>		
Exports Non-oil	71.0	48.8
oil	8.4	4.0
Total	79.4	52.8
Imports Non-oil	85.3	63.4
oil	4.3	2.2
Total	89.6	65.6
<u>Balance</u>		
Non-oil	-14.3	-14.6
oil	4.2	1.8
Total	-10.2	-12.8
Invisibles balance	7.7	3.6
Current balance	-2.5	-9.2

24. The sterling index is now some 4 per cent above its average level last year. This has contributed to a decline in competitiveness. But manufacturing industry's relative labour costs remain some 3¼ per cent better than the average of 1984 and 1985.

25. The invisibles surplus deteriorated to only £2.6bn. in the first half of the year, compared to £7.7bn. for last year as a whole. The declining surplus on services is largely to blame. The financial services surplus has declined because of a reduction in net insurance earnings, particularly for Lloyds. Spending on overseas travel has increased significantly largely due to the strength of sterling, particularly against the dollar, and continued high growth of consumers' expenditure. The stronger exchange rate and the large current account deficit should both adversely affect the UK's net external asset position. However very provisional CSO data suggest that net external assets have risen by



round £9bn. in the first half of 1988. The increase is 'explained' by a large balancing item and by the faster growth in overseas as compared to UK equity prices. (Notwithstanding their view that the positive balancing item primarily reflects unrecorded net capital inflows, the CSO treat the balancing item for these purposes as unrecorded current account credits.)

#### Public finances

26. The PSBR in 1988-89 so far is well below both last year's level and the 1988 budget profile.

Table 8 : Public Sector Finances - April to August

	<u>Differences from Budget profile</u>		<u>Differences from 1987-88</u>	
	<u>£ billion</u>	<u>%</u>	<u>£ billion</u>	<u>%</u>
<u>Receipts</u>				
Inland Revenue	+0.8	+3.4		10.4
Customs & Excise	+0.6	+3.3		12.3
NICs	+0.3	+2.1		13.6
Interest, dividends and other receipts	+0.3	+6.5		-2.9
<b>Total Receipts</b>	<b>+1.9</b>	<b>+3.3</b>		<b>10.6</b>
<u>Outlays</u>				
Privatisation proceeds	+0.1	+1.3		
Interest payments	+0.1	+2.0		3.6
other outlays	-1.9	-3.3		1.0
<b>Total Outlays</b>	<b>-1.7</b>	<b>-2.9</b>		
CGBR(O)	-3.6		-6.7	
LABR	-0.6		0.0	
PCBR	-0.1		-0.4	
<b>PSBR</b> (excluding privatisation proceeds)	<b>-4.1</b> (-4.2)		<b>-6.3</b> (-4.7)	

27. There was a net repayment of £4.6bn. in the first five months compared with borrowing of £1.7bn. in the same period of 1987-88. The net repayment is £4bn. higher than expected in the budget profile, largely as a result of a higher repayment on central government own account. The latter is due, in roughly equal amounts, to both higher than expected receipts and lower than expected central government expenditure. PAYE, national insurance contributions and VAT account for the bulk of the extra receipts and reflect higher wages and salaries and higher consumer spending



han forecast at budget time. (There have not so far been significant receipts of onshore mainstream corporation tax: the main receipts are in October and January.) The undershoot on expenditure is partly accounted for by lower social security spending and may therefore also reflect the unexpected buoyancy of economic activity. Some of the undershoot is on cash-limited spending.

28. Local authority borrowing so far this year is about £½bn. below the budget profile, but close to the previous year's level. Public corporations' net borrowing is much as expected, notwithstanding higher than expected growth.

(b) Prospects

29. The forecast for the UK is at a less advanced stage than the WEP exercise and our views could change. Our preliminary view of prospects assumes that the differential between UK and world interest rates will have to be substantial for some time to prevent any significant fall in the exchange rate. Relatively high UK rates will help to attract funds to finance the unusually large current account deficits.

Table 9 : The Outlook for 1988

	<u>FSBR</u>	<u>June Forecast</u>	<u>Preliminary Autumn Forecast</u>	
<u>Domestic demand and GDP</u> (per cent change on year earlier)				
Domestic Demand	4	5.8	5½ to 6½	6
GDP(A)	3	3.9	4 to 4½	4½
GDP excl. N.Sea Oil	3½	4.3	4¾ to 5¼	5
<u>Current Account (£billion)</u>	-4	-9.3	-12 to -14	-13
<u>RPI inflation (1988Q4)</u> (Excluding mortgage interest payments)	4	5.0(4.5)	6 to 7(4½ to 5½)	6½(5)
<u>GDP deflator (1988-89)</u>	4½	5.7	6 to 7	6½
<u>Money GDP (1988-89)</u>	7½	10.0	10½ to 11½	11

Domestic demand

30. The low second quarter figure for consumers' expenditure is the main influence underlying a slower growth in consumer spending compared to the June forecast. Nonetheless, we expect faster



growth in the average estimate of GDP. This reflects faster growth in recent output estimates of GDP than we estimated in June. The compromise adjustment (the gap between real GDP(E) growth and growth in GDP(A)) thus makes a bigger contribution to GDP(A) growth in 1988 than was expected in June. This remains an uncomfortable feature of the forecast, but is difficult to avoid given the disparity in the CSO's estimates of the different measures of GDP for the first half of the year.

31. It is still very early in the latest forecasting round to offer a confident view of the outlook for 1989. But a marked slowdown in GDP growth seems likely, dominated by much slower consumption and investment growth. Recent increases in interest rates are likely to reduce real personal disposable income growth in 1989 (personal sector net interest receipts/payments are scored in personal income). Moreover, a predicted slowdown in house prices (and hence real wealth) will also inhibit consumer spending. The saving ratio is likely to recover slowly through 1989. Investment growth is also likely to moderate from its present very high rate as domestic demand and activity growth slows down.

#### Inflation

32. RPI inflation is likely to be higher than forecast in June. This mainly reflects more rapid increases in interest rates than expected and a slightly faster trend inflation in the RPI excluding mortgage interest payments. The peak for (total) RPI inflation could occur as late as June or July 1989 at about 7-8 per cent. Thereafter, the inflation rate should fall by about 2 per cent or so by 1989Q4.

#### Current account

33. The current account now looks like being around £12-14 billion in 1988. As a share of GDP it is expected to be a little under 3 per cent, compared to 3.8 per cent in 1974, the previous post war peak. (Other high deficits as a share of GDP occurred in 1951 - 2½ per cent - and 1973 and 1975 - 1½ per cent.)

34. Manufactured imports have risen very rapidly so far this year in response to the rapid pace of domestic demand and could increase by about 15 per cent in volume terms over the year as a whole. Next year the growth rate is expected to fall sharply as domestic demand growth should slow down substantially. The slower pace of domestic demand should also ease capacity constraints which will



help to lower imports and may also boost exports. Nevertheless the current account deficit may not change much next year. Three factors explain the delay in the turnaround of the current account:

- (a) Imports are now much larger than exports, so the value of exports has to grow by 2½ percentage points more than the value of imports simply to keep the deficit constant in nominal terms.
- (b) World trade growth is projected to grow more slowly, by 6 per cent or so, in 1989 after a rise of just under 10 per cent in 1988. This slowdown, coupled with a slight deterioration in competitiveness, will limit the scope for a rapid improvement in exports.
- (c) The surplus on trade in oil is likely to continue on its downward trend. The situation will be temporarily exacerbated by the repercussions of the Piper Alpha disaster.

35. The balancing item amounted to £7 billion in the first half of the year and is assumed to reach £10 billion for the year as a whole. This assumption means that "recorded" net capital inflows of only around £4 billion would be required to finance this year's deficit. In 1989 it may still be difficult to attract the necessary inflows - whether recorded or not - without keeping UK interest rates relatively high. The healthy state of public finances suggests that the Bank will need to buy in significant amounts of gilts to avoid overfunding. This could result in a greater proportion of institutional funds being invested overseas. In addition the repatriation of overseas investments observed after the stock market crash is unlikely to continue. On the other hand the expected reduction in the US current account may well mean that the supply of internationally mobile capital expands significantly.

#### Public finances

36. The PSBR may not continue to undershoot the budget profile in the rest of 1988-89 to quite the same extent as it has so far if the pace of economic activity slows. Also an undershoot on cash-limited central government expenditure at this stage of the year does not necessarily imply an equivalent undershoot for the year as a whole given the annual nature of the planning and control process. Moreover there are still considerable upward pressures on spending, not least from higher than expected inflation which in a



World of cash planning implies a squeeze on spending in real and volume terms. Despite these qualifications the PSDR for 1988-89 will almost certainly exceed the budget forecast and is very likely to be above the June forecast of £7½bn., possibly reaching a level of £10bn. or even more.

37. Even if the rate of growth of GDP is lower in 1989, the ratio of taxes (before fiscal adjustment) to GDP could rise yet again in 1989-90 because the prospective healthy growth of profits in calendar 1988 will be generating corporation tax receipts in that year. (What figures there are from the CSO and Inland Revenue - and in the press - for profits in the first half of 1988 suggest very high growth.) The burden of debt interest could also fall in 1989-90. On the working assumption that the PSBR (as a share of GDP) is the same in 1989-90 as now provisionally forecast for 1988-89, there could be scope for a small fiscal adjustment, even if the planning total outturn in 1989-90 is higher, possibly by £2-3bn., than in current plans.



## ANNEX 1 : THE 1988 BLUE BOOK

The 1988 Blue Book presented, for the first time, constant price data rebased on 1985 prices.

**Table A: Growth rates of selected aggregates constant 1985 prices - 1988 Blue Book**

(Previous estimates in brackets - 1980 prices)

	<u>Consumption</u>	<u>Investment</u>	<u>Domestic Demand</u>	<u>GDP(E)</u>	<u>GDP(I)</u>	<u>GDP(O)</u>	<u>GDP(A)</u>
1985	3.5 (3.8)	3.8 (3.0)	2.7 (3.0)	3.9 (4.0)	4.1 (3.2)	3.5 (3.8)	3.8 (3.7)
1986	5.4 (6.0)	0.9 (-0.2)	3.9 (3.8)	2.8 (2.6)	3.4 (3.2)	2.9 (2.9)	3.0 (2.9)
1987	5.1 (5.0)	5.5 (3.9)	4.3 (4.2)	3.6 (3.3)	4.4 (4.6)	4.7 (4.8)	4.3 (4.3)

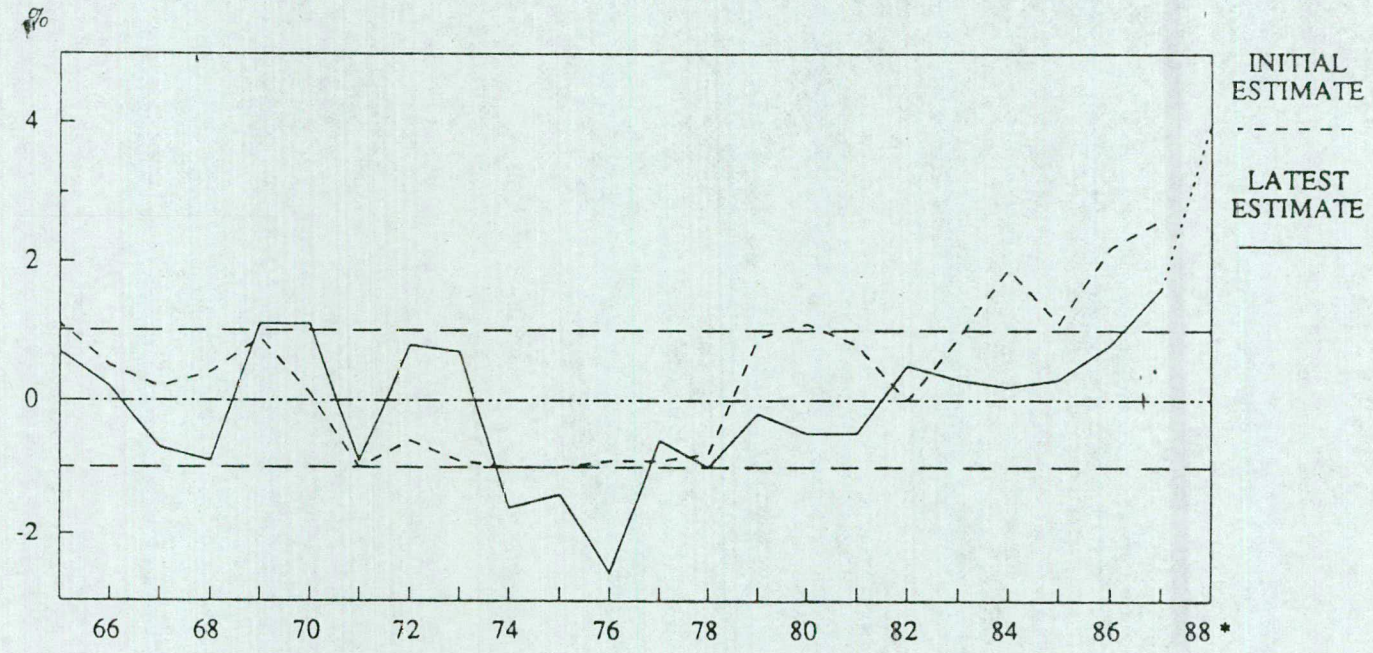
There were only modest changes to GDP and domestic demand growth in 1986 and 1987. Growth in the expenditure measure of GDP was revised up by  $\frac{1}{4}$  per cent per year. Growth in GDP(I) and GDP(O) on the other hand, were revised down slightly, so that growth in the average measure of GDP in 1987 (4.2 per cent) was largely unchanged from previous estimates. Even so, the expenditure measure still reveals slower growth over 1986 and 1987 than the other two measures.

Domestic demand growth was also largely unchanged in aggregate (just under 4 per cent in 1986 and just over 4 per cent in 1987). However, consumption growth has been revised down in 1985 and 1986, somewhat to our surprise, while investment growth has been revised up in 1987, which we had expected. Our best view remains that recent figures for domestic demand and GDP(E) still under-estimate growth in 1986 and 1987.

The residual error (the difference between the current price income and expenditure measures of GDP) was reduced over 1985-87 by Blue Book revisions. But it was still  $1\frac{1}{2}$  per cent of GDP in 1987, and looks to have worsened markedly in the first half of 1988 - to about 4 per cent. Despite these improvements, the balancing items in the sectoral accounts deteriorated sharply. This makes for even more acute



CHART  
RESIDUAL ERROR AS A PROPORTION OF GDP(E)



\* 1988 HI ESTIMATE



Difficulties in interpreting recent developments, especially personal sector saving (See Table B). The personal sector balancing item (including life assurance and pension funds) is now over £22 billion, more than 5 per cent of GDP.

**Table B: Residual error and sectoral balancing items £ billion**  
(per cent of GDP in brackets)

	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>
<u>Residual error</u>				
1988 Blue Book	0.5 ( 0.1)	1.1 ( 0.3)	2.7 ( 0.7)	5.7 ( 1.4)
Previous estimates	3.0 ( 0.9)	0.8 ( 0.2)	2.8 ( 0.7)	7.5 ( 1.8)
<u>Sectoral Balancing items (1988 Blue Book)</u>				
Personal Sector*	-4.2 (-1.3)	-8.9 (-2.5)	-17.3 (- 4.6)	-22.5 (- 5.4)
Industrial & Commercial Cos	0.4 ( 0.1)	4.8 ( 1.3)	4.6 ( 1.2)	14.1 ( 3.4)
Financial Companies**	-1.7 (-0.5)	-0.8 (-0.2)	- 0.3 (- 0.1)	9.5 ( 2.3)
Public Corporations	0.7 ( 0.2)	-0.2 (-0.1)	0.6 ( 0.2)	0.0 ( 0.0)
Central Government & Local Authorities	- .4 (-0.1)	.6 ( 0.2)	.7 ( 0.2)	1.0 ( 0.2)
Overseas sector	5.6 ( 1.7)	5.7 ( 1.6)	14.4 ( 3.8)	3.5 ( 0.9)
<u>Memo Item</u>				
Nominal GDP (£ billion)	324.1	354.3	378.8	414.8

\* Including Life Assurance and Pension Funds

\*\* Excluding Life Assurance and Pension Funds

Money GDP growth and GDP deflator inflation were hardly changed by the Blue Book.



Table C: Money GDP and GDP deflator 1988 Blue Book estimates,  
percent change

(Previous estimates in brackets)

	<u>Money GDP</u> <u>(market prices)</u>	<u>GDP deflator</u> <u>(market prices)</u>
1985	9.3 (9.7)	5.6 (5.9)
1987	6.9 (7.0)	3.6 (3.7)
1987	9.4 (9.3)	4.8 (4.9)



## ANNEX 2 : DEVELOPMENTS IN 1988 COMPARED TO FSBR FORECAST

	FSBR			Outturn and Preliminary Forecast 1988		
	1988					
	Q1	Q2	Q3	Q1	Q2	Q3*
<u>Domestic demand and GDP</u> (per cent change on a year earlier)						
Consumption	6.2	5.1	3.1	6.8	5.4	6
Investment	7.4	7.7	7.4	8.7	10.5	13
Domestic demand	6.2	5.3	2.7	6.3	5.6	5
GDP(A)	4.0	4.2	2.3	4.4	4.0	3½
<u>Current Account</u> (£ billion)	-1.0	-0.6	-1.0	-2.8	-2.9	-4
<u>PSBR</u> (£ billion)	-1.2	-1.1	-.9	-1.7	-2.2	-4½
<u>RPI Inflation (All items)</u>	3.3	3.8	4.2	3.4	4.2	5.4
<u>RPI Inflation (excl MIPS)</u>	3.6	4.1	4.3	3.7	4.4	5.1
<u>GDP deflator</u>	5.5	5.0	4.4	5.4	6.0	6
<u>Money GDP Growth on year earlier</u>	10.1	9.5	6.7	10.0	10.1	9½

\*Forecast based on latest indicators

Despite the weak recorded consumption figure for the second quarter of 1988, domestic demand growth in the first half of this year was higher than forecast in the FSBR. And there is no sign yet of the sharp slowdown in demand growth in the second half of the year which was projected in the FSBR. Although the deterioration in net trade and the current account have been considerably greater than expected, the average measure of GDP growth has been a little higher than forecast. This is largely because the strength of output growth so far this year has more than offset the effect of implausibly slow growth in the recorded expenditure measure.

Inflation (both RPI and GDP deflator) has drifted upwards more rapidly than expected. Money GDP growth seems most unlikely to slow in the second half of 1988 to the extent implied by the FSBR forecast.



*(mp)*

FROM: S J PICKFORD  
DATE: ~~27~~ 17 OCTOBER 1988

**CHANCELLOR**

- cc Chief Secretary
- Financial Secretary
- Paymaster General
- Economic Secretary
- Sir P Middleton
- Mr Anson
- Sir T Burns
- Sir G Littler
- Mr Monck
- Mr H Phillips
- Mr Scholar
- Mr Culpin
- Mr H P Evans
- Mr Odling-Smee
- Miss Peirson
- Mr Sedgwick
- Mr Turnbull
- Mr Gieve
- Mr J Hibberd
- Mr S Matthews
- Mr MacAuslan
- Mr McIntyre
- Mr Mowl
- Mr Riley
- Mr Patterson
- Miss Simpson
- Mrs Chaplin
- Mr Tyrie
- Mr Call
- GJ/003

*Ch/ figures may not be final but we thought better to show you tonight so if you have comments we can take on board on Monday*

*Thank. A few pts passed.*

*mp*

**CABINET: TUESDAY 1 NOVEMBER**

I attach briefing on:

- A Recent economic developments
- B Economic prospects
- C Fiscal prospects
- D National Insurance contributions
- E International comparisons

The briefs have been produced by EB, EA, MP, ST, and IF, respectively.

2. GEP are providing separate briefing on public expenditure and your speaking note.
3. If any of our briefing requires updating, we will let you have a revised version in the course of Monday.

*Stephen Pickford*

**S J PICKFORD**



BR 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, ~~Risen from 3.3 per cent in January 1988 to 5.9 per cent in September 1988.~~ *and x-y 2 9 months of 1988. [4.4?]*
- ~~Excluding mortgage interest payments, risen from 3.7 per cent in January 1988 to 5.2 per cent in September 1988.~~ *1985 prices?*

(ii) GDP and components (1980 prices)

percentage changes from previous period

	1981H1 to 1988H1 average annual rate	1988Q2 on 1988Q1	1988Q2 on 1987Q2
Consumers' expenditure	3½	½*	5½*
General government consumption	1	0	0
Fixed investment	5	4	10½
Exports of goods and services	4	3½	3
Imports of goods and services	7½	7	14
GDP(A)	3	½	4

\* provisionally estimated to have risen by over 2 per cent between 1988Q2 and Q3 to level 5½ per cent higher than a year earlier.

(iii) Industrial production : in 3 months to August 1½ per cent higher than in previous 3 months and nearly 4½ per cent up on a year earlier. *[USAR comparison with previous (1979) price]*

(iv) Manufacturing output: in 3 months to August nearly 3 per cent higher than in previous 3 months and nearly 7 per cent higher than a year earlier. ~~In 1987 nearly 6 per cent higher than in 1986.~~ Manufacturing productivity up 7½ per cent in year to 3 months to August.

(v) Company sector

- Industrial and commercial company (ICC) profits (excluding North Sea oil companies) up 24 per cent in 1988H1 on year earlier. More than trebled in nominal terms since 1980 and more than doubled in real terms.
- For non-North Sea ICCs, profitability over 10 per cent in 1987. Manufacturing profitability over 9 per cent in 1987. In both cases, risen every year since 1981, now highest since 1969.

*Replace with statistics show how to compare with previous (1979) price*



(vi) Fixed investment :

## per cent changes

	1988Q2 on				1974H1 on 1979H1
	1988Q1	1987Q2	1981Q1	1979H1	
Total fixed investment	3.8	10.5	46.0	28.2	0.0
Manufacturing investment	9.5	13.1	41.8	3.0	8.7

(vii) Construction output:

- Unchanged between 1988Q1 and Q2 but nearly 12 per cent higher than year earlier.
- Construction orders in 3 months to September down 3 per cent on year earlier (if Channel Tunnel project excluded).

(viii) Retail sales volume in 3 months to September 6 per cent higher than year earlier.

(ix) Current account

- Deficit of £2.5 billion in 1987, around  $\frac{1}{2}$  per cent of GDP, and £9.8 billion, 3 per cent of GDP, in first 9 months of 1988.
- Non-oil export volumes of goods (excluding erratics) in 1987 up  $6\frac{1}{2}$  per cent on 1986. In 1988Q3 up 6 per cent on a year earlier.
- Non-oil import volumes of goods (excluding erratics) in 1987 up  $8\frac{1}{2}$  per cent on 1986. In 1988Q3 up 15 per cent on a year earlier.

(x) Employment up by over 2 million since March 1983; on rising trend for over 5 years. Employees in employment risen for 21 successive quarters, by over 1 million in total.

(xi) Unemployment level : 2,267,000 (8.0 per cent of working population) in September 1988. Seasonally adjusted total fell 6,000 in September; over last 12 months fallen by 505,000. Fallen for 26 months in succession. Fallen in all regions over past year.

(xii) Underlying rate of increase in average earnings risen from  $8\frac{1}{2}$  per cent at start of 1988 to  $9\frac{1}{4}$  per cent in August. This rise mainly accounted for by high overtime payments and performance-related bonuses, as well as effect of nurse's pay settlement. But pay settlements have also edged up as labour market conditions have tightened.

(xiii) Unit wage and salary costs in manufacturing in 3 months to August up 0.7 per cent on year earlier. In whole economy risen 4.4 per cent in year to 1988Q2.



**B ECONOMIC PROSPECTS**

**Factual**

- (i) - For main points of AS forecast, see table 1 at Annex.  
- For comparisons with recent official forecasts, see table 2 at Annex.
- (ii) Output

percentage changes on year earlier

	Outturn 1987	Forecast 1988	Forecast 1989
GDP (average measure)	4	4½	3
GDP (A) excluding oil	4½	5	3½
Manufacturing output	6	7	4½

NB: Rounded to nearest ½ per cent

(iii) Inconsistencies in national accounts: In year to first half of 1988 expenditure measure of GDP rose 2½ per cent, compared with 4½ per cent for income measure and 6 per cent for output measure.

(iv) Comparison with independent forecasts:

percentage increase on year earlier	Autumn Statement		Average of independent forecasts (October)	
	1988	1989	1988	1989
GDP	4½	3	3.7	2.4
Consumers' expenditure	5½	3½	5.4	3.0
Fixed investment	12	5½	9.7	4.3
Exports of goods and services	1½	5½	1.7	4.6
Imports of goods and services	12	4½	9.8	5.6
RPI inflation (Q4)	6½	5	5.6	5.1
Current account (£ billion)	-13	-11	-10.7	-10.6
PSDR (£ billion, financial years)	10	not published	6.7	6.0*

\* PSDR figures for 1989-90 published by independent forecasters reflect various assumptions about tax changes in the Budget.



**SECRET**  
 until 1 November 1988  
 then UNCLASSIFIED

(v) <u>Fixed investment</u>	£ billion at 1985 prices 1987	percentage change on year earlier	
		1988	1989
Business investment	41.1	13½	7½
of which: manufacturing	10.1	18	10
Private dwellings <sup>(2)</sup>	16.5	13	2
General government	6.8	-1½	2½
<b>Total fixed investment</b>	<b>64.2</b>	<b>12</b>	<b>5½</b>

(vi) RPI inflation

## percentage changes on year earlier

	Weight in 1988	Outturn 1987Q4	Forecast 1988Q4	Forecast 1989Q4
Food	16¼	3½	3¼	3¼
Nationalised industries	5½	2¼	7½	6¼
Housing	15¼	7	16¼	7
Other	63	3¼	5¼	4¼
<b>Total</b>	<b>100</b>	<b>4</b>	<b>6¼</b>	<b>5</b>

NB: Rounded to nearest ¼ per cent.

(vii) Manufacturing unit labour costs growth kept down by rapid growth of productivity. But forecast to rise in 1988, just under 1 per cent.

(viii) Unemployment should continue to fall over next year, though probably at slower rate than recently.

(ix) Balance of payments:

Balances on	Manufactures	Other	Oil	Invis- ibles	Current balance
1987	-7½	-7	4	7½	-2½
1988 Partly forecast	-13	-8	2½	5½	-13
1989 Forecast	-11½	-7½	2	6	-11

(x) North Sea oil prices and exchange rate assumed to remain close to recent levels.

Positive

(i) Average annual growth of 3 per cent in 8 years to 1989 compared with 2 per cent annual growth in 1970s. Seven years to 1988 steadiest period of growth averaging over 3 per cent since War.



SECRET  
until 1 November 1988  
then UNCLASSIFIED

(ii) GDP growth likely to moderate to around 3 per cent in 1989, close to average between 1981 and 1987.

(iii) 1988 and 1989 forecast to see substantial increases in fixed investment.

(iv) Manufactured export volumes to rise over 8 per cent in 1989 in line with projected growth of world trade.

(v) Healthy growth of manufacturing productivity.

(vi) Unemployment should continue to fall over year ahead.



TABLE 1

ECONOMIC PROSPECTS: SUMMARY

Per cent changes on a year earlier unless otherwise stated

	1987	Forecast 1988	Forecast 1989	Average errors from past forecasts <sup>1</sup>
<b>GDP and domestic demand at constant prices</b>				
Domestic demand of which:	4½	6	3	1
Consumers' expenditure	5	5½	3½	1¼
General government consumption	1	½	-½	¾
Fixed investment	5½	12	5½	2¼
Change in stockbuilding (as a percentage of GDP)	0	0	0	¾
Exports of goods and services	5½	1½	5½	2¼
Imports of goods and services	7½	12	4½	2¼
Gross domestic product	4	4½	3	¾
Manufacturing output	6	7	4½	2
Balance of payments current account (£ billion)	-2½	-13	-11	4½
<b>Inflation</b>				
Retail price index (Q4 on Q4)	4	6½	5	1¾
GDP deflator at market prices (financial year)	5½	6½	5	1¾
Money GDP at market prices (financial year)	10	11	8	1¾
£ billion	424	471	508	
PSDR (financial year)				
£ billion	3½	10		3
as a per cent of GDP	¾	2		½

1 The errors relate to the average differences (on either side of the central figure) between Autumn Industry Act forecasts and outturn over the last ten years and apply to the forecasts for 1989, except for the PSDR where they apply to the forecasts for 1988-89.

Source: Autumn Statement, table 2.12.



TABLE 2

Comparisons of official forecasts(a) Output (Non-oil in brackets)

	per cent change on year earlier		
	1987	1988	1989
<b>GDP</b>			
- 1987 Autumn Statement	4 (4½)	2½ (3)	not app
- 1988 FSBR	4½ (5)	3 (3½)	2½ (3)*
- 1988 Autumn Statement	4 (4½)	4½ (5)	3 (3½)
<b>Manufacturing output</b>			
	1987	1988	1989
- 1987 Autumn Statement	5	3½	not app
- 1988 FSBR	5½	5	3½*
- 1988 Autumn Statement	6	7	4½

\* 1989H1 only

(b) Inflation

per cent change on year earlier

RPI	per cent change on year earlier			
	1987Q4	1988Q4	1989Q2	1989Q4
- 1987 Autumn Statement	4	4½	not app	not app
- 1988 FSBR	4	4	4	not app
- 1988 Autumn Statement	4	6¼	not app	5
<b>GDP deflator</b>				
	1987-88	1988-89	1989-90	1990-91
- 1987 Autumn Statement	4¼	4½	3½*	3*
- 1988 FSBR	5	4½	4*	3½*
- 1988 Autumn Statement	5¼	6¼	5	3½*

\* assumption



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EF C

FISCAL PROSPECTS AND THE PSBRFactuala) Changes to PSDR forecast for 1988-89 since Budget

	£ billion
General government expenditure	- 2.0
of which: Planning total	- 3.2
Debt Interest	+ 0.2
Other adjustments	+ 1.0
General government receipts	+3.7
of which Non-North sea receipts	+3.7
North Sea revenues	-
PCMOD	- 0.8
PSDR	- 6.6

*Yanked, what are these?*

*PCMOD?*

Lower GGE due to lower planning total - mainly reflecting lower social security expenditure as result of falling unemployment, higher local authority receipts from right-to-buy sales, and higher privatisation proceeds

Higher receipts mainly due to higher economic activity than forecast at Budget time.



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c) 1988-89 PSBR Outturn to date (monthly figures)  
 PSBR excluding privatisation proceeds April - September £4½ billion lower than in same period of 1987-88.

	<u>April to September Outturn</u>		<u>£ billion</u>
	<u>1988-89</u>	<u>1987-88</u>	<u>Difference</u>
PSBR	- 3.7	1.9	- 5.6
PSBR excluding privatisation proceeds	1.2	5.8	- 4.7
CGBR (0)	- 3.3	2.1	- 5.3
LABR	-	0.5	- 0.5
PCBR	- 0.5	- 0.7	+ 0.2

d) Non-oil tax revenues buoyant so far in 1988-89. Outturn figures for 6 months, April to September (latest available data):

	<u>£ billion</u>	<u>% change on year earlier</u>
Inland Revenue receipts	28.9	5
Customs and Excise receipts	23.5	13

e) Share of Non-North Sea Taxes and National Insurance Contributions in Non-North Sea GDP

<u>1978-79</u>	<u>1987-88</u>	<u>1988-89 (Projection)</u>
34.3	37.8	37.2

Forecast of Taxes and NICs in 1988-89

	<u>£ billion</u>		
	<u>1988</u>	<u>1988</u>	<u>Difference</u>
	<u>Budget forecast</u>	<u>Autumn Statement</u>	
Income Tax	42.1	42.8	+0.8
Non-NS Corporation Tax	17.3	17.4	+0.1
VAT	26.2	27.3	+1.1
Stamp duties	2.0	2.4	+0.4
Other Non N Sea Taxes	50.3	50.6	+0.3
NICs	31.6	32.2	+0.6
<hr/>			
Non North Sea			
Taxes and NICs	169.5	172.7	+3.3
North Sea Revenues	3.3	3.3	-



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f) International Comparisons

General government financial deficits as percentage of GDP (deficit shown as a positive number).

	1979	1986	1987	1988
US <sup>(1)</sup>	- 0.5	3.5	2.3	2.2
Japan <sup>(1)</sup>	4.7	1.1	0.4	0.1
German <sup>(1)</sup>	2.5	1.2	1.7	2.1
France	0.7	2.9	2.4	2.3
Italy	10.1	11.6	10.5	9.9
Canada <sup>(1)</sup>	2.0	5.5	4.6	3.5
UK <sup>(4)</sup>	3.3	2.4	1.4	- 0.5
G7	1.7	3.4	2.4	2.1
EC <sup>(2)</sup>	3.7	4.8	4.2	3.8
OECD <sup>(3)</sup>	1.8	3.4	2.5	2.4

Source: IMF 'World Economic Outlook', October 1988 for 1987 and 1988, EC Annual Economic Report October 1988 for EC totals, and for OECD 1979, 1986 and OECD totals.

- (1) As percentage of GNP
- (2) EC(8) before 1980. EC(12) after 1980.
- (3) Covers 18 of 24 members
- (4) 1988 - Autumn Statement forecast

Positive

1. First time since beginning of 1950's that public sector debt repayment in two consecutive years.
2. PSDR in 1988-89, at 2 per cent of GDP, expected to be highest since beginning of 1950's (the earliest date for which figures on this basis are available).
3. Even excluding privatisation proceeds, PSDR as a percentage of GDP expected to be higher than any year since early 1950's with single exception of 1969-70.
4. Reaping rewards of sticking to our policies of firm expenditure control, within framework of MTFS.
5. No other major country has budget surplus (Japan close to balance). All others have deficits of at least 2 per cent of GDP.



## D NATIONAL INSURANCE CONTRIBUTIONS

FACTUALi. Main announcements

- a. Class 1 rates for employed persons to remain unchanged
- b. Lower earnings limit up from £41 per week to £43. Upper earnings limit up from £305 per week to £325. Relationship between LEL, UEL and basic pension set by statute.
- c. Limits for reduced rate bands up from £70, £105 and £155 per week to £75, £115 and £165.
- d. Treasury supplement (currently 5 per cent) to be abolished, subject to Parliamentary approval, reducing fund income by £1.6 billion.
- e. National Health Service allocation increased from 0.95 per cent to 1.05 per cent for employees and from 0.8 per cent to 0.9 per cent for employers. An extra £350 million of planned NHS spending will be financed from NICs rather than taxation.

Positive

- i. No increase in class 1 contribution rates for the sixth year running.
- ii. Most employees and employers pay little or no more as a result of changes. Low paid employees and their employers will pay less, by up to £2.30 each per week, because of increase in ceilings for reduced rate bands and rise in LEL.

Defensive

- i. Why is Treasury Supplement being abolished?
  - Supplement not needed in view of high income from contributions and healthy state of NIF.
  - General taxation still financing non-contributory benefits at a cost of £20 billion.
  - Contributory benefits should be financed by contributions not taxpayers.
- ii. Surplus should have been used to raise benefits: National insurance benefits are all being maintained in real terms. Also plans include strong growth in spending on non-contributory benefits.



## NATIONAL INSURANCE CONTRIBUTION RATES 1989-90

## Summary of proposals

	Present 1988-89	Proposed 1989-90	Change
Employer's Class 1 (contracted in)	10.45%	10.45%	-
Employee's Class 1 (contracted in)	9%	9%	-
Opted-out married women	3.85%	3.85%	-
Lower earnings limit (Class 1)	£41	£43	+£2
Upper Earnings limit (Class 1)	£305	£325	+£20
Low-paid earnings brackets	£70 £105 £155	£75 £115 £165	+£5 +£10 +£10
Rates payable within low paid brackets	5% 7% 9%	5% 7% 9%	- - -
Class 2 (self employed)	£4.05	£4.25	+20p
Small earnings exception	£2,250	£2,350	+£100
Class 3 (voluntary)	£3.95	£4.15	+20p
Class 4 (self employed profits related)	6.3%	6.3%	-
Lower profits limit (Class 4)	£4,750	£5,050	+£300
Upper profits	£15,860	£16,900	+£1,040

Note: Contracting out rebates remain at 3.8 per cent for the employer and 2 per cent for the employee.



## BRIEF E: INTERNATIONAL COMPARISONS

1. GDP/GNP growth

- Growth in UK expected to be above major seven average and EC average in 1988 as in 1987. Growth in G7 and EC expected to moderate in 1989 with UK close to average.

	Percentage change from year earlier		
	1987	1988 (estimate)	1989 (forecast)
United Kingdom	4.2	4½	3
United States	3.4	4	2¾
Japan	4.2	5¾	4½
Germany	1.7	3	2
France	2.2	3	2½
Italy	3.1	3	2½
Canada	3.9	4	3½
Major Seven	3.3	4	3
EC	2.5	3½	2¾

Note: IMF estimates and forecasts except UK (Autumn Statement) and EC (European Commission).



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2. Inflation

- UK inflation rate highest in major 7. UK only one of major 7 (apart from Canada) to include mortgage interest payments in inflation measure. UK figures excluding mortgage interest given below.

Inflation Rates of Other Major 7 Countries and EC

Percentage change from year earlier

	December 1987	September 1988	1988 (estimate)	1989 (forecast)
UK	3.7	5.9	5	(see below)
United States	4.4	4.2	4	4½
Japan	0.4	0.6*	1	1½
Germany	1.0	1.4	1½	2½
France	3.1	3.0	2½	2½
Italy	5.0	4.8	5	5
Canada	4.2	4.1	4	3½
Major Seven	3.4	3.2*	3½	3½
EC	3.3	3.6*	3½	3½

Note: IMF forecasts of consumer price inflation except EC, and UK (Autumn Statement)

\* August 1988

UK Retail Price Inflation

1988 September		1988 Whole Year		1988Q4		1989Q4	
All items	Excl MIPs*	All items	Excl MIPs*	All items	Excl MIPs*	All items	Excl MIPs*
5.9	5.2	5	4½	6½	5	5	5

\* Excluding Mortgage Interest Payments.

Note: Autumn Statement estimate for 1988 and forecasts for 1988Q4 and 1989Q4



### 3. Productivity Growth

- Since 1980 productivity growth in UK manufacturing highest among G7.
- Since 1980 whole economy productivity growth in UK about same as Japan, and higher than any other G7 country.

	Manufacturing productivity 1980-87	Whole Economy productivity 1980-87
United Kingdom	5.3	2.7
United States	4.1	0.9
Japan	2.3	2.8
Germany	2.0	1.7
France	2.5	1.9
Italy	3.7	1.9
Canada	3.2	1.5
Major Seven	3.4	1.7

Source: OECD, IMF, CSO

### 4. Current Account

- UK deficit for 1988 expected to be about the same as US when expressed as percentage of GDP, but US deficit at or ~~about~~ <sup>above</sup> 2½ per cent of GDP since 1984.

\$ billion (per cent of GDP)

	1986	1987	1988 (estimate)
United Kingdom	0 ( 0 )	- 4 (-½)	- 23 (-2¾)
United States	-141 ( 3½)	-154 (-3½)	-129 (-2½)
Japan	86 ( 4½)	87 ( 3½)	78 ( 2¾)
Germany	38 ( 4¼)	44 ( 4 )	45 ( 3¾)
France	3 ( ½)	- 4 (- ½)	- 3 (- ¾)
Italy	3 ( ½)	0 ( 0 )	- 3 (- ¾)
Canada	- 7 (-1¾)	- 8 (-2 )	- 9 (-1¾)
Major Seven	- 20 (-1¼)	- 38 (- ¼)	- 39 (- ¼)

Source: IMF forecasts except for UK (Autumn Statement).



5. Overseas Assets and Reserves

- Of the major countries UK has highest net stock of overseas assets as a percentage of GDP and only Japan has higher reserves as a percentage of imports.

	Net stock of Overseas Assets in 1987		Foreign Exchange Reserves (minus Gold)	
	\$ Billion	% of GDP	Aug 1988 \$ billion	% of 1987 Imports
UK	160*	24	42	27
US	-380	-9	37	9
Japan	240	10	89	60
Germany	160	14	59	26
France	-10	-1	29	18
Italy	-40	-6	31	25
Canada	-10	-2	13	15

Source: Bank of England, IMF.

\*£89.5 billion

6. Interest Rates

3 month ~~run~~ rates in all the major countries have risen since June. Long ~~run~~ rates have changed very little.

	3-month rates			10-year bond yields		
	One Year ago	June 1988	26.10.88	One Year ago	June 1988	24.10.88
UK	9.2	8.8	12.1	9.6	9.5	9.7
US	7.4	7.6	8.5	8.9	9.2	9.0
Japan	4.8	4.1	4.6	5.2	5.1	5.0
Germany	4.6	3.9	5.1	6.9	6.7	6.4
France	8.2	7.4	8.1	10.2	9.0	8.9
Italy	12.0	11.1	11.6	11.2	10.5	10.7
Canada	8.3	9.3	10.4	10.7	10.1	10.0
Major Seven	7.2	6.9	7.9	8.4	8.3	8.2



CONFIDENTIAL

*PR*

FROM: SIR T BURNS  
DATE: 18 OCTOBER 1988

CHANCELLOR

*[Red handwritten notes: "Re: MB" and "from Ho Spex"]*

- cc Chief Secretary  
Financial Secretary  
Paymaster General  
Economic Secretary  
Sir P Middleton  
Mr Anson  
Sir G Littler  
Dame Anne Mueller  
Sir A Wilson  
Mr H Phillips  
Mr Byatt  
Mr Scholar  
Mr Lankester  
Mr Monck  
Mr Culpin  
Mr H Evans  
Mrs Lomax  
Mr Odling-Smee  
Mr Peretz  
Mr Sedgwick  
Mr Spackman  
Mr Turnbull  
Mr A Allan  
Mr S Davies  
Mr Gieve  
Mr Grice  
Mr Hibberd  
Mr S Matthews  
Mr Melliss  
Mr Mowl  
Mr O'Donnell  
Mr Pickford  
Mr Riley  
Mr A Hudson  
Miss Simpson  
Mr Call  
Mr Tyrie

**AUTUMN FORECAST 1988**

The strength of the economy this year has been a major surprise and follows 4 per cent growth last year. The latest monthly figures now show manufacturing production growing by about 15 per cent in total over the past two years. First estimates are likely to show that GDP has grown by 9 to 10 per cent between the third quarters of 1986 and 1988. This matches previous periods of rapid growth - the two years to the cyclical peaks of 1955, 1960, 1964 and 1973. And rapid growth has brought with it many of the



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features that accompanied earlier booms - most noticeably rising inflation and a current account deficit.

2. With unchanged tax rates and interest rates at 12 per cent the forecast shows growth averaging 2-2½ per cent a year over the next 2 years. If anything this is faster than the aftermath of previous periods of rapid growth which were followed by quite a sharp slowdown. The outcome will influence the speed with which inflation falls and the current account deficit is reduced.

3. In this note I consider a number of issues: how this upswing compares with previous periods of rapid growth; the reasons for the sharp acceleration of growth; and what is likely to happen next.

EXPLAINING THE STRENGTH OF DEMAND

4. Earlier periods of rapid growth have a number of common characteristics. They coincided with rapid growth in the OECD as a whole and an upturn of commodity prices. A stockbuilding and consumer durable surge played a major part in the demand increase. Investment grew rapidly and was also an important component of the demand increase but its rate of growth lagged behind the peak of the business cycle. The current account deteriorated sharply while the inflation rate rose significantly over the upswing. The peak inflation rate was up to 15 months after the period of fastest growth. Earnings growth also picked up sharply.

5. The policy background was also similar in each of the earlier upswings. An easing of monetary policy played an important part; short-term interest rates were reduced during each upswing; and at the beginning of three of the four upswings - 1954, 1958 and 1971 - personal sector credit controls were abolished. During each of the upswings there were substantial tax reductions.

6. I set out this history because there are clear similarities in the way the present upswing has developed. OECD output has grown much faster than expected and between mid-87 and mid-88



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commodity prices rose sharply. Tax rates have been reduced over the past two years and interest rates fell substantially between Spring 1986 and Spring 1988. Fixed investment is rising rapidly and is projected to continue to rise into next year. The current account appears to have deteriorated by 2½ per cent of GDP over the past 2 years while inflation is rising and is not projected to peak until next Summer.

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explaining)*

7. But while there are many similarities between the last two years and earlier upswings there are also important differences which could be important for influencing subsequent developments.

8. The biggest difference is that there has been no recent, sudden relaxation of credit controls. The abolition of HP and other banking controls was virtually complete by the end of 1982. There has been some easing of lending conditions for building societies but it does not compare with the scale of earlier changes. Possibly as a result there has been less of a consumer durable boom over the past two years than on earlier occasions. However at first glance this seems to have done no more than affect the composition of spending.

9. A further important difference is that although we have seen significant tax reductions during the upswing they have been accompanied by a sharp move into budget surplus even when allowance is made for privatisation proceeds. In other words the tax cuts have been more than paid for by expenditure restraint and tax buoyancy. Some seek to argue that fiscal policy has relaxed if account is taken of the growth of output. But it is of some interest that in previous rapid upswings tax reductions added to the budget deficit or simply left it unchanged despite the strength of the economy.

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10. A further potentially important factor is that there does not appear to have been a major build-up of stocks although this difference could be revised away in future. As the Forecast Report shows the position is complicated by the size of the residual error. Most of the unexplained increase in demand has not even been accounted for by the statisticians. We do not know

*no  
bridge*



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how far it is consumption, investment or exports. Given the growth of imports and the importance of stockbuilding in previous cycles it is quite possible that some of this may turn out to be unmeasured stockbuilding although I concede there is no evidence for this at present.

11. A year ago, following the stock market collapse, we revised our growth projection for 1988 down from 3 per cent to 2½ per cent. As the policy stance has not changed much in the meantime it is not surprising that we have difficulty explaining the strength of activity this year.

12. In the early months of the year there were some signs that growth was slowing. After a spurt in the middle of 1987 several indicators pointed this way. The six month growth of MO slowed sharply; industrial production hesitated (although the pause has now been revised away); CBI indicators also showed some signs of peaking. And yet within a few months we had to completely revise our view about the strength of output.

13. The Forecast Report makes clear that it is still far from clear why growth accelerated in the way it did. In addition to the problem of the statistical adjustment we are faced with a large unexplained increase in consumer spending. Despite a cumulative sharp fall of the savings ratio in previous years we have seen a further big reduction this year.

14. This unexplained growth of consumer spending is the mirror image of 1974 onwards when the recession was intensified by an unexpected increase in the savings ratio. It was only some years later that it was attributed to higher unanticipated inflation.

15. The report outlines various possible explanations for the strength of consumer spending; in particular the combination of the rapid growth of asset prices (particularly house prices), the strength of disposable income, and the ability to use mortgage borrowing to withdraw substantial amounts of housing equity. I share the view that the interaction of consumption and the housing



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market has been crucial - and will be equally important in determining the speed of any slowdown.

16. Some commentators are seeking to argue that the boom is the result of this year's Budget and the reduction of interest rates earlier this year. I find both arguments unconvincing. Undoubtedly there have been effects from the Budget. For example action on double mortgages clearly gave a temporary boost to the housing market and the rapid turnover will have had implications for equity withdrawal. And the effects of tax cuts on consumer confidence will have encouraged many to have taken on rather higher levels of debt. But the time lags associated with fiscal action suggest that the direct effects so far will have been small in relation to the unexplained component.

17. The same goes for interest rate reductions earlier this year. Not only were they short-lived but they were associated with a marked strengthening of the exchange rate.

18. It is now clear that demand has been consistently stronger since 1986 than we expected for a given fiscal and monetary stance. Looking back there is a plausible argument that monetary policy should not have eased so much in 1986 and should have been tighter on average over the whole period since then. That would have been much more significant than changes to either the Budget or interest rates earlier this year.

**WHAT HAPPENS NEXT?**

19. With unchanged tax rates and interest rates at 12 per cent the forecast shows growth averaging 2-2½ per cent a year between the second half of this year and the second half of 1990. The important question is whether this is a sufficient tightening of policy to get inflation on a clear downward track again.

20. It is interesting to look at the aftermath of previous periods of rapid growth. On each occasion the policy reaction was fairly brutal. Hire purchase controls were introduced in 1955,



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1960 and 1973 and were tightened in 1965 while interest rates rose at or before the peak of each cycle. Taxes were typically raised in the years following the peak of the cycle while incomes policies were introduced in 1962, 1966 and 1972.

21. In each case the effects of the policy tightening appeared quickly. Typically growth over the following two years slowed to an average of  $1\frac{1}{2}$ - $2\frac{1}{2}$  per cent a year, with manufacturing output barely rising (and of course falling sharply in 1974). Durables spending, stockbuilding and the housing market played a large part in the slowdown. The current account deficit generally improved by as much as it deteriorated in the upswing while inflation also subsided with a lag.

22. In retrospect it can be argued that the tightening was probably overdone on each occasion. Although it brought about rapid correction of the current account and inflation the sharpness of the stop sowed the seeds for the next 'go'.

23. How far will this experience be repeated? Are present tax rates and interest at a level to deliver the objective of lower inflation? There are points to be made on both sides.

24. Some fear it will not be enough and point to the absence of a stockbuilding and durables boom, both of which were easily reversible in the past. They argue that as we are relying on interest rates alone to bring about a slowdown they will need to be even higher to produce the desired result. On previous occasions credit controls and tax hikes were wheeled in to ensure a pronounced slowdown.

✓ 25. The case that enough is being done rests on the argument that changes to the financial system have made higher interest rates a very sharp weapon. Debt levels have increased, making the personal sector a net payer of interest. In addition now that house prices have peaked and expectations of capital gain have receded (along with fears of "missing out" on the property boom) so turnover will decline and with it equity withdrawal.



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26. My own view is that the mechanisms for bringing down the growth of consumption are there and will work. But I still fear that it may need a further tightening of monetary policy. This could come about in one of two ways; either because it is evident to us that MO growth and demand are not slowing enough; or because markets will worry and force us to react to the decline of sterling.

27. Fortunately we do not have to rely on forecasts. They help us to assess various possibilities and examine recent developments. But decisions will have to respond to events as they unfold. The key indicators will be MO, the housing market, retail sales and the exchange rate.

28. If we do manage to achieve a "soft landing" it will help the longer-term supply performance of the economy. Having experienced so many years of steady growth it would be sad to see the re-emergence of "stop-go". On the other hand we then have to accept a more sluggish adjustment of the current account and inflation rate. The current account is less of a worry and does not need immediate adjustment, for reasons you set out in Berlin. The inflation rate, on the other hand, could become more urgent, particularly if there are signs of faster growth of earnings - a real worry given the inflation profile and the tightness of the labour market. The mortgage rate effect will come to our assistance at some point but it will also be necessary to show that the underlying rate of inflation is moving in the right direction.

29. As far as the Budget is concerned my present inclination is to be content with the prospect as set out in the forecast. It would mean very little in the way of tax changes in the Budget and settling for a debt repayment next year of more or less the same size as this year.

*V. Howard*

*P.P.* T BURNS



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*Prep*

# Statistics on economy were wrong

By Ralph Atkins

ERRORS AND omissions mean that large chunks of a government book of statistics published last week are useless, officials admitted yesterday.

They said Central Statistical Office figures for national accounts in its September monthly digest were unreliable and that people were advised to use other sources.

Its admission will further undermine confidence in the government statistical service. Independent economists have complained for some time of inaccuracies and an internal Treasury review is expected to be concluded soon.

The errors in the September digest are in annual and quarterly figures for economic statistics, such as gross domestic product, investment and consumer spending.

The CSO said that the problems arose because changes to its computer system coincided with a re-basing of index numbers to 1985. However, human error was almost certainly also involved.

An official said: "I suppose in the last analysis it was sloppy editing."

The CSO said it had only become aware of the mistakes in the last few days and is still trying to find out the extent of the problem.

The result is a collection of spurious results: figures in tables do not match headings and numbers are wrong or missing.

The effect is to rewrite history. For example, the digest shows gross domestic product - or national income - falling sharply between 1982 and 1983. More reliable figures show it rising.

The CSO said correct annual figures could be found in its UK National accounts 1988, or Blue Book, published earlier last month. Users should refer to press notices, or contact the CSO, for details of recent quarterly numbers.

The monthly digest, which costs £5.50, is widely used as a reference book by academic economists and City analysts. As well as economic statistics it includes information on other subjects such as population, transport, energy and agriculture. The CSO said these were unlikely to be affected.

# Government on course for £8bn public sector surplus

By Simon Holberton, Economics Staff

THE GOVERNMENT borrowed nearly £1bn in September, the Treasury said yesterday, but its figures indicate that it could be on course to achieve a surplus of more than £8bn this financial year.

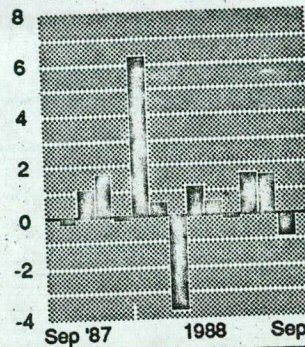
The monthly figures for the public sector borrowing requirement, which include a breakdown of expenditure and revenue, show a PSBR surplus of £3.7bn for the first six months of this financial year and will probably exceed by a large measure the Budget forecast of a £3bn debt repayment.

Revenue growth is significantly higher than predicted in the March Budget and expenditure appears to be lower than forecast.

Mr Nigel Lawson, the Chancellor, will make a new forecast for the PSBR in the Autumn Statement next month and economists in the City expect him to estimate a PSBR surplus of about £8bn, although many City analysts

## PSBR

Total public sector (£bn)



expect a much higher surplus for the year.

UK financial markets hope that tomorrow the Chancellor, in his annual address to the City at the Mansion House, will explain his policy on government debt repurchase.

Inland Revenue receipts in the first six months of the

financial year were 8 per cent higher than in the same period a year earlier and receipts from customs, excise and value added tax were up 13 per cent.

The Treasury estimated that Inland Revenue receipts would rise by 6 per cent this year and customs and excise receipts by 7 per cent.

On the expenditure side, supply expenditure was 5 per cent higher in the first six months of the year than for the same period last year.

In the Budget, the Treasury forecast that public expenditure, a slightly different category from supply expenditure, would rise by 7.4 per cent.

The Treasury said the September figures were slightly distorted by the effects of the postal strike, which lowered Inland Revenue receipts by hundreds of millions of pounds, and by the payment of a rebate to leading oil companies for Advance Petroleum Revenue Tax.

# Surplus on target for £10bn after PSBR leaps to £1bn

By David Smith, Economics Correspondent

The Government is on target for a £10 billion to £12 billion "Budget surplus" this year, in spite of larger-than-expected borrowing of nearly £1 billion last month.

The public sector borrowing requirement for September was £989 million, and this had the effect of reducing the cumulative repayment of debt this year to £3.75 billion, from £4.73 billion in the period to August.

Even so, the underlying revenue position is strong, and there were no indications in the figures of a slowdown in tax receipts or an acceleration in public spending.

Treasury officials said the postal strike had an impact of hundreds of millions of pounds on tax collections. In addition, the Government repaid around £100 million net

to the oil companies. Petroleum revenue tax receipts were weak, at £300 million, because of low oil prices and production, and the Government had to repay £400 million in advanced PRT payments to the oil companies.

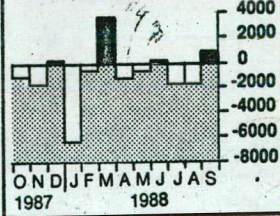
Thus, while Inland Revenue receipts in the first six months of the 1988-89 financial year were only 5 per cent up on a year earlier, the

underlying position was far stronger.

Customs and Excise receipts, which reflect the strength of consumer spending, were up by 13 per cent in the first six months, compared with a year earlier. If spending is slowing it will take several months before this shows up in lower value-added tax receipts.

The Government has all but achieved its privatization target of £5 billion for the year, with British Steel still to come next month. In the April-September period privatization proceeds were £4.9 billion. Excluding privatization, the PSBR in the first six months of the financial year was £1.2 billion, £4.6 billion lower than the total for the corresponding period last year.

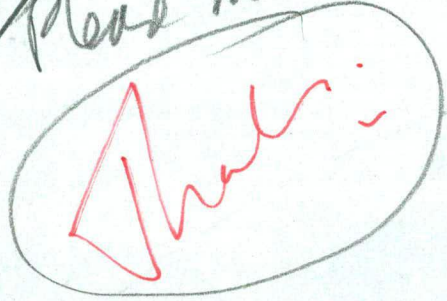
## THE BORROWING REQUIREMENT





*Tony*  
*Press minute*

FROM: BRIAN COULTON  
DATE: 27 OCTOBER 1988



- 1. MR SEDGWICK
- 2. CHANCELLOR

- cc
- Sir P Middleton
  - Sir T Burns
  - Mr Odling-Smee
  - Mr Gieve
  - Mr Hibberd
  - Mr Davies
  - Mr O'Donnell
  - Mr Pickford
  - Mr Hudson
  - Mr Owen
  - Mr Patterson
  - Ms Chaplin
  - Mr Tyrie

*Oh*  
*Making rates heavy*  
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*helpful information that we*  
*can move X to seven*  
*years i.d.c.*

*BA*

**THE STEADINESS OF ECONOMIC GROWTH**

This note updates the analysis of the steadiness of GDP growth in the UK, which was published in the June 1988 Economic Progress Report.

X

2. The article presented the evidence for the claim that "the six years to 1987 were the steadiest six year period of growth averaging 3 per cent since the war". This note re-examines this claim in the light of data revisions, and looks at the implications of our forecasts for GDP growth in 1988 and 1989. This latter part involved using seven and eight year moving averages and variances in addition to the six year period figures used in the original article.

3. The first two charts repeat the EPR analysis using the latest data for GDP(A). It is clear that the conclusion made then still holds. The six year period to 1987 had the lowest variance of growth of any six year period with average growth of 3 per cent or above since the war. (See Annex Table 1.)

4. Using seven year periods from 1949, and taking the Industry Act forecast of 4½ per cent growth of GDP(A) in 1988, the same conclusion holds. In the seven years to 1988 growth has been steadier than in any other seven year period since 1949 in which growth has averaged 3 per cent or above.

5. However, if, as we suspect, the expenditure and average



estimates of GDP have been understating growth in the last couple of years, this may impart some bias to the results. It is interesting to see the implications of using the data and forecasts for the output measure of GDP from 1987 onwards. GDP(O) has been growing markedly more rapidly than GDP(A) over this period.

6. When this is done for seven year periods up to 1988, two other periods - 1949-55 and 1963-69 - have average growth of over 3 per cent and less variation in growth than the period to 1988. (See Annex Table 1 - figures in brackets for the latest period.) However the average growth rate in 1982 to 1988 is  $3\frac{1}{2}$  per cent as against 3 per cent in the two earlier periods. (See Chart 3 and 4.) In addition, if we take the seven year period to 1989, this reservation disappears. Both measures show the lowest variance since the war of any seven year period with above 3 per cent growth.

7. Repeating the exercise using eight year periods, and incorporating the Autumn forecast of 3 per cent GDP(A) growth in 1989, again gives the most steady eight year period of growth in excess of 3 per cent since the second world war. This result still holds when the output measure of GDP is used from 1987, and moreover, this method gives the highest mean eight year growth rate of any growth period since 1949. (See Charts 5 and 6.)

8. Finally a comparison has been made with the six and seven year periods up to (and including) 1938. In the period 1933-1938 growth averaged  $3\frac{3}{4}$  per cent - equal to the highest six year average growth rate since the war (1959-64 and 1960-65). However growth was less steady than in these later periods, and substantially more variable than in the six years to 1987.

9. A similar story can be told for the seven year period to 1938. Average growth was at a high level, but was less steady than most of the post-war periods of comparable growth, including 1982-88. (See footnote Annex Table 1.)



Summary of conclusions.

10. The main conclusions are:

- (i) In the six years to 1987, growth was steadier than in any other six year period since the second world war when growth averaged 3 per cent or above.
- (ii) Using GDP(A), the seven year period to 1988 will be the steadiest seven year period of plus 3 per cent growth since the war. This does not hold when GDP(O) is used from 1987 onwards.
- (iii) Using either measure of GDP, the seven years to 1989 will be (assuming our Autumn Statement forecasts for 1988 and 1989 are correct) the steadiest period of above 3 per cent growth since the war.
- (iv) The eight year period to 1989 will be the steadiest eight year period since the war when growth averaged over 3 per cent.
- (v) Using GDP(O) data and forecasts from 1987, the eight years to 1989 will have the highest average growth rate of any eight year period since the war.

11. In public presentation it would probably be best to refer to conclusions based on the average measure of GDP for the period ending in 1988.

Line to Take:

- Assuming our latest forecast for growth this year is correct, the seven years to 1988 will be the steadiest seven year period of growth averaging over 3 per cent since the second world war.



B COULTON



CHART 1

### AVERAGE GROWTH FOR SIX YEAR PERIODS (1949-54 to 1982-87)

AVERAGE GROWTH OF GDPA

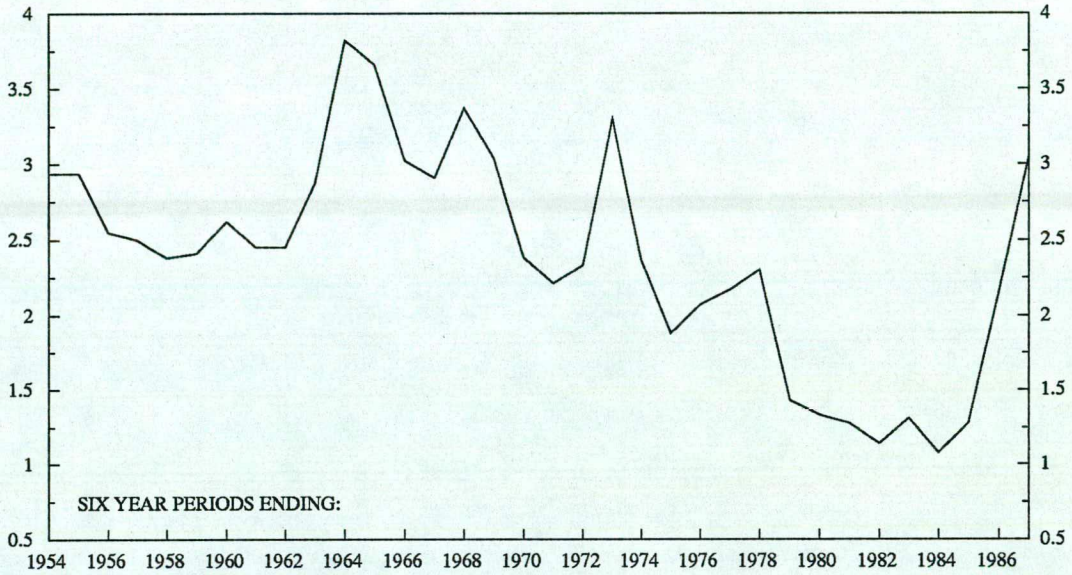


CHART 2

### VARIANCE OF GROWTH FOR SIX YEAR PERIODS (1949-54 to 1982-87)

VARIANCE OF GROWTH OF GDPA

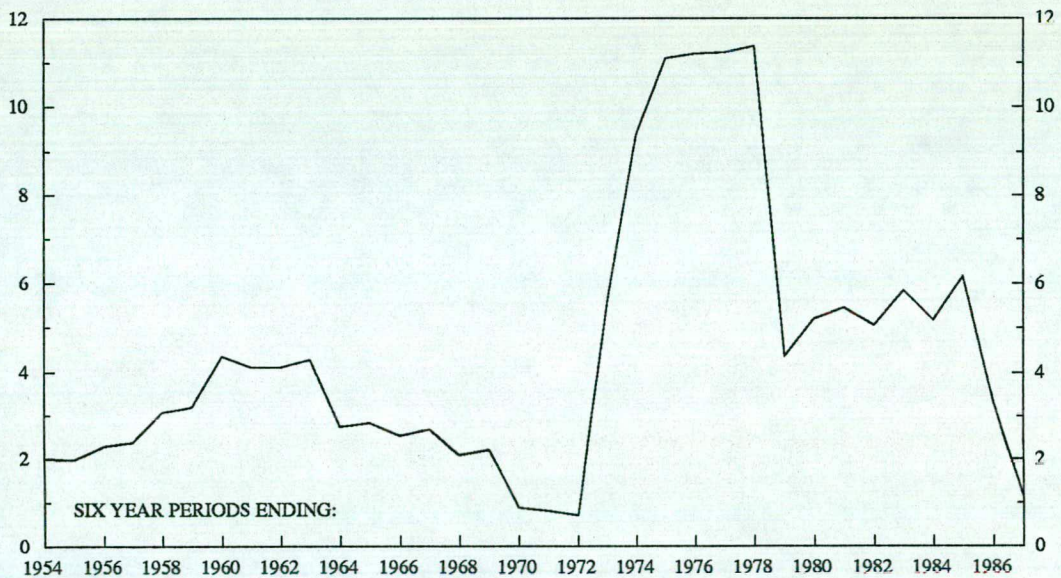
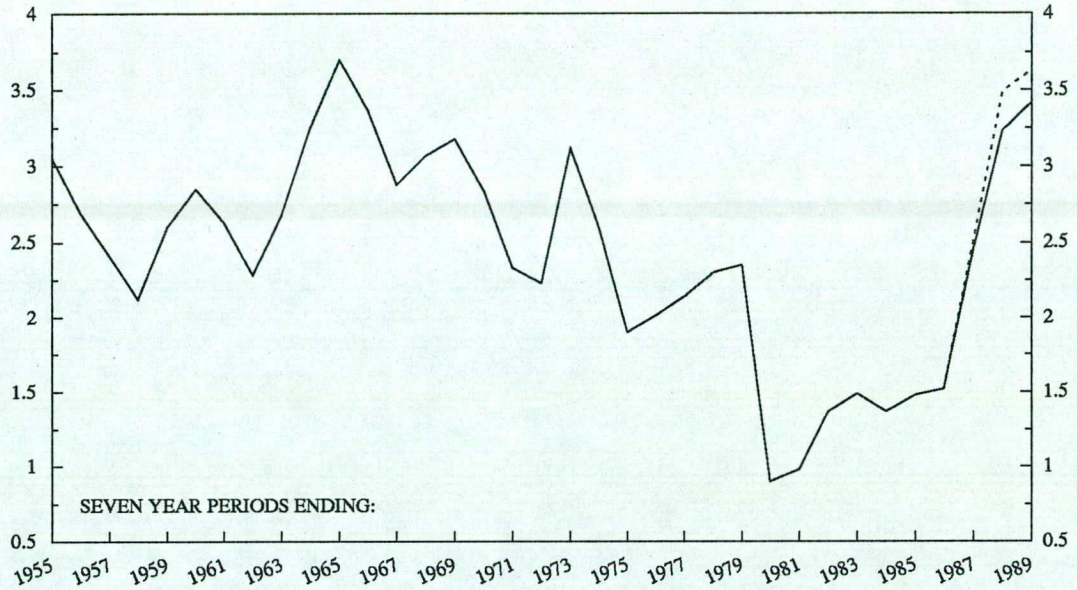




CHART 3

### AVERAGE GROWTH FOR SEVEN YEAR PERIODS (1949-55 to 1982-88)

AVERAGE GROWTH OF GDPA

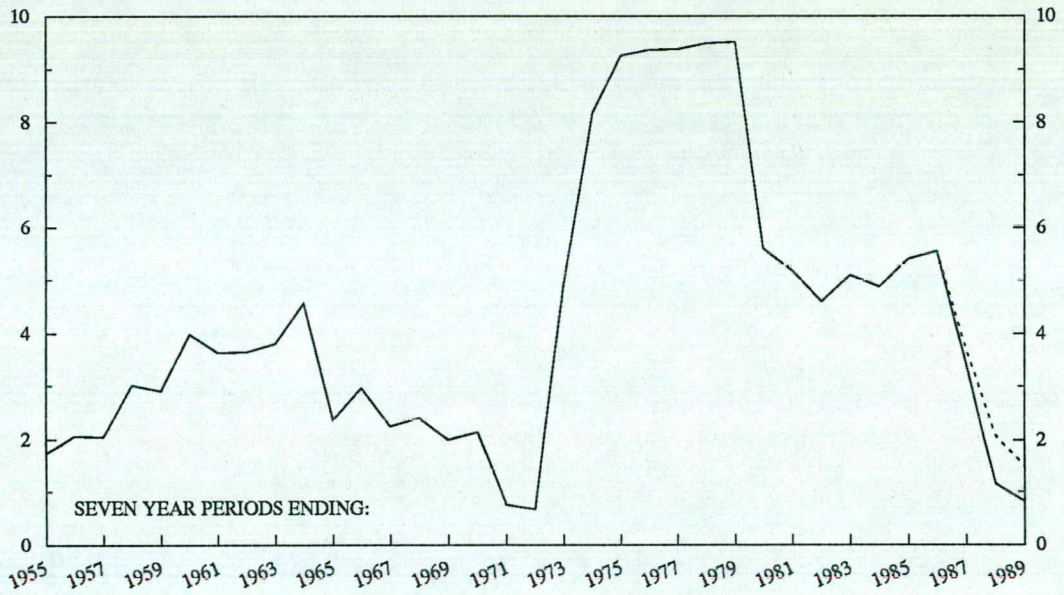


----- USING GDP(O) FIGURES FROM 1987

CHART 4

### VARIANCE OF GROWTH FOR SEVEN YEAR PERIODS (1949-55 to 1982-88)

VARIANCE OF GROWTH OF GDPA



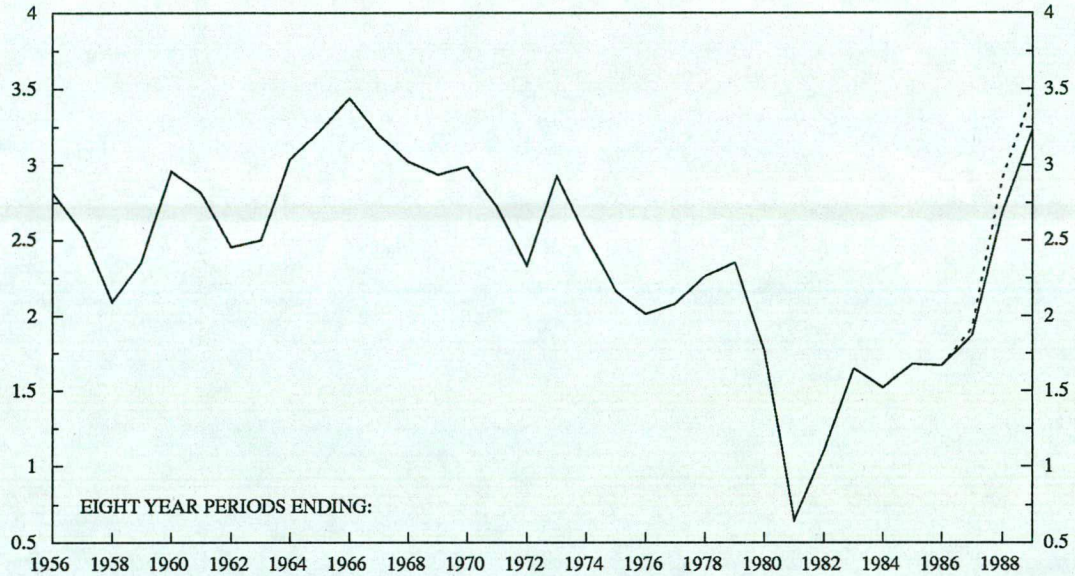
----- USING GDP(O) FIGURES FROM 1987



CHART 5

### AVERAGE GROWTH FOR EIGHT YEAR PERIODS (1949-56 to 1982-89)

AVERAGE GROWTH OF GDPA

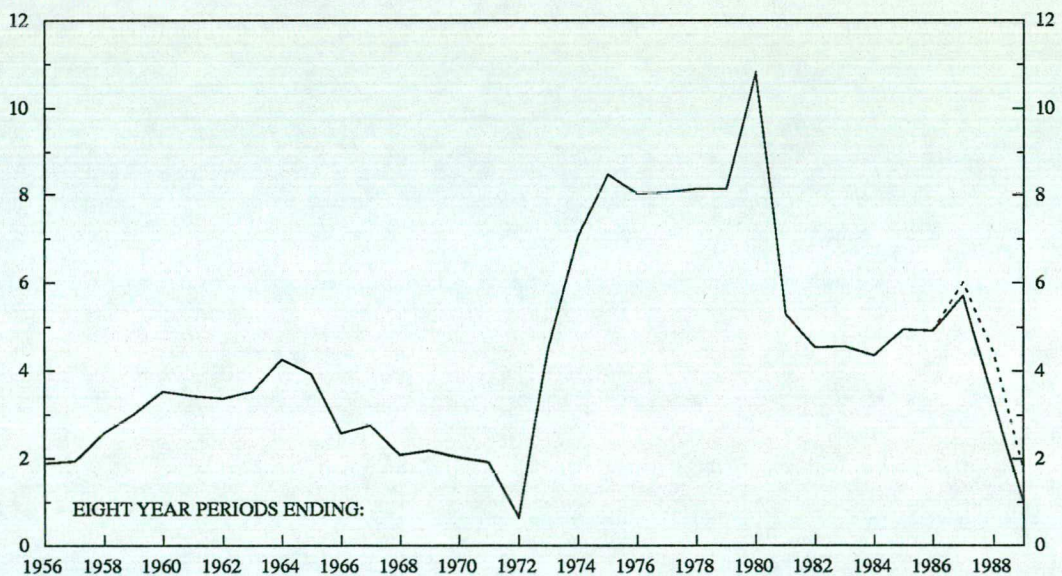


----- USING GDP(O) FIGURES FROM 1987

CHART 6

### VARIANCE OF GROWTH FOR EIGHT YEAR PERIODS (1949-56 to 1982-89)

VARIANCE OF GROWTH OF GDPA



----- USING GDP(O) FIGURES FROM 1987



ANNEX TABLE 1

## GROWTH AND VARIATION IN GROWTH OF GDP(A)

	6 year periods		7 year periods		8 year periods	
	MEAN	VARIANCE	MEAN	VARIANCE	MEAN	VARIANCE
GDP Growth in the period ending:						
1954	2.94	1.99				
55	2.94	1.98	3.05	1.74		
56	2.55	2.30	2.69	2.06	2.82	1.90
57	2.50	2.38	2.41	2.05	2.55	1.93
58	2.38	3.07	2.12	3.01	2.09	2.59
59	2.41	3.18	2.60	2.91	2.35	3.00
1960	2.62	4.35	2.85	3.98	2.96	3.52
61	2.45	4.10	2.63	3.63	2.82	3.42
62	2.45	4.11	2.28	3.64	2.45	3.36
63	2.87	4.28	2.68	3.80	2.50	3.52
64	3.82	2.75	3.25	4.56	3.04	4.26
65	3.66	2.84	3.70	2.38	3.22	3.92
66	3.02	2.54	3.37	2.97	3.44	2.59
67	2.91	2.70	2.88	2.26	3.20	2.77
68	3.37	2.10	3.07	2.41	3.02	2.03
69	3.04	2.22	3.18	2.00	2.94	2.20
1970	2.28	0.88	2.83	2.14	2.99	2.03
71	2.21	0.80	2.33	0.76	2.72	1.92
72	2.33	0.71	2.23	0.67	2.33	0.65
73	3.30	5.63	3.12	4.92	2.93	4.50
74	2.36	9.37	2.59	8.18	2.52	7.05
75	1.88	11.11	1.90	9.26	2.16	8.48
76	2.07	11.21	2.01	9.37	2.01	8.03
77	2.17	11.24	2.14	9.38	2.08	8.07
78	2.30	11.39	2.30	9.49	2.26	8.15
79	1.43	4.37	2.35	9.51	2.35	8.15
1980	1.33	5.20	0.90	5.60	1.77	10.81
81	1.28	5.45	0.98	5.18	0.65	5.30
82	1.14	5.06	1.37	4.59	1.10	4.54
83	1.31	5.83	1.49	5.09	1.65	4.56
84	1.08	5.17	1.37	4.88	1.52	4.36
85	1.28	6.15	1.48	5.40	1.68	4.95
86	2.16	3.31	1.52	5.55	1.67	4.92
87	3.05	1.12	2.46 (2.52)	3.40 (3.68)	1.87 (1.92)	5.70 (6.01)
88			3.23 (3.49)	1.16 (2.09)	2.69 (2.92)	3.34 (4.43)
89			3.42 (3.63)	0.82 (1.50)	3.23 (3.47)	0.99 (1.79)

1948-87

Mean = 2.48

Variance = 3.98

Figures in brackets using GDP(0) from 1987.

Note 1933-1938 Mean = 3.68  
Variance = 3.52

1932-1938 Mean = 3.20  
Variance = 4.57







The forecast in detail

Table 1

(percentage changes year earlier)	LBS October forecast		Autumn IAF	
	1988	1989	1988	1989
Gross Domestic Product (output measure)	4.7	3.2	5.4*	2.8*
Consumer expenditure	5.1	2.8	5½	3½
Total Fixed Investment	10.2	2.5	12	5½
General Government consumption	1.0	1.0	½	-½
Exports of goods and services	0.7	6.0	1½	5½
Imports of goods and services	9.4	3.0	12	4½
Manufacturing Output	7.0	5.4	7	4½
World Trade in manufactures	5.4	5.2	8½	7½
Retail Prices (Q4)	6.1	4.6	6½	5
Current Account (£bn)	-12.5	-11.5	-13	-11
PSBR (£bn, financial years)	-10.3	-11.8	<del>10.2</del> -9.8	-11.0* eh??

\* Not Published.

2. The outlook foresees a 'soft landing', with GDP growth falling only to 3 per cent in 1989. It judges that "monetary policy has been tightened sufficiently... to produce a gradual reduction in the current account deficit... and to prevent inflation from breaking the 7 per cent level".

*So the convention is same as previous year - 11.0 - 9.8*



3. Growth of consumers expenditure falls from over 5 per cent in 1988 to under 3 per cent in 1989, with the savings ratio expected to rise from recent very low levels. This is consistent with a decline in the rate of growth of the demand for credit which is identified as the main mechanism behind the sharp decline in the savings ratio over the 1980s.

4. Manufacturing investment is expected to grow by 10 per cent in 1989, though growth is forecast to slow down over the medium term as capacity shortages begin to ease. A sharp fall in housing investment in 1989, coupled with a small fall in public investment, imply only modest overall growth in total fixed investment.

5. The LBS identify excess domestic demand cause of the worsening current account in 1988. Lower growth in domestic demand next year and increases in supply potential following this year's investment boom lead to a slight improvement in the current account deficit. The forecast shows sharply increased export growth and considerably lower growth of imports in 1989.

6. Invisible earnings suffer from the effect of high relative UK interest rates (even with base rates falling to 11 per cent in mid-1989) on interest, profit and dividends. Competitiveness, having held up well in the face of the 1988 appreciation in sterling, is forecast to improve by 4 per cent in 1989. This is due to a depreciation in the sterling effective rate from 76 to 72 over the year.

7. Growth of the output measure of GDP slows to just over 3 per cent in 1989, with manufacturing output forecast to grow by over 5 per cent (down from 7 per cent in 1988). Service sector output is expected to be particularly hit by slower growth of consumers expenditure.



8. Manufacturing labour productivity growth slows from 7 per cent in 1988 to a 'sustainable' rate of 4 per cent in 1989 and beyond. Productivity growth in the services sector averages 1½-2 per cent over the next few years. The growth in manufacturing productivity precludes significant increases in manufacturing employment, which resumes its long run trend decline in later years. But growth in service sector employment ensures a rise in total employment of 400,000-500,000 over 1989. Unemployment continues to fall, although somewhat less rapidly.

9. A significant feature of the forecast is that earnings growth is not expected to accelerate further. This reflects some further increases in settlements, offset by a fall to more normal rates of overtime. Manufacturing earnings growth is even forecast to fall back slightly in 1989, but overall earnings growth stabilises at over 8 per cent per annum. With slower productivity growth, unit labour costs rise by 3 per cent, compared to 1½ per cent in 1988.

#### Economic Viewpoint

10. In his first viewpoint since replacing Alan Budd, David Currie looks at 'The Conduct of Monetary Policy Without Monetary Aggregates'. Currie considers the role of the exchange rate within the set of indicators which are used to determine monetary policy. UK monetary policy is characterised as having moved from being based on monetary targeting (early 1980s), to being biased towards the exchange rate (the year post Louvre) and now being driven by domestic demand. The conclusion of Currie's analysis is that the exchange rate should have a significant influence on monetary policy (because of the inflationary consequences of ignoring it) but one which should not be overdone. The adherence to the £/DM cap during the spring is mildly criticised.

11. Currie describes the dilemma between external and domestic considerations in the formulation of monetary policy as "a real source of conflict underlying the Louvre Accord and its successors". He goes on to note that, in the absence of some



reduction of imbalances on fiscal policy, G7 exchange rate agreements are likely to fail under adverse market pressures. The unreliability of monetary indicators in the UK is also stressed and Currie suggests that even M0, which alone has exhibited a fairly stable income velocity, will become considerably less useful with the advent of cashless shopping. It should be noted that this development is only likely to occur outside the period reported in the Outlook.

### Overall Assessment

12. The Outlook paints a coherent picture of a soft landing for the UK economy along similar lines to our own forecast. It will be seen as giving backing to the stance of monetary policy, and can be considered overall to be a helpful document.



Line to Take on Outlook

Positive

LBS agree with ~~recent tightening~~ <sup>current stance</sup> of monetary policy. Inflation and current account improve through 1989. GDP growth over 3 per cent, unemployment continues to fall. Improved export performance, continued productivity growth.

Defensive

Exchange Rate - policy in spring overdone

- No, DM cap not held when market conditions indicated inappropriate. Exchange rate ~~just one~~ <sup>an important</sup> consideration in formulating monetary policy. Downward pressure on inflation paramount.

but not overriding one

MO outside target range for next three years.

- True <sup>that</sup> MO currently outside target range. But every confidence that recent increases in interest rates will slow growth ~~given time~~.

its

Martin Hurst  
MARTIN HURST



## Forecast Summary

*Led by private sector demand, the economy has grown very rapidly in the last 12 months, Output has risen nearly 6 per cent and unemployment has fallen by over 1/2 million but the current account deficit has widened dramatically and wage and price inflation is increasing. Monetary policy has been tightened sufficiently, we believe, to produce a gradual reduction in the current deficit over the medium term and to prevent inflation from breaking the 7 per cent level which a higher mortgage rate will ensure early next year. But, as demand is reined back, there is a cost to output which rises 3 per cent next year, 2-2 1/2 per cent thereafter. Unemployment continues to fall, dropping below 2 million at the end of next year and reaching 1.8 million by 1992.*

Just as the Chancellor has had to raise his Budget forecast for the current account by a factor of three – from £4bn to £12bn – it appears that his PSBR projection was equally underestimated. Against a Budget estimate of £3.2bn for 1988-9, we are now projecting a surplus in excess of £10bn. The current MTFS sets a medium-term objective of a balanced budget but, as before, this guideline is unlikely to be retained. Our assumption is that fiscal policy will be constrained by the need to hold back inflation and to put the current account deficit onto a declining trend. On this basis we find scope for only modest tax cuts: 1 per cent off the standard rate of income tax in the next year's Budget and cuts of 2 per cent in each of the following two years. The PSBR remains in massive surplus – £12bn p.a., equivalent to 2 1/4 per cent of GDP.

The policy of holding the pound below DM3 was abandoned in March after which, and despite a cut in base rates to 7 1/2 per cent, sterling rose quickly, reaching DM3.20 and \$1.90. More recently, as the scale of the current account deficit has been revealed, the exchange rate has come under downwards pressure. This has enabled the government to raise interest rates in support of the currency, for a time satisfying its internal and external objectives with one policy instrument.

Interest rates are unlikely to fall from their present high level until it becomes clear that inflation has peaked and the current deficit is narrowing. This suggests that there will be no cut until the middle of next year when we expect base rates to fall to 11 per cent and then again to 10 per

cent by the end of the year. UK interest rates of 12 per cent and a range of 4-8 per cent in our major trading partners implies a 6 per cent decline in sterling over the next 12 months. On our relatively favourable current account projections, we expect the exchange rate to fall by less than this – to around 72 on the sterling index by the end of next year, more slowly over the medium term.

Fuelled by the house price boom and Budget measures to end multiple mortgage tax relief, bank and building society lending has expanded very rapidly this year. This is reflected in the growth of the broader measures of the money supply (20 per cent for M3, 17 per cent for M4), though the narrow measure, M0, has also accelerated. Over the last 12 months it has risen 7.8 per cent, well above its 1-5 per cent target range. We expect higher interest rates to exert a gradual downwards pressure on monetary growth from now on. But even so, M0 continues to expand by 5-6 per cent p.a., still outside the target range.

The surge in credit demand is the main mechanism by which the personal savings ratio has continued its longstanding decline, hitting a thirty-year low of 3 1/2 per cent in the second quarter. In combination with the most rapid growth of real incomes since the 1970s, this has produced another strong year of consumer spending. We estimate that real personal disposable income will rise by more than 4 per cent this year with an increase in consumption in excess of 5 per cent. But this is expected to be the cyclical peak. Higher interest rates should effect some increase in the savings ratio and, compared with this year, employment prospects are weaker. The forecast of 3 per cent real income growth next year and a 0.5 per cent rebound in the savings ratio points to a halving in the growth of consumers' expenditure. Over the medium term, consumption is expected to rise by 2 1/2-3 per cent p.a.

Investment is the most rapidly growing component of demand. The strength of output has pushed capacity utilization to very high levels and, against the background of extremely healthy corporate finances, business investment is expanding very fast. In manufacturing, we expect a rise of over 16 per cent for 1988 as a whole. Again, such a pace of growth is unlikely to be sustained. The need to expand capacity is less, though competitive pressures to cut costs will remain strong. This is likely to sustain manufacturing investment for a further 12 months at a rate in excess of 10 per cent and even in the medium term we expect private non-oil, non-

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residential investment to expand at 4 per cent p.a.

In sharp contrast to the strength of domestic demand, net exports have been falling. The rise in the exchange rate, which has reduced UK competitiveness, is one factor but of more importance is the pressure of demand, which has sucked in imports and diverted potential exports to the home market. On our forecast of a sharp slowdown in domestic demand and a lower exchange rate, the prospects for net exports will be markedly different. We expect exports to rebound, rising nearly 7 per cent for manufactures while import growth falls back from nearly 10 per cent this year to 3 per cent in 1989 and even lower in 1990 and beyond.

The trade gap has widened from £10bn last year to over £8bn in the first half of 1988 and for the year as a whole we expect a deficit of £17½bn. At the same time the invisibles surplus has declined so that the current deficit has also increased – from £2.5bn in 1987 to an estimated £12½bn this year. Again, we believe that this will prove to be the peak though we also expect the deficit to narrow only slowly. From 1989 onwards the trade gap is forecast to get smaller but invisibles will suffer from the adverse effect of high UK rates on net interest, profits and dividends receipts. By the end of the forecast period the current deficit is still as high as £7bn, over 1 per cent of GDP.

The recovery in the exchange rate together with weak commodity prices is holding back inflation

but these benefits are being outweighed by demand pressures and the increase in the mortgage rate. Retail price inflation has moved back up to 6 per cent from 3.3 per cent at the start of the year and is certain to rise towards 7 per cent early next year. We believe, however, that this will prove to be a local peak (as it was in similar circumstances in 1985) and that by the end of 1989 retail price inflation will be down to 5 per cent.

It is critical to this view that earnings do not accelerate any further. Since the opening months of 1987, the underlying rate of growth of earnings has risen from 7.5 per cent to 9.25 per cent as wage settlements have edged higher, overtime has risen and profits- and productivity-related payments have increased. It is unlikely that pay awards will fall back in the near future but nor do we expect a significant increase. At the same time, wage drift should be lower, which implies little change in earnings growth. We expect earnings to rise at a rate of over 8 per cent over the next four years.

Earnings have been contained, particularly in manufacturing, by a surge in productivity, so that unit labour costs have risen only very slowly. But the corollary of high productivity is that manufacturing employment has not risen. Outside manufacturing there has been a significant increase in employment though, as the economy slows down, fewer jobs will be created. This suggests that unemployment will fall less quickly from now on – to 2 million at the end of next year.

% change unless otherwise shown	1988	1989	1990	1991	1992
<b>Gross Domestic Product (output)</b>	4.7	3.2	2.7	2.5	2.3
<b>Inflation (consumer prices)</b>	4.2	5.0	5.6	5.9	5.5
<b>Current balance of payments (£bn)</b>	-12.5	-11.5	-10.2	-8.0	-6.8
<i>Components of Demand (volumes)</i>					
Consumers' expenditure	5.1	2.8	3.1	2.7	3.1
Total fixed investment	10.2	2.5	2.6	3.0	3.0
General government consumption	1.0	1.0	0.9	0.9	0.9
Stockbuilding (£bn 80)	2.4	1.9	1.3	1.4	1.6
Exports of goods and services	0.7	6.0	3.0	1.9	1.5
Imports of goods and services	9.4	3.0	1.7	1.4	2.6
<i>Financial Background</i>					
Exchange rate (sterling index, 1975 = 100)	76	73	71	71	72
Public sector borrowing requirement (£bn fin. years)	-10.3	-11.8	-12.6	-12.6	-15.4
Money stock M3 (% change in fin. year)	20.3	17.3	14.5	12.8	10.8
<i>Labour Market</i>					
Wages & salaries per employce	8.4	8.3	8.8	8.9	8.3
Average earnings in manufacturing	8.5	8.1	8.5	8.8	8.3
Adult unemployment (UK, millions)	2.4	2.1	1.9	1.8	1.8





FROM: A C S ALLAN

DATE: 31 October 1988

MR HURST

cc PS/Chief Secretary  
PS/Financial Secretary  
PS/Paymaster General  
PS/Economic Secretary  
Sir P Middleton  
Sir T Burns  
Sir G Littler  
Mr Anson  
Dame A Mueller  
Mr Scholar  
Mr Odling-Smee  
Mr Sedgwick  
Mr S J Davies  
Mr Grice  
Mr Hibberd  
Mr Mowl  
Mr O'Donnell  
Mr Pickford  
Mr Hudson  
Mr Patterson

ACSA  
LBS  
Economic  
Outlook  
31/10/88

## LBS ECONOMIC OUTLOOK

The Chancellor was most grateful for your minute of 28 October. For the record, he had the following amendments to the line to take:

- (i) Change the first sentence to read "LBS agree with current stance of monetary policy", rather than "recent tightening".
- (ii) Amend the second sentence of the Defensive supplementary on the exchange rate to read "Exchange rate an important consideration in formulating monetary policy but not overriding one".





(iii) Amend the last sentence of the Defensive supplementary on M0 to read "...recent increases in interest rates will slow its growth".

3. There is a mistake in your table 1, which shows the Autumn IAF forecast for the PSDR in 1989 as £11 billion. The convention is that we use the same PSDR as in the current year.

4. He thought the piece by David Currie was interesting. One point which Currie made was that "There may be advantages in the Chancellor announcing publicly that he is willing to contemplate automatic swings in the public sector deficit resulting from fluctuations in demand". In fact, the Chancellor has said something very much like this on a number of occasions, from his FT conference speech in January 1980 to, most recently, his oral evidence to the TCSC on last year's Autumn Statement (see extract ... attached.)

A handwritten signature in black ink, appearing to read "ACSA".

A C S ALLAN



9th December 1987]

THE RT HON NIGEL LAWSON, MP  
Sir PETER MIDDLETON, KCB and Sir TERENCE BURNS

[Continued

[Mr Radice *Contd*]  
reduce interest rates.

(Mr Lawson) Obviously interest rates are something which I watch carefully all the time and when I think they ought to go up they go up and when I think they should come down they come down.

Mr Budgen

140. I thought they were decided by markets.

(Mr Lawson) No, that would be an abandonment of monetary policy and that I am not prepared to do.

Mr Radice

141. I am sure colleagues would like to follow up what you said about interest rates but just turning to the public sector borrowing requirement I notice that when you came before the Committee earlier this year at the time of the Budget you said that you saw a 1 per cent PSBR as a kind of modern equivalent of the balanced budget. That was your concept of what the PSBR's role was. Do you think that in present circumstances following the stock market crash there is a role for the PSBR as an anti-cyclical device? Your adviser, Sir Terence Burns, implied that he could see circumstances in which the PSBR would play that kind of role.

(Mr Lawson) Of course there is a relationship between the PSBR and the economic cycle. May I refer you to a speech I made when I was Financial Secretary to the Treasury at a Financial Times conference in London on 21 January 1980.

142. I keep your collected works under my pillow.

(Mr Lawson) I went into that there and it is something which has always been part of my thinking.

143. So in fact you always have been a Keynesian.

(Mr Lawson) No, it is nothing to do with Keynes. I advise you to read the speech because you clearly do not keep my works to hand, which may be one of the reasons why you have such difficulty.

144. Perhaps you would like to read it out to the Committee.

(Mr Lawson) I drew there the distinction between the Keynesian approach which was to use the PSBR to have an effect on the cycle, and what I was talking about which was the way in which the cycle affects the PSBR.

145. So you do not believe there is any room for anti-cyclical budgetary spending?

(Mr Lawson) No, certainly not. I will take a decision on the PSBR at the time of the Budget and I am not going to take that decision now. I set out more recently in my speech to the Lombard Association what I thought was the right way in which to set fiscal policy and the PSBR. What I would certainly not do is try in any way to boost activity in this country by what you describe as contra-cyclical spending. You seem to have as the premise of your question the assumption that the world is going into recession. I have to say that on all

the evidence before me I see no sign of that: a slowing down of the rate of growth maybe, but not a recession.

Chairman

146. Might I intervene for a moment. I will remember the speech to which you refer.

(Mr Lawson) I knew you would.

147. I always mark particular ones you wrote entirely yourself. Could I just clarify one point. Mr Radice referred to the views which you expressed at a previous hearing after the last Budget about what was in effect a modern equivalent of a balanced budget doctrine. Of course the figures for the outturn are now significantly less—I think I would be right in saying—than those which would be consistent with that doctrine, that is to say you picked a figure of 1 per cent whereas in fact we are down to one quarter of one per cent now. Do you think that requires any adjustment?

(Mr Lawson) No, it does not necessarily require any adjustment at all, for two reasons. First of all, this modern equivalent of the balanced budget is the point where, even if there were no inflation at all, the debt/income ratio would be falling rather than rising. That is a sustainable position, whereas an indefinitely rising ratio would mean you got into all manner of difficulties. There would not be any problems in having a PSBR which was slightly less than that. What we have demonstrated in recent years—and this bears on Mr Beaumont-Dark's concerns—is that within an overall objective for public expenditure, if your burden of debt interest is lower, then *pro tanto* you have more scope for increasing expenditure on programmes. The other thing—which comes back to what Mr Radice was saying—is that in so far as the cycle will have an impact on the PSBR—the PSBR is unlikely to be an absolutely straight line—then I think it would be quite normal to expect it to be below the “balanced budget” line this year; and it may well be—though I have not taken a decision—that it could be lower than the 1 per cent next year; or it may be that the 1 per cent is appropriate. I certainly would not like to see it any higher than that.

Mr Winnick

148. Could I preface my questions by saying that though there is not time I was far from satisfied with your answers to Mr Beaumont-Dark on the National Health Service. I represent a West Midlands constituency and there is an acute crisis of hospital beds. Whilst not wishing to be personal, as I understand it no member of the Cabinet, including yourself, actually uses the National Health Service.

(Mr Lawson) I have never known you satisfied with any answer. As it happens, on the rare occasions I need anything I use the National Health Service; but that has not got anything to do with the policy issues. It is interesting to note that, so far as health spending is concerned, the West Midlands had a cash increase this year, 1987-88 over 1986-87, of 9.3 per cent, which is quite substantial.

149. I would ask other questions but clearly you